Certain Financial Instruments with Characteristics of Both Liabilities and Equity

Handbook

US GAAP

November 2017

kpmg.com/us/frv
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Preface

The purpose of KPMG's series of Handbooks is to assist you in understanding the application of US GAAP in practice, and to explain the conclusions that we have reached on many interpretive issues.

We expect to update this Handbook as needed based on developments in practice. You will always be able to find the most up-to-date version of this and other KPMG publications on KPMG's Financial Reporting View.

CURRENTLY EFFECTIVE REQUIREMENTS

This Handbook takes an in-depth look at the application of ASC Topic 480, Distinguishing Liabilities from Equity.

This publication provides our current interpretations, which are based partly on periodic, informal discussions with the FASB and SEC staffs. Our interpretations may be affected by future guidance issued by the FASB or its staff, the SEC staff, and others involved in the standard-setting process.

ORGANIZATION OF THE TEXT

Each section of this Handbook includes references to or excerpts from the FASB’s Accounting Standards Codification® to supplement our interpretive guidance, and illustrative examples that address the specific implementation issues we have identified.

NEW IN 2017

In response to difficulties implementing ASC Topic 480, in 2003 the FASB indefinitely deferred certain provisions of ASC Topic 480 for mandatorily redeemable financial instruments of certain nonpublic entities and for certain mandatorily redeemable noncontrolling interests. In Part II of ASU 2017-11, (Part I) Accounting for Certain Financial Instruments with Down Round Features, (Part II) Replacement of the Indefinite Deferral for Mandatorily Redeemable Financial, Instruments of Certain Nonpublic Entities and Certain Mandatorily Redeemable Noncontrolling Interests with a Scope Exception, the FASB recharacterized the indefinite deferral as a scope exception. These amendments move, but do not change, the guidance within Topic 480 and do not change the accounting effect.

In 2017, we have replaced discussion about the indefinite deferral with discussion about the scope exception, and have omitted discussion about the indefinite referral unless it was helpful to provide context. We have not revised the related interpretative guidance about accounting for mandatorily redeemable financial instruments of certain nonpublic entities and for certain mandatorily redeemable noncontrolling interests, because the
amendments do not change the accounting effect. See Section 12 of this Handbook for a detailed discussion of Part II of ASU 2017-11 and the scope exception.

Also in 2017, we have updated or added the following significant guidance in this Handbook.

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1. Introduction

Introduction to ASC Topic 480

Background Information

Key Terms

   Obligations
   Settlement Methods
   Options and Forwards
   Conditional and Unconditional Obligations
   Monetary Value
   Shares, Equity Shares, and Issuer’s Equity Shares
   Other Definitions

Concepts Statement 6

Further Guidance to ASC Topic 480

Questions and Answers
1. Introduction

1.000 This Section discusses the overview and background sections of FASB Accounting Standards Codification (ASC) Topic 480, Distinguishing Liabilities from Equity, including background information and definitions of key terms used throughout the ASC Topic 480.

INTRODUCTION TO ASC TOPIC 480

1.001 ASC paragraph 480-10-05-1 discusses its purpose:

ASC Subtopic 480-10 establishes standards for how an issuer\(^1\) classifies and measures in its statement of financial position certain financial instruments with characteristics of both liabilities and equity. It requires that an issuer classify a financial instrument that is within its scope as a liability (or an asset\(^2\) in some circumstances) because that financial instrument embodies an obligation of the issuer.

1.002 For purposes of applying ASC Topic 480, a financial instrument is cash, evidence of an ownership interest in an entity, or a contract that both:

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

1.003 The issuer, as that term is used in ASC Topic 480, is the entity that issued a financial instrument or may be required under the terms of a financial instrument to issue its equity shares. An entity that issues a financial instrument to repurchase its equity shares and to transfer assets may be required to classify that financial instrument as a liability and measure the financial instrument using the guidance in ASC Topic 480. In addition, an entity that issues a financial instrument that may result in it issuing a variable number of its equity shares may be required to classify that financial instrument as a liability and measure the financial instrument using the guidance in ASC Topic 480.

1.004 While ASC Topic 480 establishes guidance for how an issuer classifies certain financial instruments with characteristics of both liabilities and equity, its primary focus is that an issuer is required to classify a financial instrument within its scope as a liability.

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\(^1\) Terms defined in ASC Section 480-10-20 are set in boldface type the first time they appear.

\(^2\) ASC Topic 480 does not address instruments that have only characteristics of assets. However, ASC Topic 480 does apply to instruments having characteristics of both liabilities and equity that, in some circumstances, also have characteristics of assets, for example, a forward contract to purchase the issuer’s equity shares that is to be net cash settled.
There is no guidance within ASC Topic 480 to indicate when an entity should classify a financial instrument as equity; instead, for financial instruments that are outside the scope of ASC Topic 480, other generally accepted accounting principles and relevant SEC guidance should be followed.

1.005 In general, financial instruments can have characteristics of (1) assets only (e.g., marketable equity securities an entity owns), (2) liabilities only (e.g., debt issued to a third party), (3) equity only (e.g., an outstanding share of an issuer’s stock), (4) assets and liabilities (e.g., an interest rate swap), (5) assets and equity (e.g., a purchased call option on an entity’s own shares), (6) liabilities and equity (e.g., a written put option on an entity’s own shares), or (7) assets, liabilities, and equity (e.g., a forward purchase contract on an entity’s own shares). While the focus of ASC Topic 480 is primarily on financial instruments that have characteristics of liabilities and equity, it also encompasses certain financial instruments that have characteristics of assets, liabilities, and equity.

BACKGROUND INFORMATION

1.006 Not used.

1.007 ASC Topic 480 was issued as part of the Board’s broad project on financial instruments. In August 1990, the Board issued a Discussion Memorandum, *Distinguishing between Liability and Equity Instruments and Accounting for Instruments with Characteristics of Both*. The Discussion Memorandum was considered the first step in the Board’s overall Liabilities and Equity Project and elicited views on issues related to (1) the interpretation and application of the definition of liabilities and equity in FASB Concepts Statement No. 6, *Elements of Financial Statements*, and whether the distinction between liabilities and equity should be changed, (2) whether particular instruments should be classified as liabilities or as equity, (3) whether the Board should change the distinction between liabilities and equity, (4) measurement at the issuance date and the repurchase date of equity instruments, and (5) the accounting by issuers for compound instruments with characteristics of liabilities and equity.

1.008 After discussing the comment letters received related to the Discussion Memorandum, participating in several public hearings on the Discussion Memorandum, and discussing the issues related to the Liabilities and Equity Project at numerous Board meetings, in October 2000 the Board issued an Exposure Draft of a proposed Statement of Financial Accounting Standards, *Accounting for Financial Instruments with Characteristics of Liabilities, Equity, or Both*. At the same time, the Board issued another Exposure Draft, *Proposed Amendment to FASB Concepts Statement No. 6 to Revise the Definition of Liabilities*.

1.009 Throughout 2001 and 2002, the Board redeliberated the issues raised in the Exposure Drafts and comment letters received on the Exposure Drafts and reached tentative conclusions on some of those issues. However, by the end of 2002 the Board had not completed its redeliberations on a majority of the issues raised in the Exposure Drafts. In order to provide constituents with guidance that the Board believed was necessary in the short term for certain instruments for which the practice problems were
both clear and resolvable, the Board decided to issue a limited-scope standard—ASC Topic 480—and address all other issues raised in the Exposure Drafts in the future.

1.010 As a result, some of the provisions of ASC Topic 480 are consistent with the current definition of liabilities in Concepts Statement 6 (e.g., ASC paragraphs 480-10-25-4, 25-6, 25-8 through 25-10, and 25-12), while other provisions of ASC Topic 480 are consistent with the Board’s proposal to revise that definition to encompass certain obligations that a reporting entity must or can settle by issuing its own equity shares (e.g., ASC paragraph 480-10-25-14). The Board plans to continue redeliberating the remaining issues in the Exposure Drafts and issue additional standards when those issues are resolved.

**KEY TERMS**

1.011 ASC paragraphs 480-10-05-2 through 05-6; ASC Section 480-10-20; and ASC paragraph 480-10-25-13 provide definitions of some of the terms used throughout the Topic. Entities applying the provisions of ASC Topic 480 should have a thorough understanding of these terms. This book uses those terms in the same manner as in ASC Topic 480 and its related guidance.

**Obligations**

1.012 Financial instruments within the scope of ASC Topic 480 must represent an obligation on the part of the issuer. ASC paragraphs 480-10-05-2 and 05-3 state:

In ASC Topic 480, an obligation is a conditional or unconditional duty or responsibility to transfer assets or to issue equity shares. For example, an entity incurs a conditional obligation to transfer assets by issuing (writing) a put option that would, if exercised, require an entity to repurchase its equity shares by physical settlement. (Further, an instrument that requires the issuer to settle its obligation by issuing another instrument [for example, a note payable in cash] ultimately requires settlement by a transfer of assets). An entity also incurs a conditional obligation to transfer assets by issuing a similar contract that requires or could require net cash settlement. An entity incurs a conditional obligation to issue its equity shares by issuing a similar contract that requires net share settlement. In contrast, by issuing shares of stock, an entity generally does not incur an obligation to redeem the shares, and, therefore, that entity does not incur an obligation to transfer assets or issue additional equity shares. However, some issuances of stock (e.g., mandatorily redeemable preferred stock) do impose obligations requiring the issuer to transfer assets or issue its equity shares.

1.013 Identifying whether a financial instrument embodies an obligation is the starting point in determining the appropriate classification of that instrument. The definition of a

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3 An instrument that requires the issuer to settle its obligation by issuing another instrument (e.g., a note payable in cash) ultimately requires settlement by a transfer of assets.
liability and the essential characteristics of a liability described in Concepts Statement 6 include the notion of an obligation. As a result, a financial instrument that does not embody an obligation cannot be a liability under the current Concepts Statement 6 definition.

1.014 ASC Topic 480 indicates that an obligation is a duty or responsibility on the part of the issuer either to transfer assets or to issue its equity shares. The standard adds to the notion in Concepts Statement 6 that an obligation is a duty or responsibility to issue equity shares. Although an issuer’s equity shares are not assets to the issuer, they become assets to the new holder of shares. Settling an obligation by issuing shares will adversely affect the interests of the other holders of the issuer’s equity shares by diluting their interests in the issuer’s assets, just as settling an obligation by transferring assets will adversely affect their interests by reducing the issuer’s assets. The duty or responsibility to issue shares leaves an entity little or no discretion to avoid taking an action that it might otherwise wish to avoid. As a result, a duty or responsibility to issue shares is an obligation under ASC Topic 480 and a freestanding financial instrument that embodies such an obligation may be a liability under the provisions of ASC Topic 480.

Settlement Methods

1.015 In order to describe certain financial instruments within its scope, ASC Topic 480 discusses the various settlement methods an instrument may contain, as follows:

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

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

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

Options and Forwards

1.016 ASC Topic 480 uses the terms *option contract* and *forward contract* to describe some of the instruments within its scope. The following represents a generic description of the various option and forward contracts that are discussed in this book and may be within the scope of ASC Topic 480:
Option

A contract that conveys a right to buy or sell an underlying (e.g., an issuer’s equity shares) that is granted in exchange for an agreed-upon fee. If the right is not exercised after a specified period of time, the option expires.

Call Option

An option contract that gives its buyer the right to buy an underlying (e.g., an issuer’s equity shares) at a specified price (e.g., a fixed price) on or before a specified date in the future. For this right, the call option buyer typically pays the call option seller a fee, called a premium. A call option buyer speculates that the price of the underlying will rise above the specified price within the specified period, thus providing the buyer with the right to purchase the underlying at a price that is lower than the then-current price. A call option seller speculates that the price of the underlying will fall below the specified price within the specified period, thus providing the seller with income related to the premium received for selling the option. If the right is not exercised after a specified period of time, the call option expires.

Put Option

An option contract that gives the buyer the right to sell an underlying (e.g., an issuer’s equity shares) at a specified price (e.g., a fixed price) on or before a specified date in the future. For this right, the put option buyer typically pays the put option seller a fee, called a premium. A put option buyer speculates that the price of the underlying will fall below the specified price within the specified period, thus providing the buyer with the right to sell the underlying at a price that is higher than the then-current price. A put option seller speculates that the price of the underlying will rise above the specified price within the specified period, thus providing the seller with income related to the premium received for selling the option. If the right is not exercised after a specified period of time, the put option expires.

Option Holder

Someone who has bought or purchased a call or put option but has not yet exercised or sold it.

Option Writer

Someone who has sold or written a call or put option that has not yet been exercised.

Forward

A contract to purchase or sell a specific quantity of an underlying (e.g., an issuer’s equity shares) at a specified price with delivery and settlement at a specified future date.
Conditional and Unconditional Obligations

1.017 Some financial instruments represent a conditional obligation on the part of the issuer. That is, the issuer is not obligated to perform under the financial instrument unless and until a specified condition has been satisfied. Other financial instruments represent an unconditional obligation on the part of the issuer. That is, the issuer is obligated to perform under the financial instrument, typically after the passage of time, regardless of future events. A financial instrument that represents a conditional or unconditional obligation to transfer assets or issue equity shares may be within the scope of ASC Topic 480.

1.018 Ordinarily, an entity incurs a conditional obligation to transfer assets if it issues (writes) an option that would, if exercised, require it to repurchase its equity shares by physical settlement. By writing such an option, the entity has provided the holder with the ability to force it to pay cash to repurchase its own equity shares. This is a conditional obligation since it is at the holder’s discretion as to whether the issuer (writer) will be required to transfer assets. That is, when the option contract is issued, the issuer will not be required to transfer its assets unless the holder exercises its option (e.g., if the issuer’s current share price is less than the specified price in the option contract). Likewise, an entity incurs a conditional obligation to transfer assets by issuing a similar option contract that requires or could require net cash settlement. An entity also incurs a conditional obligation to issue its equity shares by issuing a similar option contract that requires net share settlement.

1.019 Ordinarily, an entity incurs an unconditional obligation to transfer assets if it enters into a forward purchase contract that requires it to repurchase its equity shares by physical settlement. By entering into such a contract, the entity has an obligation to repurchase its own equity shares for cash. This is an unconditional obligation since it is required to occur at a point in time and the entity is required to transfer assets regardless of future events. However, an entity incurs a conditional obligation to transfer assets by issuing a similar forward contract that requires net cash settlement. This is a conditional obligation because at inception of the contract it is generally unknown whether the issuer will be required to transfer assets or will receive assets from the holder of the contract. That is, at settlement of the contract, if the contract is in a gain position for the issuer, it will receive cash and there is no obligation for the issuer to deliver its assets. However, if the contract is in a loss position for the issuer, it will pay cash to satisfy its obligation. Likewise, an entity also incurs a conditional obligation to issue its equity shares by issuing a similar forward contract that requires net share settlement.

1.020 In contrast, by issuing shares of stock, an entity generally does not incur an obligation to redeem the shares, and, therefore, that entity does not incur an obligation to transfer assets or issue additional equity shares. However, some issuances of shares (e.g., redeemable preferred stock) represent conditional or unconditional obligations requiring the issuer to transfer assets or issue its equity shares.
Monetary Value

1.021 Certain financial instruments may be within the scope of ASC Topic 480 depending on whether and how the monetary value of the instrument varies in response to changes in market conditions. ASC paragraphs 480-10-05-4 and 05-5; 480-10-55-2; and ASC Section 480-10-20 define monetary value and distinguishes between fixed and variable monetary values, as follows:

In ASC Topic 480, monetary value is what the fair value of the cash, shares, or other instruments that a financial instrument obligates the issuer to convey to the holder would be at the settlement date under specified market conditions. For certain financial instruments, ASC Topic 480 requires consideration of whether monetary value would remain fixed or would vary in response to changes in market conditions. How the monetary value of a financial instrument varies in response to changes in market conditions depends on the nature of the arrangement, including, in part, the form of settlement. For example, for a financial instrument that embodies an obligation that requires:

(a) Settlement either by transfer of $100,000 in cash or by issuance of $100,000 worth of equity shares, the monetary value is fixed at $100,000, even if the share price changes.

(b) Physical settlement by transfer of $100,000 in cash in exchange for the issuer’s equity shares, the monetary value is fixed at $100,000, even if the fair value of the equity shares changes.

(c) Net share settlement by issuance of a variable number of shares based on the change in the fair value of a fixed number of the issuer’s equity shares, the monetary value varies based on the number of shares required to be issued to satisfy the obligation. For example, if the exercise price of a net share settled written put option entitling the holder to put back 10,000 of the issuer’s equity shares is $11, and the fair value of the issuing entity’s equity shares on the exercise date decreases from $13 to $10, that change in fair value of the issuer’s shares increases the monetary value of that obligation at settlement from $0 to $10,000 ($110,000 minus $100,000), and the option would be settled by issuance of 1,000 shares ($10,000 divided by $10).

(d) Net cash settlement based on the change in the fair value of a fixed number of the issuer’s equity shares, the monetary value varies in the same manner as in the illustration for net share settlement, but the obligation is settled with cash. In a net cash settled variation of the previous example, the option would be settled by delivery of $10,000.

(e) Settlement by issuance of a variable number of shares that is based on variations in something other than the issuer’s equity shares, the monetary value varies based on changes in the price of another variable. For example, a net share settled obligation to deliver the number of shares
equal in value at settlement to the change in fair value of 100 ounces of gold has a monetary value that varies based on the price of gold and not on the price of the issuer’s equity shares.

1.022 The focus of the determination of monetary value in ASC Topic 480 is the fair value of the cash, shares, or other instruments that a financial instrument obligates the issuer to convey to the holder at the settlement date. That is, the focus is on the fair value the holder receives at settlement of the financial instrument and not on the amount of cash or other consideration the holder is required to pay, under the terms of the financial instrument, at settlement. The term fair value is used throughout ASC Topic 480, including when defining monetary value, and is the amount at which an asset (liability) could be bought (incurred) or sold (settled) in a current transaction between willing parties, that is, other than in a forced or liquidation sale.

1.023 To determine whether certain financial instruments are within the scope of ASC Topic 480, it will be necessary to determine the monetary value of that instrument. If the monetary value of the financial instrument is fixed, the instrument may be within the scope of ASC Topic 480. If the monetary value of the financial instrument is variable, an analysis of how the monetary value moves in response to changes in the value of the issuer’s shares is necessary to determine whether the instrument is within the scope of ASC Topic 480.

1.024 The following examples illustrate the concept of monetary value:

Example 1.1: Determining the Monetary Value of an Instrument Settleable in the Issuer’s Shares

Background

On April 1, 20X2, Company A issues a financial instrument to Company B and receives $95,000 in proceeds. The instrument matures in one year. At the maturity date, Company A has the option of paying Company B $100,000 in cash or a variable number of its common shares that have a fair value of $100,000 at the maturity date.

Analysis

The monetary value of the financial instrument is fixed at $100,000. That is, at the maturity date of the financial instrument, Company B (the holder) will always receive a fixed amount of value of $100,000. That fixed amount of value will either be $100,000 in cash or a variable number of Company A common shares that have a fair value of $100,000 at the maturity date.
Example 1.2: Determining the Monetary Value of a Physically-Settled Forward Contract

Background

On April 1, 20X2, Company A enters into a forward contract to purchase 10,000 shares of its own common stock for $100,000 in cash from Company B. The instrument settles in one year and physical settlement is required.

Analysis

The monetary value of the financial instrument is fixed at $100,000. That is, at the settlement date of the financial instrument, Company B (the holder) will always receive a fixed amount of value of $100,000 in cash. It should be noted that if Company A’s common shares are trading at $15 per share, the fair value of the shares Company B (the holder) is required to provide is $150,000 ($15 per share x 10,000 shares); however, the calculation of monetary value focuses on the fair value the holder (Company B) receives at settlement of the financial instrument (which will always be $100,000 in cash) and not on the fair value of the 10,000 common shares the holder relinquishes at settlement (which may vary throughout the term of the forward contract).

Example 1.3: Determining the Monetary Value of a Net Share Settled Written Put Option

Background

On April 1, 20X2, Company A writes a put option to Company B. Under the terms of the option, Company B has the right to sell (put) 10,000 Company A common shares back to Company A at a price of $11. The instrument expires in one year and, if exercised, will settle in net shares.

Analysis

Since net share settlement results in Company B receiving a variable number of shares based on the change in fair value of 10,000 Company A common shares, the monetary value of the instrument varies based on the number of shares required to be issued by Company A at the exercise date (which will depend on the fair value of the common shares at that date). For example, if the fair value of Company A common shares at the date the put option is exercised is $10, the monetary value at
settlement would be $10,000 (($11 strike price less $10 fair value) x 10,000 shares) and the contract would be settled by Company A issuing 1,000 common shares ($10,000 divided by $10) to Company B.

**Example 1.4: Determining the Monetary Value of a Net Cash Settled Written Put Option**

**Background**

On April 1, 20X2, Company A writes a put option to Company B. Under the terms of the option, Company B has the right to sell (put) 10,000 Company A common shares back to Company A at a price of $11. The instrument expires in one year and, if exercised, will settle in net cash.

**Analysis**

Since net cash settlement results in Company B receiving a variable amount of cash based on the change in fair value of 10,000 Company A common shares, the monetary value of the instrument varies. For example, if the fair value of Company A common shares at the date the put option is exercised is $10, the monetary value at settlement would be $10,000 (($11 strike price less $10 fair value) x 10,000 shares) and the contract would be settled by Company A issuing $10,000 in cash to Company B.

**Example 1.5: Determining the Monetary Value of a Net Share Settled Contract**

**Background**

On April 1, 20X2, Company A writes a put option to Company B. Under the terms of the option, Company B has the right to sell (put) 100 ounces of gold to Company A at a strike price of $35,000. The instrument expires in one year and, if exercised, will settle by Company B receiving a variable number of Company A common shares that have a fair value at the settlement date equal to the difference between the strike price of the put option ($35,000) and the fair value of 100 ounces of gold at the settlement date.

**Analysis**

Since net share settlement results in Company B receiving a variable number of shares based on the change in fair value of 100 ounces of gold, the monetary value
of the instrument varies based on the change in the price of gold. For example, if
the fair value of 100 ounces of gold is $30,000 and the common share price of
Company A shares is $10 at the date the put option is exercised, the monetary value
at settlement would be $5,000 ($35,000 strike price of the option less $30,000 fair
value of the gold) and the contract would be settled by Company A issuing 500
shares ($5,000 divided by $10 per share) to Company B.

**Shares, Equity Shares, and Issuer’s Equity Shares**

1.025 ASC paragraph 480-10-05-6 and ASC Section 480-10-20 describe how the terms
shares, equity shares, and issuer’s equity shares are used in the standard, as follows:

For purposes of ASC Topic 480, three related terms are used in particular
ways. Shares includes various forms of ownership that may not take the legal
form of securities (e.g., partnership interests), as well as other interests,
including those that are liabilities in substance but not in form. Equity shares
refers only to shares that are accounted for as equity. For financial instruments
issued by members of a consolidated group of entities, issuer’s equity shares
include the equity shares of any entity whose financial statements are included
in the consolidated financial statements.

1.026 ASC Section 480-10-20 defines three common terms so that its guidance is applied
consistently. Those terms are as follows:

*Shares*

The various forms of ownership that may not take the legal form of securities
(e.g., partnership or LLC interests), as well as other interests, including those that
are liabilities in substance but not in form. Shares may be classified as liabilities
or equity in the balance sheet of the issuer.

*Equity Shares*

Shares that are accounted for as equity in the balance sheet of the issuer.

*Issuer’s Equity Shares*

Equity shares of any entity whose financial statements are included in the
consolidated financial statements.

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4 Business enterprises have interest holders that are commonly known by specialized names, such as
stockholders, partners, and proprietors, and by more general names, such as investors, but all are
encompassed by the descriptive term owners. Equity of business enterprises is, thus, commonly known by
several names, such as owners’ equity, stockholders’ equity, ownership, equity capital, partners’ capital,
and proprietorship. Some enterprises (e.g., mutual organizations) do not have stockholders, partners, or
proprietors in the usual sense of those terms but do have participants whose interests are essentially
ownership interests, residual interests, or both.
The definitions provided in ASC Section 480-10-20 only are applicable for purposes of applying its guidance. For financial statements issued by members of a consolidated group of entities, the issuer’s equity shares include the equity shares of any entity whose financial statements are included in the consolidated financial statements. That is, if a subsidiary issues a financial instrument that is within the scope of ASC Topic 480, that instrument would also be within the scope of ASC Topic 480 in the consolidated financial statements. This definition of issuer’s equity shares, however, is only relevant when analyzing an instrument within the scope of ASC Topic 480 such that the financial instrument is classified as a liability and the definition does not affect the application of other ASC Topics.

Other Definitions

Additional specific definitions are used in ASC Topic 480 and its related guidance to describe an entity. Like the definitions discussed in Paragraph 1.026, these entity-type definitions are specific to ASC Topic 480. The entity-specific definitions are as follows:

An SEC registrant is an entity, or an entity that is controlled by an entity, (a) that has issued or will issue debt or equity securities that are traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local or regional markets), (b) that is required to file financial statements with the SEC, or (c) that provides financial statements for the purpose of issuing any class of securities in a public market. Therefore, a subsidiary of an SEC registrant also is an SEC registrant.

A non-SEC registrant is an entity that is not an SEC registrant as defined above. All entities consist of all SEC registrants and all non-SEC registrants.

A nonpublic entity is any entity other than one (a) whose equity securities trade in a public market either on a stock exchange (domestic or foreign) or in the over-the-counter market, including securities quoted only locally or regionally, (b) that makes a filing with a regulatory agency in preparation for the sale of any class of equity security in a public market, or (c) that is controlled by an entity covered by (a) or (b). By definition, a nonpublic entity can be an SEC registrant or a non-SEC registrant. For example, a nonpublic entity may be an SEC registrant because it has debt that is traded in a public market or is otherwise required to file financial statements with the SEC (e.g., certain broker/dealers).

CONCEPTS STATEMENT 6

Paragraph 6 of Statement 150 describes the status of the FASB’s plans to revise the definition of liabilities in Concepts Statement 6.

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

1.030 As part of its deliberations in the Liabilities and Equity Project, the Board discussed the accounting for financial instruments that embody obligations that require (or permit at the issuer’s discretion) settlement by issuance of the issuer’s equity shares. Those obligations do not require a transfer of assets and, thus, do not meet the current definition of liabilities in Concepts Statement 6. Prior to the effective date of ASC Topic 480, those financial instruments may have been classified as equity. However, not all such obligations establish the type of relationship that exists between an entity and its owners. For example, a financial instrument that requires settlement by issuance of $100,000 worth of equity shares establishes something more akin to a debtor-creditor relationship than to an ownership relationship, because it requires that the issuer convey a fixed amount of value to the holder that does not vary with the value of the issuer’s equity shares. For example, a net share-settled put option on the issuer’s equity shares establishes the opposite (inverse) of an ownership relationship, because it requires the issuer to convey value to the holder that increases as the value of other owners’ interests decreases.

1.031 As a result of its deliberations, the Board decided to reconsider the distinction between liabilities and equity. Otherwise, classification by issuers of financial instruments that embody obligations would be based solely on whether the obligation requires settlement by a transfer of assets or by issuance of equity instruments, regardless of whether an ownership relationship has been established. The Board decided that the relevance and representational faithfulness of reporting those obligations would be improved if classification were based on the type of relationship established between the issuer and the holder of the instrument as well as the form of settlement. Therefore, the Board proposed an amendment to Concepts Statement 6 to revise its definition of liabilities.

1.032 Commentators generally objected to the proposed amendment to the definition of liabilities for a variety of reasons. After considering those comments and events since the issuance of the earlier Exposure Drafts, the Board did not agree with the majority of commentators and decided that an amendment to Concepts Statement 6 to revise the definition of liabilities is necessary and that the amendment should incorporate the absence of an ownership relationship into the definition of liabilities. However, the Board agreed that the proposed amendment to Concepts Statement 6 needed further refinements and that the refinements could not be completed until the Board considers, in further detail, certain instruments with liability and equity characteristics that are beyond the limited scope of ASC Topic 480. The Board plans to review those instruments, including
compound financial instruments, puttable shares, and dual-indexed financial instruments, in the next phase of its Liabilities and Equity Project. Additionally, the Board has a project on revenue recognition that may require other amendments to concepts of liabilities and international standards-setting bodies have decided to work toward converging their standards and concepts statements. The revenue recognition project and those international convergence efforts also may affect the timing of the amendment to the definition of liabilities in Concepts Statement 6.

FURTHER GUIDANCE TO ASC TOPIC 480

1.033 ASC Section 480-10-55 provides implementation guidance and examples of financial instruments that are within the scope of ASC Topic 480 and are classified as liabilities. ASC Section 480-10-20 provides a glossary of certain terms that are used in ASC Topic 480.

1.034 ASC Section 480-10-55 provides implementation guidance and examples of financial instruments that are in its scope. Section 480-10-20 provides a glossary of terms that are used in the standard. The information within these appendices is incorporated within this book.

1.035 This book also incorporates the following FASB Staff Positions that were approved by the Board after portions of ASC Topic 480 were issued:

- FASB Staff Position 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, Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity” (ASC paragraphs 480-10-55-29 through 55-32 and 55-42 through 52)
- FASB Staff Position 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, Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity” (ASC paragraphs 480-10-45-2A and 45-2B)
- FASB Staff Position 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, Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity” The provisions of this FSP were recharacterized as a scope exception by Part II of ASU 2017, (Part I) Accounting for Certain Financial Instruments with Down Round Features, (Part II) Replacement of the Indefinite Deferral for Mandatorily Redeemable Financial Instruments of Certain Nonpublic Entities and Certain Mandatorily Redeemable Noncontrolling Interests with a Scope Exception (ASC paragraphs 480-10-15-7A to 15-7F and 15-8A)
FASB Staff Position FAS 150-4, “Issuers’ Accounting for Employee Stock Ownership Plans under FASB Statement No. 150, Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity” (ASC paragraph 480-10-15-8)

QUESTIONS AND ANSWERS

Q&A 1.1: Company A issued a financial instrument on July 1, 20X0 and asserts the financial instrument should be classified within stockholders’ equity in its financial statements.

Q. Does ASC Topic 480 address when an entity should classify a freestanding financial instrument as equity?

A. No. While ASC Topic 480 establishes standards for how an issuer classifies, measures, and discloses certain freestanding financial instruments with characteristics of both liabilities and equity, its focus is that an issuer is required to classify a freestanding financial instrument within its scope as a liability (or an asset in some circumstances). There is no guidance within ASC Topic 480 to indicate when an entity should classify a freestanding financial instrument as equity; instead, for freestanding financial instruments that are outside its scope, other generally accepted accounting principles and relevant SEC guidance should be followed to determine classification.

Q&A 1.2: The consolidated financial statements of Company A include its 90% owned subsidiary, Company B.

Q. Are the equity shares of Company B considered equity shares of Company A for purposes of applying the provisions of ASC Topic 480 in the consolidated financial statements of Company A?

A. Yes, but only for purposes of applying the provisions of ASC Topic 480. For financial statements issued by members of a consolidated group of entities, the issuer’s equity shares (as that term is used in ASC Topic 480) include the equity shares of any entity whose financial statements are included in the consolidated financial statements. For example, if a subsidiary issues an instrument to a third party that is required to be classified as a liability under ASC Topic 480, the parent company should classify that instrument as a liability in its consolidated financial statements. However, if a financial instrument is issued by a subsidiary and is outside the scope of ASC Topic 480, the definition of an issuer’s equity shares in the standard does not change the application of other authoritative literature for that instrument.
Q&A 1.3: ASC paragraph 815-10-15-74(a) of ASC Topic 815, Derivatives and Hedging, indicates that contracts issued by a reporting entity that are both (1) indexed to its own stock and (2) classified in stockholders’ equity in its statement of financial position are not accounted for as derivatives for purposes of ASC Topic 815. ASC Topic 480 indicates that the issuer’s equity shares include the equity shares of any entity whose financial statements are included in the consolidated financial statements.

Q. Would a freestanding derivative instrument issued by a parent company that is indexed to shares of its consolidated subsidiary automatically meet the scope exclusion in ASC paragraph 815-10-15-74(a) in the consolidated financial statements if that freestanding derivative instrument is outside the scope of ASC Topic 480?

A. No. The definition of issuer’s equity shares in ASC Section 480-10-20 is only relevant for instruments that are within its scope. As a result, a freestanding derivative instrument issued by a parent company that is indexed to shares of its consolidated subsidiary and is outside the scope of ASC Topic 480 should be analyzed under other existing authoritative literature e.g., (ASC paragraphs 810-10-05-7; 810-10-25-17 through 25-19; 815-10-15-77; 815-10-55-64 and 55-65; 810-10-35-1 and 35-2) and an analogy to the definition of the issuer’s equity shares in the standard is not appropriate. However, if an instrument is within the scope of ASC Topic 480, it is required to be classified as a liability and would not meet the scope exception in ASC paragraph 815-10-15-74(a) because it would not be classified in stockholders’ equity.
2. Scope and Initial Classification

Introduction

Objective of ASC Topic 480

ASR 268

Freestanding Financial Instruments

Embedded Features

Nonsubstantive or Minimal Features
2. Scope and Initial Classification

INTRODUCTION

2.000 This section discusses general information related to the scope of ASC Topic 480 and its initial classification requirements.

OBJECTIVE OF ASC TOPIC 480

2.001 ASC paragraph 480-10-10-1 specifies that its scope is limited to three classes of freestanding financial instruments that embody obligations for the issuer.

The objective of ASC Topic 480 is to require issuers to classify as liabilities (or assets in some circumstances) three classes of freestanding financial instruments that embody obligations for the issuer. In applying ASC Topic 480, that objective shall not be circumvented by nonsubstantive or minimal features included in instruments. Any nonsubstantive or minimal features shall be disregarded in applying the classification provisions of ASC paragraphs 480-10-25-1 through 25-15; ASC paragraphs 480-10-15-3 through 15-7. Judgment, based on consideration of all the terms of an instrument and other relevant facts and circumstances, is necessary to distinguish substantive, nonminimal features from nonsubstantive or minimal features.

2.002 ASC Topic 480 provides guidance for determining the classification and measurement for certain freestanding financial instruments that embody obligations of the issuing entity that fall within its limited scope. Financial instruments that may be within the limited scope of ASC Topic 480 include: (1) mandatorily redeemable financial instruments (see Section 3 for additional information), (2) freestanding financial instruments that embody obligations to repurchase (or obligations that are indexed to the repurchase of) an issuer’s equity shares by transferring assets (see Section 4 for additional information), and (3) freestanding financial instruments that embody certain obligations that the issuer must or can settle by issuing a variable number of its equity shares (see Section 5 for additional information).

2.003 Instruments within the scope of ASC Topic 480 are classified as liabilities (or assets in some circumstances). For financial instruments that are not within the scope of ASC Topic 480, other generally accepted accounting principles and relevant SEC guidance should be followed to determine classification.

ASR 268

2.004 SEC Accounting Series Release No. 268, Presentation in Financial Statements of “Redeemable Preferred Stocks,” and its related guidance is applicable to SEC registrants and requires an equity security to be classified outside of permanent equity if it is redeemable: (1) at a fixed or determinable price on a fixed or determinable date, (2) at the
option of the holder, or (3) upon the occurrence of an event that is not solely within the control of the issuer. Certain instruments that are within the scope of ASC Topic 480 were previously within the scope of ASR 268. Because ASC Topic 480 requires certain instruments to be classified as liabilities, any instrument within its scope is not subject to the requirements of ASR 268 or its related interpretations (ASC paragraphs 480-10-S99-2 and S99-3). However, financial instruments that are not within the scope of ASC Topic 480 may continue to be within the scope of ASR 268. See Paragraph 3.008 of Section 3 for further information.

FREESTANDING FINANCIAL INSTRUMENTS

2.005 To be within the scope of ASC Topic 480, a financial instrument is required to be freestanding. A freestanding financial instrument is a financial instrument that is entered into (1) separately and apart from any of the entity’s other financial instruments or equity transactions, or (2) in conjunction with some other transaction and is legally detachable and separately exercisable. See Section 6 for additional information.

EMBEDDED FEATURES

2.006 In general, the classification requirements of ASC Topic 480 do not apply to features embedded within a financial instrument. As a result, the written embedded put option within an issuer’s share of puttable stock is not subject to the classification provisions of ASC Topic 480; however, a freestanding written put option on an issuer’s share of stock generally is subject to the provisions of ASC Topic 480. Other standards and guidance for example, the embedded derivative provisions of (ASC paragraphs 815-15-05-1; 815-15-25-1 and 25-14) may require certain compound instruments to be analyzed and separated into components and that guidance continues to apply to embedded features.

NONSUBSTANTIVE OR MINIMAL FEATURES

2.007 In reaching the conclusion to limit ASC Topic 480’s classification requirements only to certain freestanding financial instruments, the Board became concerned that a nonsubstantive or minimal feature might be inserted into a financial instrument, which otherwise would be a freestanding financial instrument subject to ASC Topic 480, to circumvent its provisions. The Board decided to mitigate that possibility by providing that any nonsubstantive or minimal feature should be disregarded in applying the classification provisions of ASC Topic 480. In some circumstances that may mean that a specific feature is ignored and the remaining instrument is evaluated to determine whether it is within the scope of ASC Topic 480. In other circumstances, the substance of a feature differs from its legal form, which may incorporate nonsubstantive attributes. Such nonsubstantive or minimal attributes are disregarded when determining whether an instrument is within the scope of ASC Topic 480. See Paragraphs 3.009–3.012 of Section 3 for additional information.
2.008 The evaluation of whether a feature is nonsubstantive or minimal under ASC Topic 480 is made at inception of the instrument and entities are neither required nor permitted to reassess the feature at a later date, except in situations where a conditionally redeemable instrument becomes mandatorily redeemable because the event has occurred, the condition is resolved, or the event becomes certain to occur (see Paragraphs 3.040–3.044 of Section 3 for additional information about conditional or contingent redemption features). Judgment, based on consideration of all the terms of an instrument and other relevant facts and circumstances, should be applied to distinguish substantive, nonminimal features from nonsubstantive or minimal features.

2.009 The following are examples of the analysis an entity may wish to consider to determine whether a feature embedded within a freestanding financial instrument is nonsubstantive or minimal:

Example 2.1: Evaluating Whether a Feature Is Nonsubstantive or Minimal at Inception of an Instrument

**Background**

On March 1, 20X2, Company A issues shares of Series B convertible redeemable preferred stock for its stated value of $1,000 per share. Each convertible redeemable preferred share has the following terms: (1) 8% cumulative dividends, payable when and if declared by the board of directors, (2) convertible into common shares of Company A at the option of the holder at a conversion price equal to the then-current liquidation preference divided by $200 per share, and (3) if the preferred share has not been converted, the share is mandatorily redeemable for cash by the Company on January 1, 20X5 for an amount equal to the then-current liquidation preference of the share. Over the past several years, Company A’s common share price has fluctuated between $10 and $20 per share, Company A’s common share price on March 1, 20X2 was $12 per share, and the volatility of its common share price is low. Additionally, Company A issued shares of Series A redeemable preferred shares two months earlier (January 1, 20X2) for a stated value of $1,000 per share. The Series A redeemable preferred shares have identical features to the Series B convertible redeemable preferred shares except the Series A shares do not have a conversion feature. Holders of the Series A and Series B shares receive the same level of priority in the event of liquidation. There were no significant changes in market interest rates or in Company A’s credit quality between January 1, 20X2 and March 1, 20X2.

**Analysis**

Given the range of Company A’s historical common share price (between $10 and $20 per share) over the past several years, the common share price on March 1, 20X2, and its low volatility, the likelihood that the common share price will not reach the $200 conversion price prior to the January 1, 20X5 mandatory redemption date is virtually certain. Additionally, the facts indicate that the Series
B investors ascribed little or no incremental value to the conversion option because the Series A investors paid the same price per share for nonconvertible preferred shares with substantially the same features two months earlier. In this fact pattern, the conversion option embedded in the Series B convertible redeemable preferred shares is deemed nonsubstantive and should be disregarded when applying the classification provisions of ASC Topic 480. That is, the conversion feature should be ignored and Company A should analyze whether its Series B preferred shares (that pay 8% cumulative dividends and must be redeemed on January 1, 20X5 for an amount equal to the then-current liquidation preference) are within the scope of ASC Topic 480.

Example 2.2: Evaluating Whether a Feature Is Nonsubstantive or Minimal at Inception of an Instrument

Background

On March 1, 20X2, Company A issues shares of Series B convertible redeemable preferred stock for its stated value of $1,000 per share. Each convertible redeemable preferred share has the following terms: (1) 8% cumulative dividends, payable when and if declared by the board of directors, (2) convertible into common shares of Company A at the option of the holder at a conversion price equal to the then-current liquidation preference divided by $15 per share, and (3) if the preferred share has not been converted, the share is mandatorily redeemable for cash by the Company on January 1, 20X5 for an amount equal to the then-current liquidation preference of the share. Over the past several years, Company A’s common share price has fluctuated between $10 and $20 per share, Company A’s common share price on March 1, 20X2 was $12 per share, and the volatility of its common share price is low. Additionally, Company A issued shares of Series A redeemable preferred shares two months earlier (January 1, 20X2) for a stated value of $1,000 per share. The Series A redeemable preferred shares have the following terms: (1) 12% cumulative dividends, payable when and if declared by the board of directors, and (2) the shares are mandatorily redeemable for cash on January 1, 20X5 for an amount equal to the then-current liquidation preference of the shares. Holders of the Series A and Series B shares receive the same level of priority in the event of liquidation. There were no significant changes in market interest rates or in Company A’s credit quality between January 1, 20X2 and March 1, 20X2.

Analysis

Given the range of Company A’s historical common share price (between $10 and $20 per share) over the past several years, the common share price on March 1, 20X2, the likelihood that the common share price, despite its low volatility, will reach the $15 conversion price prior to the January 1, 20X5 mandatory redemption date is more than remote. Additionally, the Series B investors ascribed value to the
conversion option because the Series A investors paid the same price per share for nonconvertible preferred shares two months earlier and receive a higher dividend rate (12% instead of 8%). In this fact pattern, the conversion option embedded in the Series B convertible redeemable preferred shares is substantive and should not be disregarded when applying the classification provisions of ASC Topic 480. That is, Company A should evaluate the Series B preferred shares, as issued, to determine whether they are within the scope of ASC Topic 480.

Additional Information

Due to various factors, Company A’s common share price declined dramatically throughout 20X3. The average daily closing price of its common shares for 20X3 was $3 per share and its closing price on December 31, 20X3 was $1 per share. Company A determines that the conversion feature in its Series B redeemable preferred shares is now nonsubstantive because the conversion price ($15 per share) is high in relation to the current common share price and Company A does not expect its common share price to increase above $15 before the Series B shares are required to be redeemed for cash on January 1, 20X5.

Subsequent Analysis

The evaluation of whether a feature is nonsubstantive or minimal is made only at inception of the instrument. As a result, Company A should not re-evaluate the application of ASC Topic 480 even though the conversion feature within its Series B redeemable preferred shares is no longer substantive.

Example 2.3: Evaluating Whether a Feature Is Nonsubstantive or Minimal at Inception of an Instrument

Background

On March 1, 20X2, Company A issues shares of preferred stock for its stated value of $1,000 per share to a group of individuals. Each preferred share has the following terms: (1) 8% cumulative dividends, payable when and if declared by the board of directors and (2) Company A has the right to call the share from the holder for cash on January 1, 20X5 for an amount equal to the then-current liquidation preference of the share. Over the past several years, Company A issued similar instruments to the same group of individuals and in each case, Company A exercised the embedded call option. In addition, Company A’s corporate charter indicates that the only type of perpetual equity instrument it is permitted to issue is common stock and in order to protect the common shareholders requires that any other type of issued equity instrument be redeemed by the company at the earliest possible date.
Scope and Initial Classification

Analysis

The preferred stock has an embedded call option. Company A should evaluate the instrument to determine whether the embedded call option is nonsubstantive or minimal at inception of the instrument. The call option itself is not nonsubstantive or minimal; however, the substance of this feature differs from its legal form. Given the provisions of Company A’s corporate charter, Company A should conclude that the optionality of the embedded call “option” is nonsubstantive because no optionality (uncertainty) exists as to the instruments’ redemption on January 1, 20X5. That is, given the requirement in its corporate charter to redeem the shares, Company A should view the preferred stock as an instrument with a substantive mandatory redemption date of January 1, 20X5 for purposes of determining whether the instrument is within the scope of ASC Topic 480. See Paragraphs 3.009 – 3.012 of Section 3 for additional information.
3. Mandatorily Redeemable Financial Instruments

Introduction

Instruments within the Scope of ASC Topic 480

Conditional Obligations

 Callable Shares
 Puttable Shares
 Callable and Puttable Shares
 Convertible Shares

Term-Extension Options and Similar Features

Redemption Occurs at Liquidation or Termination

Noncontrolling Interests of All Entities

 Limited-Life Entities
 Noncontrolling Interests of Non-Limited-Life Entities

Mandatorily Redeemable Financial Instruments of Non-SEC Registrants

 Redemption on a Fixed Date for a Fixed or Determinable Amount
 All Other Mandatorily Redeemable Instruments

Conditional or Contingent Redemption Features

Increasing-Rate Preferred Shares

Modifications, Exchanges, and Extinguishment of Mandatorily Redeemable Financial Instruments

Questions and Answers
3. Mandatorily Redeemable Financial Instruments

INTRODUCTION

3.000 This section discusses the first class of freestanding financial instruments that is within the scope of ASC Topic 480—mandatorily redeemable financial instruments. Financial instruments issued in the form of shares that are mandatorily redeemable by transfers of assets are within the scope of ASC Topic 480 because such instruments embody obligations that meet the definition of a liability. Mandatorily redeemable instruments, even though they may have the form of shares, (1) embody a present duty that entails settlement by future transfer of assets at a specified or determinable date or on occurrence of a specified event, (2) leave the issuer no discretion to avoid the future sacrifice of assets, and (3) result from a transaction—the issuance of the instrument— that has already happened. Liabilities for mandatorily redeemable instruments also satisfy the other recognition criteria since they are readily measurable, for example, at fair value by observing market prices or by determining the present value of the future cash flows required by the instrument. The measure, and other information about the obligation, is clearly relevant to investors, creditors, and other users of financial statements and has sufficient reliability at issuance for a liability to be recognized.

3.000a In contrast to mandatorily redeemable shares, shares of nonredeemable common stock do not impose on the issuer an obligation to pay dividends or to reacquire the shares. Declaration of dividends is at the discretion of the issuer, as is a decision to reacquire the shares. Similarly, preferred stock that is not redeemable does not impose on the issuer any obligation either to repurchase the shares or to pay dividends, even though failure to pay dividends may have adverse economic consequences for the issuer. As a result, nonredeemable outstanding shares of both common and preferred stock lack an essential characteristic of a liability.

INSTRUMENTS WITHIN THE SCOPE OF ASC TOPIC 480

3.001 ASC paragraphs 480-10-25-4 through 25-6 describe freestanding mandatorily redeemable financial instruments that are within its scope.

A mandatorily redeemable financial instrument shall be classified as a liability unless the redemption is required to occur only upon the liquidation or termination of the reporting entity. A financial instrument issued in the form of shares is mandatorily redeemable if it embodies an unconditional obligation...
Mandatorily Redeemable Financial Instruments

requiring the issuer to redeem the instrument by transferring its assets at a specified or determinable date (or dates) or upon an event certain to occur.¹

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

3.002 A redeemable financial instrument is an instrument that may be redeemed either at the issuer’s option (e.g., a callable security), the holder’s option (e.g., a puttable security), by contract (for example, a security that matures on a specific date), or a combination thereof. ASC Topic 480 uses the term mandatorily redeemable financial instrument to clarify that the financial instrument must include a contractual requirement to redeem the instrument. Specifically, ASC Section 480-10-20 defines mandatorily redeemable financial instruments as any of various financial instruments issued in the form of shares that embody an unconditional obligation requiring the issuer to redeem the instrument by transferring its assets at a specified or determinable date (or dates) or upon an event that is certain to occur. That is, in order for a financial instrument to be within the scope of ASC paragraphs 480-10-25-4 and 25-6, it must (1) be issued in the form of shares, (2) embody an unconditional obligation that requires the issuer to redeem the instrument by transferring assets, and (3) contain a specific date, a determinable date, or an event certain to occur, upon which the issuer’s assets must be transferred.

3.003 The first characteristic of a freestanding mandatorily redeemable financial instrument is that the instrument is issued in the form of shares. While common shares and preferred shares are two well-known types of shares, for purposes of applying ASC Topic 480, shares also include the various other forms of ownership that may not take the legal form of securities, as well as other interests, including those that are liabilities in substance but not in form. Business enterprises have interest holders that are commonly known by specialized names, such as stockholders, partners, LLC members, and proprietors, and by more general names, such as investors, but all are considered owners. Equity of business enterprises is, thus, commonly known by several names, such as owners’ equity, stockholders’ equity, ownership, equity capital, partners’ capital, LLC members’ interests and proprietorship. Some enterprises (e.g., mutual organizations) do not have stockholders, partners, LLC members, or proprietors in the usual sense of those terms but do have participants whose interests are essentially ownership interests, retained interests, or both.

3.004 The second characteristic of a freestanding mandatorily redeemable financial instrument is that the instrument must embody an unconditional obligation that requires the issuer to redeem the instrument. An unconditional obligation is a duty or responsibility on the part of the issuer to perform under the terms of the financial

¹ In determining if an instrument is mandatorily redeemable, all terms within a redeemable instrument shall be considered. A term extension option, a provision that defers redemption until a specified liquidity level is reached, or a similar provision that may delay or accelerate the timing of a mandatory redemption does not affect the classification of a mandatorily redeemable financial instrument as a liability.

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instrument, typically after the passage of time, regardless of future events. That is, the redemption is outside the control of both the issuer and the holder.

3.005 The third characteristic of a freestanding mandatorily redeemable financial instrument is that the issuer must redeem the instrument by transferring its assets at a specified or determinable date (or dates) or upon an event that is certain to occur. When determining whether an instrument contains a determinable date or an event that is certain to occur, a probability analysis is not relevant. In essence, the contract must specify a date or an event that is certain to occur whereby the issuer is contractually required to transfer its assets (e.g., cash) to satisfy the redemption requirement. Examples of events certain to occur include death, termination, or retirement of any person.

3.006 Mandatorily redeemable financial instruments in the form of shares are included in the scope of ASC Topic 480 because, irrespective of their legal form, those instruments embody obligations that meet the definition of liabilities set forth in Concepts Statement 6. Specifically, as a result of past transactions, the instruments contain a requirement to transfer assets of the enterprise at a future date, and the issuing enterprise does not have the discretion to avoid that transfer. Those instruments also satisfy the recognition criteria set forth in FASB Concepts Statement No. 5, Recognition and Measurement in Financial Statements of Business Enterprises, in terms of measurement, relevance, and reliability.

3.007 The following example illustrates the application of the definition of mandatorily redeemable financial instruments:

**Example 3.1: Preferred Shares**

**Background**

Company A issues preferred shares on January 1, 20X1 that are required to be redeemed for $1,000 cash on December 31, 20X5.

**Analysis**

The instrument is considered a mandatorily redeemable financial instrument under the provisions of ASC paragraphs 480-10-25-4 and 25-6 because the instrument (1) is issued in the form of shares (i.e., preferred shares), (2) embodies an unconditional obligation that requires the issuer to redeem the instrument by transferring assets (i.e., regardless of future events, Company A is required to pay the holder $1,000 cash), and (3) contains a specific date upon which the assets must be transferred (i.e., December 31, 20X5).

3.008 Liability classification for mandatorily redeemable financial instruments within the scope of ASC Topic 480 represents a significant change from past accounting practice. Previously, SEC registrants followed the guidance in ASR 268, which requires securities subject to mandatory redemption (or with redemption features outside the control of the issuer) to be classified outside of permanent equity (see Paragraph 2.004 of Section 2 for
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additional information). Such instruments were frequently classified in the “mezzanine” or “temporary equity” section of the balance sheet (between liabilities and equity) by SEC registrants and were subject to the subsequent measurement guidance in ASC paragraphs 480-10-S99-2 and S99-3. Non-SEC registrants are not subject to the classification requirements in ASR 268, so those entities generally classified mandatorily redeemable financial instruments within stockholders’ equity. Upon adoption of ASC Topic 480, certain instruments that were previously reported as equity (or temporary equity) will be reported as liabilities by all entities. The presentation and measurement requirements in ASR 268 and its related interpretations do not apply to instruments within the scope of ASC Topic 480. The SEC staff updated ASC paragraph 480-10-S99-3 to clarify that it is not applicable to instruments that are within the scope of ASC Topic 480. However, ASR 268 and its related interpretations continue to apply to instruments issued by an SEC registrant that are outside the scope of ASC Topic 480 (e.g., contingently redeemable shares and puttable shares).

CONDITIONAL OBLIGATIONS

3.009 Certain financial instruments contain embedded options (e.g., call options and put options) that represent a conditional obligation on the part of the issuer to redeem the financial instrument by transferring its assets. If a financial instrument contains only a conditional obligation on the part of the issuer to redeem the financial instrument by transferring its assets and that conditional obligation is embedded within the financial instrument, the financial instrument generally is outside the scope of ASC paragraphs 480-10-25-4 and 25-6.

3.010 In some instances, the exercise of the embedded option may be within the control of the issuer (e.g., an embedded purchased call option) and in other instances the exercise of the embedded option may be within the control of the holder (e.g., an embedded written put option). However, the definition of mandatorily redeemable financial instruments in ASC Section 480-10-20 does not extend to an instrument that contains a redemption that could occur; consequently, instruments that are puttable or callable but have no mandatory redemption requirement generally are outside the scope of ASC paragraphs 480-10-25-4 and 25-6. Similarly, instruments that are redeemable solely upon the occurrence of an event that is not certain to occur and that is outside the control of the issuer or holder (e.g., redemption is required if there is a reduction in the issuer’s credit rating) generally do not meet the definition of mandatorily redeemable financial instruments in ASC Section 480-10-20. However, if redemption is outside the control of the issuer, the instrument generally continues to be subject to ASR 268 and its related interpretations for SEC registrants.

3.011 However, if a financial instrument contains a conditional obligation on the part of the issuer to redeem the financial instrument by transferring its assets, the conditional obligation should be evaluated at the date of issuance to determine whether the conditionality is substantive or nonminimal. That is, an analysis should be performed to determine whether the conditionality in the instrument has no substance such that the financial instrument is required to be redeemed by the issuer by transferring its assets on
a specific date, a determinable date, or upon an event certain to occur. If that is the case, the obligation is considered unconditional (i.e., the conditionality should be disregarded if it is nonsubstantive or minimal) and the instrument typically will be within the scope of ASC paragraphs 480-10-25-4 and 25-6. Judgment, based on consideration of all the terms of an instrument and other relevant facts and circumstances, should be applied to determine whether the conditionality is nonsubstantive or minimal at inception of the instrument. If the conditionality is deemed to be nonsubstantive or minimal, it may result in the conclusion that there is a substantive mandatory redemption feature when applying the provisions of ASC Topic 480 (i.e., the instrument should be viewed as an unconditional obligation). See Paragraphs 2.007–2.009 and Example 2.3 of Section 2 for additional information.

3.012 To determine whether the conditionality within a redeemable financial instrument is nonsubstantive or minimal, the issuer should evaluate whether the feature effectively transforms the instrument into a mandatorily redeemable financial instrument. However, a probability analysis should not be used in the evaluation. While no single factor is determinative of whether the conditionality is nonsubstantive or minimal, resulting in the conclusion that a substantive mandatory redemption feature exists, we believe the following are questions an entity should consider in its evaluation:

- Is redemption contractually required at a certain date?
- Is either party required to exercise its “conditional” option?
- Is mandatory redemption of the instrument required by another contract?
- Is mandatory redemption of the instrument required by the documents governing the operations of the issuer (e.g., Articles of Incorporation, Charter, etc.)?
- Has the issuer otherwise committed itself to redeem the instrument?

Callable Shares

3.013 An entity may issue shares that contain an embedded option that allows the issuer to call the shares back from the holder for cash. Such instruments are referred to as callable shares. Callable shares do not meet the definition of mandatorily redeemable financial instruments because they do not embody an unconditional obligation that requires the issuer to redeem the instruments by transferring assets. The following example illustrates the application of ASC paragraphs 480-10-25-4 and 25-6 to a financial instrument that contains a conditional obligation.
Example 3.2: Callable Preferred Shares

Background

Company A issues preferred shares on January 1, 20X1 that can be redeemed (i.e., called) for $1,000 cash at Company A’s option any time after December 31, 20X5. Assume the option is not nonsubstantive or minimal.

Analysis

The instrument is not considered a mandatorily redeemable financial instrument under the provisions of ASC paragraphs 480-10-25-4 and 25-6 because, while the instrument is issued in the form of shares (i.e., preferred shares), it (1) does not embody an unconditional obligation that requires the issuer to redeem the instrument by transferring assets (i.e., it contains a call option that can be exercised at Company A’s discretion), and (2) does not contain a specific date upon which assets must be transferred (i.e., it contains a date at which Company A may call the preferred shares). That is, the instrument is not considered a mandatorily redeemable financial instrument under the provisions of ASC paragraphs 480-10-25-4 and 25-6 because there is no specific date on which the issuer is required to redeem the instrument, the exercise of the call option is not an event certain to occur, and the redemption is not outside the control of the issuer and the holder.

Puttable Shares

3.014 An entity may issue shares that contain an embedded option that allows the holder to put the shares back to the issuer for cash. Such instruments are referred to as puttable shares. Puttable shares do not meet the definition of mandatorily redeemable financial instruments (and as indicated in Paragraph 2.006 of Section 2, the classification provisions of ASC Topic 480 do not apply to embedded features), so they are outside the scope of the standard. The exclusion of puttable shares from the scope of ASC Topic 480 creates an inconsistency with International Financial Reporting Standards.2 The international standards require liability classification for shares that can be redeemed if redemption is outside the issuer’s control. During the deliberations that led to the issuance of ASC Topic 480, the Board determined that puttable shares and contingently redeemable shares raise issues that should be discussed in the next phase of the Board’s Liabilities and Equity Project, together with convertible bonds and other instruments that raise similar issues.

3.015 The exclusion of puttable shares from the scope of ASC Topic 480 also results in inconsistent accounting treatment between shares with embedded written put options and

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2 International Accounting Standard 32 (Revised March 2004), Financial Instruments: Disclosure and Presentation
freestanding written put options on an issuer’s shares because those freestanding put options are classified as liabilities under either ASC paragraphs 480-10-25-8 through 25-10 and 25-12 or 480-10-25-14 (depending on the settlement method). See discussion of freestanding financial instruments subject to ASC paragraphs 480-10-25-8 through 25-10, 25-12, and 25-14 in Sections 4 and 5 of this book, respectively. This inconsistency is due to the limited scope of ASC Topic 480 and is expected to be resolved upon completion of the next phase of the Board’s Liabilities and Equity Project. The following example illustrates the application of ASC paragraphs 480-10-25-4 and 25-6 to a financial instrument that contains a conditional obligation:

**Example 3.3: Puttable Preferred Shares**

**Background**

Company A issues preferred shares on January 1, 20X1 that can be redeemed (i.e., put back to Company A) for $1,000 cash at the holder’s option any time after December 31, 20X5. Assume the option is not nonsubstantive or minimal.

**Analysis**

The instrument is not considered a mandatorily redeemable financial instrument under the provisions of ASC paragraphs 480-10-25-4 and 25-6 because, while the instrument is issued in the form of shares (i.e., preferred shares), it (1) does not embody an unconditional obligation that requires the issuer to redeem the instrument by transferring assets (i.e., it contains a put option that can be exercised at the holder’s discretion), and (2) does not contain a specific date upon which assets must be transferred (i.e., it contains a date at which the holder may put the preferred shares). That is, the instrument is not considered a mandatorily redeemable financial instrument under the provisions of ASC paragraphs 480-10-25-4 and 25-6 because there is no specific date on which the issuer is required to redeem the instrument, the exercise of the put option is not an event certain to occur, and the redemption is not outside the control of the issuer and the holder.

**Callable and Puttable Shares**

**3.016** ASC Section 815-10-25 addresses whether the combination of a purchased call (put) option and a written put (call) option embedded within an instrument should be considered as two separate options or as a single forward contract. ASC paragraphs 815-10-25-7 through 25-13; 815-20-25-43 indicate that if the embedded options have the same terms (strike price, notional amount, and exercise date), they should be considered an embedded forward contract for purposes of applying the provisions of ASC Topic 815 and its related guidance. The combination of options is considered an embedded forward contract under ASC Topic 815 because the options (1) convey rights (to the holder) and obligations (to the writer) that are equivalent from an economic and risk perspective to an embedded forward contract, and (2) cannot be separated from the instrument in which they are embedded. As a result, even though neither party is required to exercise its
purchased option, the result of the overall structure is an instrument that will likely be redeemed at a point in time and that likelihood is expected by the holder and the issuer.

3.017 Despite the guidance in ASC Section 815-10-25, a share of stock that is puttable by the holder and callable by the issuer under the same terms does not render the shares mandatorily redeemable under the provisions of ASC Topic 480. That is, although the combination of options may economically function as a forward contract (i.e., a redemption date in which the issuer is required to redeem the instrument by transferring its assets), the combination of options represents a conditional obligation because redemption is not required to occur by the contractual terms of the instrument (e.g., the options could expire at the money, unexercised). However, if the optionality in the instrument has no substance such that the financial instrument must be redeemed by the issuer by transferring its assets on a specific date, a determinable date, or upon an event certain to occur, the optionality should be disregarded for purposes of applying the provisions of ASC Topic 480.

3.018 The following example illustrates the application of ASC paragraphs 480-10-25-4 and 25-6 to a financial instrument that contains a combination of options:

Example 3.4: Callable and Puttable Preferred Shares

Background

Company A issues preferred shares on January 1, 20X1 that can be redeemed (i.e., called) for $1,000 cash at Company A’s option any time after December 31, 20X5 and can be redeemed (i.e., put) for $1,000 cash at the holder’s option any time after December 31, 20X5. Assume the options are not nonsubstantive or minimal.

Analysis

The instrument is not considered a mandatorily redeemable financial instrument under the provisions of ASC paragraphs 480-10-25-4 and 25-6 because, while the instrument is issued in the form of shares (i.e., preferred shares), it (1) does not embody an unconditional obligation that requires the issuer to redeem the instrument by transferring assets (i.e., it contains a call option that may be exercised at Company A’s discretion and a put option that may be exercised at the holder’s discretion), and (2) does not contain a specific date upon which assets must be transferred (i.e., it contains a date at which Company A may call the preferred shares and a date at which the holder may put the preferred shares). That is, the instrument is not considered a mandatorily redeemable financial instrument under the provisions of ASC paragraphs 480-10-25-4 and 25-6 because there is no specific date on which the issuer is required to redeem the instrument, the exercise of the call option and the put option is not an event certain to occur, and the redemption is not outside the control of the issuer and the holder.

Even though a combination of a put option and a call option with the same exercise date and strike price creates a synthetic forward contract, that combination of
embedded features does not render the shares mandatorily redeemable under the provisions of ASC Topic 480 because the options could expire at the money, unexercised. As a result, the redemption is not unconditional.

Convertible Shares

3.019 Some financial instruments are shares that contain a conversion option such that the holder has the option to convert the shares into a fixed number of another type of the issuer’s shares. Those financial instruments may indicate that if the holder does not choose to exercise the conversion option, the existing shares continue in perpetuity. In such cases, the instrument does not contain an unconditional obligation that requires the issuer to redeem the instrument by transferring assets and, thus, the instrument is outside the scope of ASC paragraphs 480-10-25-4 and 25-6.

3.020 Other financial instruments may require the issuer to redeem the instrument for cash on a specified date if the conversion option is not exercised. That is, if the holder does not convert the instrument, the issuer is required to redeem the instrument by transferring its assets. While such a provision represents an obligation for the issuer, it is a conditional obligation because the issuer will only be required to redeem the instrument if the holder does not convert it. As a result, if the conversion option has not expired, such an instrument is outside the scope of ASC Topic 480. However, if the conversion option expires, the instrument becomes a mandatorily redeemable financial instrument and is subject to the provisions of ASC Topic 480 at that time.

3.021 Before an entity concludes that convertible shares are outside the scope of ASC paragraphs 480-10-25-4 and 25-6, the conversion option is required to be evaluated to determine whether it is substantive and nonminimal. See Paragraphs 2.007-2.009 and Examples 2.1 and 2.2 in Section 2 for additional information.

3.022 The following example illustrates the application of ASC paragraphs 480-10-25-4 and 25-6 to a convertible instrument:

Example 3.5: Convertible Redeemable Preferred Shares

Background

Company A issues preferred shares on January 1, 20X1 that are convertible into a fixed number of its common shares at the option of the holder. If the holder does not convert its preferred shares into common shares, the issuer is required to redeem the instrument for $1,000 cash on December 31, 20X5. Assume the conversion option is not nonsubstantive or minimal.

Analysis

The instrument is not considered a mandatorily redeemable financial instrument under the provisions of ASC paragraphs 480-10-25-4 and 25-6 because, while the
instrument is issued in the form of shares (i.e., preferred shares), it (1) does not embody an unconditional obligation that requires the issuer to redeem the instrument by transferring assets (i.e., the holder may convert prior to the redemption date and Company A would transfer a fixed number of its shares and not its assets), and (2) does not contain a specific date upon which assets must be transferred (i.e., it contains a date at which Company A may be required to pay cash if, and only if, the holder did not previously convert the instrument into a fixed number of Company A common shares). That is, the instrument permits the holder to choose to convert the instrument into a fixed number of the issuer’s common shares or to hold the instrument to maturity and receive cash. As a result, the redemption in cash is not unconditional.

TERM-EXTENSION OPTIONS AND SIMILAR FEATURES

3.023 Some instruments allow the issuer to extend their term, defer redemption until a specified liquidity level is reached, or have similar provisions that may delay or accelerate the timing of a required redemption. While those provisions may affect the timing of redemption, they do not remove the unconditional requirement for the issuer to redeem the shares. Accordingly, such provisions should not be considered when determining the applicability of ASC Topic 480 to those instruments. However, entities are required to evaluate term-extension options and similar features under other applicable accounting literature (e.g., ASC Topic 815 and ASC paragraphs 470-10-35-1 and 35-2; 470-10-45-7 and 45-8).

REDEMPTION OCCURS AT LIQUIDATION OR TERMINATION

3.024 An instrument may meet the definition of a mandatorily redeemable financial instrument under ASC Topic 480 but be excluded from its scope. ASC paragraphs 480-10-25-4 and 25-6 indicate that a mandatorily redeemable financial instrument is outside its scope if redemption is required to occur only upon the liquidation or termination of the reporting entity. The rationale for that guidance is that if the issuing entity is liquidated and ceases to exist when the mandatory redemption of its shares occurs, then the holders of those shares have an ownership interest similar to the equity owners of the company.

NONCONTROLLING INTERESTS OF ALL ENTITIES

3.025 When one entity (a parent) consolidates another entity (a subsidiary) that is not wholly owned, the other owners of the consolidated entity (e.g., third-party holders of a subsidiary’s preferred shares or common shares) are referred to as noncontrolling interests (e.g., minority interest holders) in the consolidated financial statements.

3.026 ASC paragraphs 480-10-25-4 and 25-6 indicate that a mandatorily redeemable financial instrument is outside its scope if redemption is required to occur only upon the liquidation or termination of the reporting entity. However, this exclusion in ASC Topic 480 only would apply to the reporting entity itself. As a result, if a subsidiary had shares...
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whereby redemption was required to occur only upon the subsidiary’s liquidation or termination, those shares would not have been within the scope of ASC Topic 480 for purposes of the separate subsidiary’s financial statements. However, because redemption is required to occur prior to the liquidation or termination of the parent entity, the shares originally were within the scope of ASC Topic 480 in the consolidated financial statements that include the subsidiary.

3.027 After ASC Topic 480 was issued, implementation issues arose with respect to its application to noncontrolling interests in consolidated financial statements. Under ASU 2017-11, the FASB added ASC paragraphs 480-10-15-7E and 480-10-15-7F to specify that Topic 480 does not apply to certain mandatorily redeemable noncontrolling interests. See Section 12 for a detailed description of the provisions of ASU 2017-11 and Paragraph 1.028 for the entity-type definitions used in ASU 2017-11.

Limited-Life Entities

3.028 The governing agreements of partnerships, limited liability companies, trusts, and entities domiciled in certain foreign jurisdictions frequently specify a fixed term for the entity’s existence whereby the entity will be terminated on a specified date (i.e., a limited-life entity).

3.029 For purposes of the consolidated financial statements, ASC paragraph 480-10-15-7E states that the classification and measurement provisions of ASC Topic 480 do not apply to instruments issued by a subsidiary that are required to be redeemed only upon liquidation or termination of that subsidiary. As a result, if a mandatorily redeemable instrument is outside the scope of ASC Topic 480 in the subsidiary’s stand-alone financial statements because redemption will occur upon liquidation or termination of the subsidiary, then the instrument is not subject to the classification and measurement requirements of ASC Topic 480 in the parent’s consolidated financial statements.

3.030 The following example illustrates the effects of ASC paragraph 480-10-15-7E for a limited-life entity:

**Example 3.6: Limited-Life Entity**

**Background**

Parent Company, a real estate developer, has a 75% interest in a partnership that it consolidates. An unrelated third party owns the other 25% interest. The terms of the partnership agreement require that the partnership be terminated no later than December 31, 20Z5. As part of the termination procedures, the assets of the partnership are to be sold, liabilities are to be settled, and the remaining cash distributed to the partners based on their ownership interests. The partnership owns land with a historical cost of $1,000 and has no other assets or liabilities. The fair value of the land at September 30, 20X3 is $6,000. Parent Company’s consolidated financial statements and the partnership’s separate financial statements report the land at $1,000. The noncontrolling interest in the partnership has previously been
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reported by Parent Company at $250. Parent Company is reporting its financial statements for the three-month period ending September 30, 20X3.

Analysis

If the scope exception were not applicable, the noncontrolling interest would have been reported as a liability of $1,500 (25% of $6,000). However, under ASC paragraph 480-10-15-7E, the noncontrolling interest is reported using the applicable classification and measurement methods without the specific liquidation requirements in Parent Company’s consolidated financial statements at September 30, 20X3 (i.e., noncontrolling interest is reported at $250).

3.031 In addition to disclosures required by other standards (e.g., ASC Topic 505, Equity), the subsidiary and parent are required to apply the disclosure requirements of ASC Topic 480 for financial instruments representing noncontrolling interests in a limited-life entity that is consolidated if either is an SEC registrant. For example, a real estate company that is an SEC registrant with a consolidated non-wholly-owned investment in a limited-life partnership is required to disclose the amount of consideration that would be paid to the holders of the noncontrolling interests as if termination of that partnership occurred on the reporting date. Likewise, SEC registrants with consolidated non-wholly-owned subsidiaries in foreign jurisdictions that specify a termination date in their articles of incorporation or other applicable governing documents (e.g., as a matter of law) are similarly affected. The disclosure requirements associated with financial instruments that represent a noncontrolling interest in a limited-life subsidiary could prove onerous for some entities.

3.032 ASC paragraph 480-10-15-7F states that, for non-SEC registrants, the disclosure requirements in ASC Topic 480 do not apply to financial instruments representing a noncontrolling interest in a limited-life entity. However, the disclosure requirements in ASC Topic 505, including disclosure of information about redemption requirements, apply to all entities.

Noncontrolling Interests of Non-Limited-Life Entities

3.033 An entity that has mandatorily redeemable noncontrolling interests of a non-limited-life entity (e.g., instruments within the scope of ASC Topic 480 at both the subsidiary and parent level) is required to apply all of ASC Topic 480’s classification and measurement provisions to the instrument. (Note certain provisions of ASC Topic 480 do not apply to certain noncontrolling interests of a non-limited-life entity, depending on when the instrument was issued. See Section 12 for additional information.)

3.034 SEC registrants are required to furnish the disclosures prescribed by ASC Topic 480, in addition to disclosures required by other standards (e.g., ASC Topic 505), for financial instruments representing a noncontrolling interest in non-limited-life entities.

3.035 The following example illustrates this provision:
Example 3.7: Shares Issued by a Subsidiary

Background

On December 1, 20X3, Subsidiary issues preferred shares to an unrelated investor that requires redemption on a fixed date (prior to liquidation or termination of Subsidiary) for a fixed amount. Parent Company consolidates Subsidiary and is an SEC registrant.

Analysis

The instrument is within the scope of ASC Topic 480 and its classification, measurement, and disclosure provisions are required to be applied in the financial statements of both the Subsidiary and Parent.

3.036 For non-SEC registrants, based on ASC paragraph 480-10-15-7F, the disclosure requirements in ASC Topic 480 do not apply to instruments representing a noncontrolling interest in a non-limited-life entity. However, in addition to disclosures required by other standards for these instruments (e.g., ASC Topic 505), non-SEC registrants are not prohibited from furnishing the disclosures prescribed by ASC Topic 480.

MANDATORILY REDEEMABLE FINANCIAL INSTRUMENTS OF NON-SEC REGISTRANTS

3.037 Some non-SEC registrant entities restrict ownership of common shares to active employees by requiring their shares to be redeemed upon the employee’s death or termination. ASC Topic 480 would have required those shares to be classified as liabilities because death or termination of employment is an event certain to occur. As a result, many employee-owned companies with those provisions would not have had outstanding “equity” instruments, because mandatorily redeemable shares are classified as liabilities under ASC Topic 480. However, in ASU 2017-11, the Board provided a scope exception for certain mandatorily redeemable financial instruments issued by non-SEC registrants.

Redemption on a Fixed Date for a Fixed or Determinable Amount

3.038 Instruments issued by a non-SEC registrant that are mandatorily redeemable on fixed dates for amounts that are fixed or are determinable by reference to an interest rate index, currency index, or another external index, are not subject to the classification, measurement, or disclosure requirements of ASC Topic 480 until fiscal periods beginning after December 15, 2004 (i.e., January 1, 2005 for calendar year companies). Instruments that meet this criterion include fixed- and floating-rate preferred shares issued by an entity (that is not required to be liquidated or terminated when the preferred shares are redeemed) whereby the preferred shares are required to be redeemed on a fixed date.
All Other Mandatorily Redeemable Instruments

3.039 Under ASC paragraph 480-10-15-7A, the classification, measurement, and disclosure requirements of ASC Topic 480 do not apply to instruments issued by a non-SEC registrant that are mandatorily redeemable but are not (1) redeemable on a fixed date or (2) redeemable for an amount that is fixed or determined by reference to an interest rate index, currency index, or another external index. Instruments that meet these criteria include shares issued by a non-SEC registrant that are required to be redeemed when an employee dies or otherwise terminates employment and shares issued by a non-SEC registrant that are required to be redeemed for fair value on a fixed date.

CONDITIONAL OR CONTINGENT REDEMPTION FEATURES

3.040 Conditional obligations to redeem financial instruments upon an event that is not certain to occur are addressed in ASC paragraph 480-10-25-5, which specifies that such instruments become liabilities when the condition is resolved and the instrument becomes mandatorily redeemable. As discussed in Section 2 of this book, relevant features (which include redemption contingencies) are required to be evaluated at inception of the instrument to determine whether they are nonsubstantive or minimal, in which case they would be disregarded when applying the classification provision of ASC Topic 480.

However, if an instrument contains a contingent redemption feature that is deemed to be substantive or nonminimal at inception, the financial instrument is required to be assessed at each subsequent reporting period to determine whether circumstances have changed such that the contingency has been resolved and the instrument currently meets the definition of mandatorily redeemable (i.e., redemption is no longer contingent because the condition has occurred or the contingency has been resolved such that redemption is required to occur).

3.041 If the contingent event has occurred or becomes certain to occur, the freestanding financial instrument is reclassified to a liability at its fair value with an offset to equity (no gain or loss is recorded in the income statement). However, the SEC staff amended ASC paragraph 480-10-S99-3 to clarify that, upon reclassification of a contingently redeemable instrument to a liability once the contingency has been resolved, the difference between its fair value and previous carrying amount should be added to or subtracted from net earnings available to common shareholders in the calculation of earnings per share (consistent with the guidance in ASC paragraph 260-10-S99-2). See further discussion of this revision to ASC paragraphs 260-10-S99-2 and S99-3 in Paragraphs 10.015-10.016 of Section 10.

3.042 The following examples illustrate this guidance:
Example 3.8: Puttable Preferred Shares

Background

Company A issued preferred shares that are puttable by the holder for an amount equal to its liquidation preference (including cumulative, unpaid dividends). The terms of the instrument require payment of cash to satisfy the holder’s redemption request within 30 days after the holder delivers an irrevocable “put notice” to the company. Assume the option is not nonsubstantive or minimal.

The holder delivered an irrevocable put notice to the company on December 15, 20X5 and the Company redeemed the instrument for cash in January 20X6.

Analysis

At issuance, the preferred shares are outside the scope of ASC paragraphs 480-10-25-4 and 25-6 because, while the instrument is issued in the form of shares (i.e., preferred shares), it (1) does not embody an unconditional obligation that requires the issuer to redeem the instrument by transferring assets (i.e., it contains a put option that is exercisable at the holder’s discretion), and (2) does not contain a specific date on which assets must be transferred (i.e., it contains a date on which the holder may put the preferred shares).

However, upon receipt of an irrevocable put notice from the holder on December 15, 20X5, the instrument is now within the scope of ASC paragraphs 480-10-25-4 and 25-6 and should be reclassified to a liability at its then fair value, with an offset to equity. The instrument should be classified as a liability in Company A’s December 31, 20X5 balance sheet and dividends accumulated between December 15, 20X5 and redemption of the instrument in January 20X6 should be classified as interest expense. The instrument is within the scope of ASC paragraphs 480-10-25-4 and 25-6 on December 15, 20X5 because at that date, the shares embody an unconditional obligation that requires Company A to redeem the instrument by transferring its assets on or before January 14, 20X6.

Example 3.9: Redeemable Preferred Shares

Background

On January 1, 20X4 Company A issued preferred shares that are required to be redeemed for an amount equal to its liquidation preference (including cumulative, unpaid dividends) six months after a change in control. The terms of the instrument
require payment of cash to satisfy the redemption. Assume the contingent redemption is not nonsubstantive or minimal.

On December 30, 20X8 there is a change in control, requiring the shares to be redeemed for cash on June 30, 20X9.

**Analysis**

At issuance, the preferred shares are outside the scope of ASC paragraphs 480-10-25-4 and 25-6 because, while the instrument is issued in the form of shares (i.e., preferred shares), it (1) does not embody an unconditional obligation that requires the issuer to redeem the instrument by transferring assets (i.e., it contains a contingent redemption), and (2) does not contain a specific date, a determinable date, or an event certain to occur, upon which assets *must* be transferred.

However, upon the change in control on December 30, 20X8, the instrument is now within the scope of ASC paragraphs 480-10-25-4 and 25-6 and should be reclassified to a liability at its fair value, with an offset to equity. The instrument should be classified as a liability in Company A’s December 31, 20X8 balance sheet and dividends accumulated between December 30, 20X8 and redemption of the instrument on June 30, 20X9 should be classified as interest expense. The instrument is within the scope of ASC paragraphs 480-10-25-4 and 25-6 on December 30, 20X8 because at that date, the shares embody an unconditional obligation that requires Company A to redeem the instrument by transferring its assets on June 30, 20X9.

**Example 3.10: Convertible Redeemable Preferred Shares**

**Background**

On June 30, 20X1, Company A issued preferred shares that are convertible into a fixed number of Company A common shares at the holder’s option for a period of 5 years from the date of issuance. The preferred shares are required to be redeemed by Company A for an amount equal to its liquidation preference (including cumulative, unpaid dividends) on June 30, 20X8 (7 years from the date of issuance). Assume the conversion option is not nonsubstantive or minimal.

**Analysis**

The preferred shares are not mandatorily redeemable for the first 5 years after issuance because, while the instrument is issued in the form of shares (i.e., preferred shares), it (1) does not embody an unconditional obligation that requires the issuer to redeem the instrument by transferring assets (i.e., the holder may
convert the preferred shares into common shares prior to the redemption date and Company A would transfer a fixed number of its shares and not its assets), and (2) does not contain a specific date on which assets must be transferred (i.e., it contains a date at which Company A may be required to pay cash if, and only if, the holder did not previously convert the instrument into a fixed number of Company A common shares).

If the conversion option expires after 5 years, any outstanding preferred shares are within the scope of ASC paragraphs 480-10-25-4 and 25-6 and would be classified as liabilities at fair value, with an offset to equity. The instrument is within the scope of ASC paragraphs 480-10-25-4 and 25-6 after five years because, at that time, the shares embody an unconditional obligation that requires Company A to redeem the instrument by transferring its assets on June 30, 20X8.

3.043 Situations will arise in which an enterprise will receive information after the balance sheet date but before its financial statements are issued that a conditionally redeemable instrument has become mandatorily redeemable. In these circumstances, the relevant guidance in ASC Topic 855, Subsequent Events, should be applied. If the information received after the balance sheet date demonstrates that the conditional feature had been resolved before the balance sheet date, the instrument should be reclassified as a liability before the financial statements are issued. Alternatively, if the information shows that the instrument became mandatorily redeemable after the balance sheet date, the classification in the financial statements should not be revised, but appropriate disclosures should be provided.

3.044 Although ASC Topic 480 does not address how to assess an instrument to determine whether it contains an embedded derivative, this analysis is required under the provisions of ASC Topic 815. Consequently, at the time an instrument is issued, the entity is required to determine whether any embedded feature, including an embedded contingency feature, is required to be separated from the host instrument pursuant to ASC Topic 815.

INCREASING-RATE PREFERRED SHARES

3.045 When an unconditional obligation for mandatory redemption is absent, a financial instrument is not considered mandatorily redeemable under ASC Topic 480, even if it is considered probable that the issuer will redeem the instrument. Some types of preferred shares pay no, or low, dividends during the first year they are outstanding and then pay dividends at an increasing rate. Such instruments are referred to as increasing-rate preferred shares. When increasing-rate preferred shares are mandatorily redeemable on (or not later than) a specified date, they are classified as a liability under ASC Topic 480. However, generally, increasing-rate preferred shares with no mandatory redemption provision are outside the scope of ASC Topic 480, even if the increasing-rate feature makes redemption by the issuer economically compelling such that there is an “implied mandatory redemption date.” SEC registrants are subject to the guidance in ASC paragraph 505-10-S99-7, with respect to such instruments. Due to the absence of other
authoritative literature, non-SEC registrants also may refer to that guidance when accounting for increasing-rate preferred stock.

MODIFICATIONS, EXCHANGES, AND EXTINGUISHMENT OF MANDATORILY REDEEMABLE FINANCIAL INSTRUMENTS

3.046 Mandatorily redeemable financial instruments within the scope of ASC Topic 480 are subject to the accounting literature applicable to other debt instruments in the event of modification, exchange, or extinguishment. An entity should consider the guidance in ASC Subtopic 310-40, Troubled Debt Restructuring by Creditors; ASC Subtopic 470-60, Troubled Debt Restructuring by Debtors, and ASC paragraphs 470-60-55-4 through 55-14 to evaluate whether the modification, exchange, or extinguishment should be accounted for as a troubled debt restructuring. In a nontroubled situation, the guidance in ASC Subtopic 470-50, Modification and Extinguishments, and ASC Topic 860, Transfers and Servicing, should be considered. Mandatorily redeemable financial instruments issued by subsidiaries also are subject to this guidance if those instruments are classified as liabilities under ASC Topic 480.

3.047 If an instrument meets the definition of a mandatorily redeemable financial instrument but is outside the scope of ASC Topic 480, other accounting principles should be applied. For example, if a mandatorily redeemable financial instrument issued by a nonpublic subsidiary is outside the scope of ASC Topic 480 because redemption occurs upon liquidation or termination of the subsidiary, in the parent’s consolidated financial statements the extinguishment of the instrument is accounted for as a capital transaction under ASC paragraph 810-10-40-2.

QUESTIONS AND ANSWERS

Q&A 3.1: Company A is an SEC registrant and issues a financial instrument on July 1, 20X0 and determines it is within the scope of ASC Topic 480.

Q. If an instrument is within the scope of ASC Topic 480, is it subject to the SEC requirements in ASR 268 for public companies?

A. No. ASR 268 and its related guidance address instruments that are classified as equity but are or could be required to be settled or redeemed for cash or other assets. ASR 268 generally requires such instruments to be classified outside of permanent equity. Because ASC Topic 480 requires instruments within its scope to be classified as liabilities, any instrument within the scope of ASC Topic 480 is not subject to the requirements of ASR 268 or its related interpretations (e.g., ASC paragraphs 480-10-S99-2 and S99-3).
**Q&A 3.2:** Company A is an SEC registrant and adopted the provisions of ASC Topic 480. Company A has several instruments that are classified as temporary equity in accordance with ASR 268.

**Q.** Will all instruments previously classified as temporary equity under ASR 268 be classified as liabilities under ASC Topic 480?

**A.** No. ASR 268 and its related guidance require equity securities to be classified outside of permanent equity if they are redeemable: (1) at a fixed or determinable price on a fixed or determinable date, (2) at the option of the holder, or (3) upon the occurrence of an event that is not solely within the control of the issuer. ASC Section 480-10-20 defines mandatorily redeemable financial instruments as instruments issued in the form of shares that embody an unconditional obligation requiring the issuer to redeem the instrument by transferring its assets at a specified or determinable date (or dates) or upon an event that is certain to occur. As a result, an instrument may not be considered mandatorily redeemable under the provisions of ASC Topic 480 and, therefore, appropriately may be classified as equity or temporary equity under other generally accepted accounting principles. It should be noted that any freestanding derivative equity instrument that was in the scope of ASC Subtopic 815-40, Contracts in Entity’s Own Equity, prior to ASC Topic 480 and was classified as temporary equity under ASR 268 would be classified as a liability under ASC Topic 480 (see discussion of such instruments in Section 4 of this book). Additionally, certain freestanding equity instruments that were within the scope of ASC Subtopic 815-40 prior to ASC Topic 480 and were classified as permanent equity (e.g., a net share settled written put option) may require liability classification under ASC Topic 480 (see discussion of such instruments in Section 5 of this book).

**Q&A 3.3:** Company A issues a financial instrument that appears to meet the definition of a mandatorily redeemable financial instrument under ASC Topic 480. The instrument is required to be redeemed for cash on June 15, 20X1 but contains a provision that allows Company A to delay the redemption of the instrument for ten years if certain events occur.

**Q.** When applying the provisions of ASC paragraphs 480-10-25-4 and 25-6, would a term extension option or a similar provision within an instrument affect whether that instrument is considered mandatorily redeemable under the standard’s provisions?

**A.** No. ASC paragraph 480-10-25-6 indicates that a term extension option, a provision that defers redemption until a specified liquidity level is reached, or a similar provision that may delay or accelerate the timing of a mandatory redemption does not affect the classification of a mandatorily redeemable financial
instrument as a liability. As a result, the instrument issued by Company A is within the scope of ASC Topic 480 on the date it is issued.

**Q&A 3.4:** Company A is a partnership that has issued financial instruments in the form of partnership interests that are required to be redeemed for cash when Company A is liquidated or terminated. The documents governing the operations of Company A (its partnership agreement, corporate charter, etc.) do not specify a future dissolution or liquidation date.

Q. Are the partnership interests within the scope of ASC Topic 480?

A. No. The partnership interests issued by Company A are redeemable upon liquidation or dissolution of the partnership. ASC paragraphs 480-10-25-4 and 25-6 indicates a mandatorily redeemable financial instrument is classified as a liability unless the redemption is required to occur only upon the liquidation or termination of the reporting entity. Based on this guidance, the partnership interests are outside the scope of ASC Topic 480. This also would be true if a liquidation date had been specified in the documents governing the operations of Company A.

**Q&A 3.5:** Company A is a non-SEC registrant partnership that has issued financial instruments in the form of partnership interests that are required to be redeemed for cash: (i) upon the death of a partner, (ii) upon withdrawal of a partner from the partnership, or (iii) upon liquidation of Company A. The documents governing the operations of Company A (its partnership agreement, corporate charter, etc.) indicate that the entity will be liquidated five years after inception.

Q. Are the partnership interests within the scope of ASC Topic 480?

A. No. The partnership interests issued by Company A are redeemable: (i) upon the death of a partner, (ii) upon withdrawal of a partner from the partnership, or (iii) upon liquidation of Company A. ASC Topic 480 specifies that shares (or partnership interests in this example) that are required to be redeemed upon the death of the holder are classified as liability instruments because the death of the holder is certain to occur. Similarly, if an instrument is required to be redeemed for cash upon the withdrawal of a partner, the instrument is classified as a liability because the withdrawal of a partner is certain to occur (e.g., because the partner retires, is terminated, or dies). However, this general guidance does not apply to this specific fact pattern. The death or withdrawal of a partner, while certain to occur eventually, is not certain to occur before the specified dissolution of the partnership in five years nor on any other fixed date nor for an amount that is either fixed or determinable by reference to an index. Accordingly, the partnership interests are outside the scope of ASC Topic 480 in this fact pattern because it is
only certain that the instrument will be redeemed in five years upon the liquidation of the partnership (see the previous question for additional information). However, if the partnership had no specified dissolution date or the dissolution date was distant, the general guidance related to redemption upon death or retirement in ASC Topic 480 applies and the partnership interests would be classified as liabilities if the partnership is an SEC registrant. If the partnership is a non-SEC registrant, this general guidance does not apply and the partnership interests would be classified as equity. See Paragraphs 3.024–3.039 and Section 12 of this book, for a discussion on the scope exception in ASC Topic 480 for certain types of instruments.

Q&A 3.6: Company A is a partnership that has issued financial instruments in the form of partnership interests that are required to be redeemed for cash on December 15, 2010. The documents governing the operations of Company A (its partnership agreement, corporate charter, etc.) do not specify a future dissolution or liquidation date; however, once the instruments are liquidated, the partnership will effectively cease to exist (i.e., there would be no partners left).

Q. Are the partnership interests within the scope of ASC Topic 480?

A. No. All partnership interests issued by Company A will be redeemed on December 15, 2010, resulting in the effective dissolution of the partnership on that date because there will be no remaining partners. Because redemption will occur concurrently with the liquidation of the partnership, the partnership interests are not classified as liability instruments pursuant to ASC paragraphs 480-10-25-4 and 25-6. However, this conclusion is based on the following: (1) the partnership will cease to exist upon redemption of the partnership interests, and (2) the partnership governing documents do not permit new partnership interests to be issued that would be redeemed on a different date than that of the current partners’ interests. When evaluating structures with this fact pattern, careful consideration of applicable state laws governing the partnership structure and the specific partnership agreement is recommended.

Q&A 3.7: Company A issues mandatorily redeemable preferred shares that are convertible into a fixed number of its common shares at the option of the holder. If the holder does not convert, Company A is required to redeem the instrument for cash at a specified date.

Q. Assuming the conversion option is not nonsubstantive or minimal, is the instrument within the scope of ASC Topic 480?

A. No. The instrument permits the holder to choose to convert the instrument into a fixed number of the issuer’s common shares or to hold the instrument to maturity and receive cash. If the holder decides to convert prior to the redemption date, the
issuer will settle the conversion with a fixed number of shares known at inception and thus, while the instrument is issued in the form of shares (i.e., preferred shares), it (1) does not embody an unconditional obligation that requires the issuer to redeem the instrument by transferring assets (i.e., the holder may convert prior to the redemption date and Company A would transfer a fixed number of its shares and not its assets), and (2) does not contain a specific date on which assets must be transferred (i.e., it contains a date on which Company A may be required to pay cash if, and only if, the holder did not previously convert the instrument into a fixed number of Company A common shares). Accordingly, the instrument is outside the scope of ASC Topic 480, even though the choice of settlement is controlled by the holder. However, if the conversion option expires before the specified cash redemption date or the instrument remains outstanding at the specified redemption date, the instrument would become mandatorily redeemable and within the scope of ASC Topic 480 because, at that time, the shares would embody an unconditional obligation that requires Company A to redeem the instrument by transferring its assets on a specified date.

Q&A 3.8: Company A issues mandatorily redeemable preferred shares that are contingently convertible into a fixed number of its common shares. The preferred shares can be converted to common shares at the option of the holder if the common shares reach a certain market price. If the specified share price is not achieved or the holder does not convert, the issuer is required to redeem the instrument for cash at a specified date.

Q. Assuming the conversion option is not nonsubstantive or minimal, is the instrument within the scope of ASC Topic 480?

A. No. If the contingency is resolved, the instrument permits the holder to either convert the instrument into a fixed number of the issuer’s common shares or hold the instrument to maturity and receive cash. That is, the holder could decide to convert prior to the redemption date such that the issuer can settle the instrument by delivering a fixed number of shares known at inception and thus, while the instrument is issued in the form of shares (i.e., preferred shares), it (1) does not embody an unconditional obligation that requires the issuer to redeem the instrument by transferring assets (i.e., if the contingency is resolved, the holder may convert prior to the redemption date and Company A would transfer a fixed number of its shares and not its assets), and (2) does not contain a specific date on which assets are required to be transferred (i.e., it contains a date on which Company A may be required to pay cash if, and only if, the holder has not previously converted the instrument into a fixed number of Company A common shares). Accordingly, the instrument is outside the scope of ASC Topic 480, even though the choice of settlement is controlled by the holder once the contingency is resolved. However, if the conversion option expires before the specified cash redemption date or the instrument remains outstanding at the specified redemption date.
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date, the instrument would become mandatorily redeemable and within the scope of ASC Topic 480, because at that time the shares would embody an unconditional obligation that requires Company A to redeem the instrument by transferring its assets on a specified date.

Q&A 3.9: Company A issues contingently redeemable preferred shares. The shares are required to be redeemed for $1,000 cash if Company A issues additional shares (either preferred or common).

Q. Assuming the contingency is not nonsubstantive or minimal, is the instrument within the scope of ASC Topic 480?

A. No. Freestanding financial instruments that are issued in the form of shares whereby if a contingency occurs (or does not occur) the issuer is required to redeem the instrument by transferring cash or other assets are not considered mandatorily redeemable under ASC Topic 480 because, while the instrument is issued in the form of shares (i.e., preferred shares), it (1) does not embody an unconditional obligation that requires the issuer to redeem the instrument by transferring assets (i.e., if Company A does not issue additional shares, the instrument remains outstanding), and (2) does not contain a specific date on which assets are required to be transferred (i.e., it contains a date on which Company A may be required to pay cash if, and only if, it issues additional shares).

Q&A 3.10: Company A issues preferred stock on January 1, 20X1 that is puttable upon the death of the holder, pursuant to put rights embedded in the preferred stock.

Q. Assuming the option is not nonsubstantive or minimal, are the shares within the scope of ASC Topic 480?

A. No. A share of stock that is contingently puttable by the holder is not a mandatorily redeemable instrument under the provisions of ASC paragraphs 480-10-25-4 and 25-6 because, while the instrument is issued in the form of shares (i.e., preferred shares), it (1) does not embody an unconditional obligation that requires the issuer to redeem the instrument by transferring assets (i.e., it contains a contingent put option), and (2) does not contain a specific date, a determinable date, or an event certain to occur upon which assets are required to be transferred (i.e., it contains an event upon which the holder may put the preferred shares).
Q&A 3.11: Company A issues common shares to its employees. By its terms, each share is puttable by the holder upon the death, termination, or retirement of the employee and callable by the issuer upon the death, termination, or retirement of the employee.

Q. Assuming the options are not nonsubstantive or minimal, are the shares within the scope of ASC Topic 480?

A. No. A share of stock that is contingently puttable by the holder and contingently callable by the issuer is not a mandatorily redeemable instrument under the provisions of ASC paragraphs 480-10-25-4 and 25-6 because, while the instrument is issued in the form of shares (i.e., common shares), it (1) does not embody an unconditional obligation that requires the issuer to redeem the instrument by transferring assets (i.e., it contains a contingent put and a contingent call option), and (2) does not contain a specific date, a determinable date, or an event certain to occur upon which assets are required to be transferred (i.e., it contains an event upon which Company A may call the common shares and an event upon which the employee may put the common shares).
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INTRODUCTION

4.000 This section discusses the second class of freestanding financial instruments that are within the scope of ASC Topic 480–instruments that embody obligations to repurchase the issuer’s equity shares by transferring assets. Instruments, other than outstanding shares, that, at inception, embody an obligation to repurchase the issuer’s equity shares (or are indexed to such an obligation) and require or may require the issuer to settle the obligation by transferring assets are within the scope of ASC Topic 480 because such instruments embody obligations that meet the definition of a liability and satisfy the recognition criteria.

INSTRUMENTS WITHIN THE SCOPE OF ASC TOPIC 480

4.001 ASC paragraphs 480-10-25-8 through 25-10 and 25-12 describe freestanding instruments that embody an obligation to repurchase the issuer’s equity shares that are within its scope.

A financial instrument, other than an outstanding share, that, at inception, (a) embodies an obligation to repurchase the issuer’s equity shares, or is indexed to¹ such an obligation, and (b) requires or may require the issuer to settle the obligation by transferring assets shall be classified as a liability (or an asset in some circumstances²). Examples include forward purchase contracts or written put options on the issuer’s equity shares that are to be physically settled or net cash settled.

4.002 ASC paragraphs 480-10-25-8 through 25-10 and 25-12 indicate that a financial instrument is required to be classified as a liability if (1) it is not an outstanding share of the issuer, (2) it embodies an obligation, at inception, to repurchase the issuer’s equity shares, or is indexed to such an obligation, and (3) requires or may require, at inception, the issuer to settle the obligation by transferring its assets.

¹ In ASC Topic 480, indexed to is used interchangeably with based on variations in the fair value of.
² Certain financial instruments that embody obligations that are liabilities within the scope of ASC Topic 480 also may contain characteristics of assets but be reported as single items. (ASC paragraph 480-10-25-12). Some examples include net cash settled or net share settled forward purchase contracts and certain combined options to repurchase the issuer’s shares. Those instruments are classified as assets or liabilities initially or subsequently depending on the instrument’s fair value on the reporting date.
The first characteristic of a freestanding financial instrument that is within the scope of ASC paragraphs 480-10-25-8 through 25-10 and 25-12 is that the instrument is not an outstanding share of the issuer. While common shares and preferred shares are two well-known types of shares, for purposes of applying ASC Topic 480, shares also include various forms of ownership that may not take the legal form of securities, as well as other interests, including those that are liabilities in substance but not in form. Business enterprises have interest holders that are commonly known by specialized names, such as stockholders, partners, LLC members, and proprietors, and, by more general names, such as investors, but all are considered owners. Equity of business enterprises is, thus, commonly known by several names, such as owners’ equity, stockholders’ equity, ownership, equity capital, partners’ capital, LLC members’ interests, and proprietorship. Some enterprises (for example, mutual organizations) do not have stockholders, partners, LLC members, or proprietors in the usual sense of those terms but do have participants whose interests are essentially ownership interests, retained interests, or both.

As a result, outstanding common and preferred shares as well as outstanding partnership interests of an issuer are not within the scope of ASC paragraphs 480-10-25-8 through 25-10 and 25-12. However, such instruments may be within the scope of ASC paragraphs 480-10-25-4 through 25-6 (see Section 3 for additional information) or ASC paragraph 480-10-25-14 (see Section 5 for additional information).

The second characteristic of a freestanding financial instrument that is within the scope of ASC paragraphs 480-10-25-8 through 25-10 and 25-12 is that the instrument embodies an obligation, at inception, to repurchase the issuer’s equity shares, or is indexed to such an obligation. If, at inception, a financial instrument contains a duty or responsibility on the part of the issuer that may require it to repurchase its equity shares, or is indexed to such an obligation, the instrument meets this characteristic. That duty or responsibility can be a conditional obligation or an unconditional obligation. For purposes of determining if an instrument is indexed to the repurchase of an issuer’s equity shares, the issuer should evaluate whether the instrument is based on variations in the fair value of an obligation to repurchase its equity shares.

The third characteristic of a freestanding financial instrument that is within the scope of ASC paragraphs 480-10-25-8 through 25-10 and 25-12 is that the instrument, at inception, requires or may require the issuer to settle its duty or responsibility by transferring its assets. That is, if there is any possibility that the issuer could be required to settle the conditional or unconditional obligation by transferring its assets (for example, cash), the instrument meets this characteristic.

Freestanding financial instruments within the scope of ASC paragraphs 480-10-25-8 through 25-10 and 25-12 meet the current definition of liabilities in Concepts Statement 6 and satisfy the recognition criteria in Concepts Statement 5.
Physical Settlement

4.008 Instruments within the scope of ASC paragraphs 480-10-25-8 through 25-10 and 25-12 may be physically settled. As discussed in Paragraph 1.015 of Section 1, physical settlement is 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. The following examples illustrate the application of ASC paragraphs 480-10-25-8 through 25-10 and 25-12 to financial instruments that are physically settled:

Example 4.1: Forward Purchase Contract

Background

On March 1, 20X3, Company A enters into a forward contract to purchase its own shares on March 1, 20X4. The terms of the contract require Company A to pay $1,000 cash to the counterparty in exchange for 50 shares of its common stock.

Analysis

The instrument is within the scope of ASC paragraphs 480-10-25-8 through 25-10 and 25-12 because the instrument (a) is not an outstanding share of the issuer (i.e., it is a forward purchase contract), (b) embodies an obligation, at inception, such that Company A is required to repurchase its own shares (i.e., in this case it represents an unconditional obligation), and (c) requires Company A to settle the obligation by transferring its assets (i.e., $1,000 cash).

Example 4.2: Forward Sales Contract

Background

On March 1, 20X3, Company A enters into a forward contract to sell its own shares on March 1, 20X4. The terms of the contract require Company A to deliver 50 shares of its common stock to the counterparty in exchange for $1,000 cash.

Analysis

The instrument is not within the scope of ASC paragraphs 480-10-25-8 through 25-10 and 25-12 because, while the instrument is not an outstanding share of the issuer (i.e., it is a forward sales contract), it (a) does not embody an obligation such that Company A will repurchase its own shares (i.e., it represents an unconditional obligation for Company A to sell its own shares), and (b) does not require
Company A to settle the obligation by transferring its assets (i.e., Company A will settle the obligation by transferring a fixed number of its shares and receiving $1,000 cash).

While this instrument is not within the scope of ASC Topic 480, other authoritative guidance is required to be evaluated to determine the appropriate classification, measurement, and disclosure of the financial instrument (e.g., ASC Topic 815 and ASC Subtopic 815-40; ASC paragraph 480-10-55-63).

**Example 4.3: Written Put Option Contract**

**Background**

On March 1, 20X3, Company A writes an option contract. The terms of the contract allow the counterparty, at its option, to sell (put) 50 shares of Company A’s common stock to Company A in exchange for $1,000 cash at any time during the next year.

**Analysis**

The instrument is within the scope of ASC paragraphs 480-10-25-8 through 25-10 and 25-12 because the instrument (a) is not an outstanding share of the issuer (i.e., it is an option contract), (b) embodies an obligation, at inception, such that Company A is required to repurchase its own shares if the holder exercises the option (i.e., in this case it represents a conditional obligation), and (c) requires Company A to settle the obligation by transferring its assets (i.e., $1,000 cash).

**Example 4.4: Written Call Option Contract**

**Background**

On March 1, 20X3, Company A writes an option contract. The terms of the contract allow the counterparty, at its option, to purchase (call) 50 shares of Company A’s common stock from Company A in exchange for $1,000 cash at any time during the next year.

**Analysis**

The instrument is not within the scope of ASC paragraphs 480-10-25-8 through 25-10 and 25-12 because, while the instrument is not an outstanding share of the issuer (i.e., it is an option contract), it (a) does not embody an obligation such that Company A will repurchase its own shares if the holder exercises the option (i.e., it represents a conditional obligation for Company A to sell its own shares), and (b)
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does not require Company A to settle the obligation by transferring its assets (i.e., Company A will settle the obligation by transferring a fixed number of its shares and receiving $1,000 cash).

While this instrument is not within the scope of ASC Topic 480, other authoritative guidance is required to be evaluated to determine the appropriate classification, measurement, and disclosure of the financial instrument (e.g., ASC Topic 815 and ASC Subtopic 815-40; ASC paragraph 480-10-55-63).

Net Cash Settlement

4.009 Instruments within the scope of ASC paragraphs 480-10-25-8 through 25-10 and 25-12 may be net cash settled. As discussed in Paragraph 1.015 of Section 1, net cash settlement is a form of settling a financial instrument in which the party with a loss delivers to the party with a gain cash equal to the gain. The following examples illustrate the application of ASC paragraphs 480-10-25-8 through 25-10 and 25-12 to financial instruments that are net cash settled:

Example 4.5: Forward Purchase Contract

Background

On March 1, 20X3, Company A enters into a forward contract to purchase its own shares on March 1, 20X4. The terms of the contract require that if the common share price of Company A on March 1, 20X4 is greater than $20, Company A will receive from the counterparty 50 times the amount above $20, in cash; however, if the common share price of Company A on March 1, 20X4 is less than $20, Company A will pay the counterparty 50 times the amount below $20, in cash.

Analysis

The instrument is within the scope of ASC paragraphs 480-10-25-8 through 25-10 and 25-12 because the instrument (a) is not an outstanding share of the issuer (i.e., it is a forward purchase contract), (b) embodies an obligation, at inception, that is indexed to an obligation such that Company A is required to repurchase its own shares (i.e., in this case it represents a conditional obligation), and (c) may require Company A to settle the obligation by transferring its assets (i.e., if Company A’s common share price is less than $20, Company A is required to transfer cash).

Even though Company A may not be required to settle the instrument by transferring its assets in all cases (i.e., Company A will receive cash if its common share price is greater than $20), the instrument is within the scope of ASC paragraphs 480-10-25-8 through 25-10 and 25-12 because, at inception, the contract may require Company A to settle by transferring its assets.
Example 4.6: Forward Sales Contract

Background

On March 1, 20X3, Company A enters into a forward contract to sell its own shares on March 1, 20X4. The terms of the contract require that if the common share price of Company A on March 1, 20X4 is less than $20, Company A will receive from the counterparty 50 times the amount below $20, in cash; however, if the common share price of Company A on March 1, 20X4 is greater than $20, Company A will pay the counterparty 50 times the amount above $20, in cash.

Analysis

The instrument is not within the scope of ASC paragraphs 480-10-25-8 through 25-10 and 25-12 because, while the instrument (a) is not an outstanding share of the issuer (i.e., it is a forward sales contract), and (b) may require Company A to settle the obligation by transferring its assets (i.e., if Company A’s share price is greater than $20, Company A is required to transfer cash), the instrument does not embody an obligation (and it is not indexed to an obligation) such that Company A is required to repurchase its own shares (i.e., it represents a conditional obligation for Company A to sell its own shares).

While this instrument is not within the scope of ASC Topic 480, other authoritative guidance is required to be evaluated to determine the appropriate classification, measurement, and disclosure of the financial instrument (e.g., ASC Topic 815 and ASC Subtopic 815-40; ASC paragraph 480-10-55-63).

Example 4.7: Written Put Option Contract

Background

On March 1, 20X3, Company A writes an option contract. The terms of the contract allow the counterparty, at its option, to sell (put) 50 shares of Company A’s common stock to Company A at any time during the next year. If the counterparty exercises the option, the terms of the contract require that if the common share price of Company A on the exercise date is less than $20, then Company A will pay the counterparty 50 times the amount below $20, in cash.

Analysis

The instrument is within the scope of ASC paragraphs 480-10-25-8 through 25-10 and 25-12 because the instrument (a) is not an outstanding share of the issuer (i.e., it is an option contract), (b) embodies an obligation, at inception, that is indexed to an obligation such that Company A is required to repurchase its own shares if the holder exercises the option (i.e., in this case it represents a conditional obligation),
and (c) may require Company A to settle the obligation by transferring its assets (i.e., if Company A’s common share price is less than $20, Company A is required to transfer cash).

Example 4.8: Written Call Option Contract

Background

On March 1, 20X3, Company A writes an option contract. The terms of the contract allow the counterparty, at its option, to buy (call) 50 shares of Company A’s common stock from Company A at any time during the next year. If the counterparty exercises the option, the terms of the contract require that if the common share price of Company A on the exercise date is greater than $20, then Company A will pay the counterparty 50 times the amount above $20, in cash.

Analysis

The instrument is not within the scope of ASC paragraphs 480-10-25-8 through 25-10 and 25-12 because, while the instrument (a) is not an outstanding share of the issuer (i.e., it is an option contract), and (b) will require the issuer to settle the obligation by transferring its assets if the holder exercises the option (i.e., if Company A’s share price is greater than $20, Company A is required to transfer cash), the instrument does not embody an obligation (and it is not indexed to an obligation) such that Company A is required to repurchase its own shares (i.e., it represents a conditional obligation for Company A to sell its own shares).

While this instrument is not within the scope of ASC Topic 480, other authoritative guidance is required to be evaluated to determine the appropriate classification, measurement, and disclosure of the financial instrument (e.g., ASC Topic 815 and ASC Subtopic 815-40; ASC paragraph 480-10-55-63).

CLASSIFICATION

4.010 While an instrument within the scope of ASC Topic 480 generally is required to be classified as a liability, an instrument within the scope of ASC paragraphs 480-10-25-8 through 25-10 and 25-12 may be classified as a liability or, in certain circumstances, an asset.

4.011 Forward purchase contracts are not outstanding shares of the issuer. Forward purchase contracts that are required to be physically settled by delivering cash in exchange for a fixed number of shares embody an unconditional obligation to transfer cash to pay the full repurchase price and, thus, are within the scope of ASC paragraphs 480-10-25-8 through 25-10 and 25-12. Such forward contracts are akin to a treasury share purchase using borrowed funds, that is, such a forward contract effectively converts the...
shares that the counterparty is required to deliver into mandatorily redeemable instruments, which are required to be classified as a liability under ASC Topic 480 (see Section 3 for additional information). As a result, forward contracts that are required to be physically settled by delivering cash in exchange for a fixed number of the issuer’s equity shares are always classified as a liability under ASC paragraphs 480-10-25-8 through 25-10 and 25-12. See Paragraphs 9.008–9.014 of Section 9 for additional information.

4.012 In contrast, other kinds of contracts to repurchase an issuer’s equity shares embody conditional obligations for the issuer to transfer cash. For example, forward purchase contracts that must or can be net cash settled embody obligations that are indexed to the repurchase of an issuer’s equity shares. Such contracts require the issuer to transfer assets if the fair value of the forward purchase contract at the settlement date places the issuer in a loss position. However, if the fair value of the forward purchase contract at the settlement date places the issuer in a gain position, the issuer will receive assets and will not have to transfer anything. As a result, a forward purchase contract within the scope of ASC paragraphs 480-10-25-8 through 25-10 and 25-12 that must or can be net cash settled may be an asset or a liability for the issuer.

4.013 Other purchase contracts within the scope of ASC paragraphs 480-10-25-8 through 25-10 and 25-12 also embody obligations that are conditional, whether settled physically or by a net cash payment, but cannot be classified as assets. For example, the issuer might have to transfer assets if the holder of a put option exercises its option, but the issuer will not have to transfer assets if that put option expires unexercised. In either case, except for the premium received for writing the option, the issuer is not entitled to receive assets from the counterparty under any condition. As a result, such contracts that are within the scope of ASC paragraphs 480-10-25-8 through 25-10 and 25-12 that must or can be physically settled or that must or can be net cash settled generally will be a liability for the issuer.

QUESTIONS AND ANSWERS

Q&A 4.1: Company A issues common shares on July 1, 20X0. The shares are puttable for cash by the counterparty any time after July 1, 20X5 pursuant to put rights embedded in the shares.

Q. Assuming the put option is not nonsubstantive or minimal, are the instruments within the scope of ASC Topic 480?

A. No. The instruments are not mandatorily redeemable under ASC paragraphs 480-10-25-4 and 25-6 because, while the instrument is issued in the form of shares (i.e., common shares), it (1) does not embody an unconditional obligation that requires the issuer to redeem the instrument by transferring assets (i.e., it contains a
Obligations to Repurchase the Issuer’s Equity Shares by Transferring Assets

put option that is exercisable at the holder’s discretion), and (2) does not contain a specific date on which assets are required to be transferred (i.e., it indicates the dates on which the holder may put the common shares).

Even though the instrument, at inception, (1) embodies an obligation for Company A to repurchase its equity shares (i.e., in this case it represents a conditional obligation), and (2) may require Company A to settle the obligation by transferring its assets, the put option is embedded within an outstanding equity share and any outstanding share, regardless of its embedded features, is not within the scope of ASC paragraphs 480-10-25-8 through 25-10 and 25-12.

If the put option were a freestanding instrument, the put option would be accounted for as a liability pursuant to ASC paragraphs 480-10-25-8 through 25-10 and 25-12 because it would (1) not be an outstanding share, (2) embody an obligation that is indexed to an obligation such that Company A is required to repurchase its own shares, and (3) may require Company A to settle the obligation by transferring its assets.

Q&A 4.2: Company A issues preferred shares on July 1, 20X0. The shares are puttable for cash upon the death of the holder pursuant to put rights embedded in the shares.

Q. Assuming the put option is not nonsubstantive or minimal, are the instruments within the scope of ASC Topic 480?

A. No. A share of stock that is contingently puttable by the holder does not cause the stock to be mandatorily redeemable under the provisions of ASC paragraphs 480-10-25-4 and 25-6 because, while the instrument is issued in the form of shares (i.e., preferred shares), it (1) does not embody an unconditional obligation that requires the issuer to redeem the instrument by transferring assets (i.e., it contains a contingent put option that is exercisable at the holder’s option), and (2) does not contain a specific date (or an event certain to occur) upon which assets are required to be transferred (i.e., it indicates an event upon which the holder may put the preferred shares).

Even though the instrument, at inception, (1) embodies an obligation for Company A to repurchase its equity shares (i.e., in this case it represents a conditional obligation), and (2) may require Company A to settle the obligation by transferring its assets, the contingent put option is embedded within an outstanding equity share. Any outstanding share, regardless of its embedded features, is not within the scope of ASC paragraphs 480-10-25-8 through 25-10 and 25-12.

If the put option were a freestanding instrument, the put option would be accounted for as a liability pursuant to ASC paragraphs 480-10-25-8 through 25-10 and 25-12 because it would (1) not be an outstanding share, (2) embody an obligation that is
indexed to an obligation such that Company A is required to repurchase its own shares, and (3) may require Company A to settle the obligation by transferring its assets.

**Q&A 4.3:** Company A contracts with a broker to acquire a specified number of the company's shares based on ranges of market prices, over a six-month period, at a price equal to the then-market price on the date of acquisition. The contract is cancellable by the company or the broker at any time.

**Q.** Has the Company incurred a liability within the scope of ASC Topic 480?

**A.** No. A contract to acquire the Company's shares on the open market at a price equal to the then-market price on the date of acquisition, which is cancellable by the company at any time for any reason, does not embody an obligation requiring liability accounting under ASC Topic 480. The contract requires the broker to acquire a specified number of shares based on ranges of market prices over a six-month period. If the market price does not trade within the specified range, no shares will be acquired. Under the contract, the company acquires its shares at the then-market price and the broker has no risk of loss or ability to gain from market movements. The broker receives only a fixed fee per share acquired. The contract in this Q&A differs from financial instruments often associated with share repurchases. For example, a forward contract to acquire shares, or a put option that forces the company to acquire shares if exercised, leaves the company no choice but to acquire its shares regardless of the then market price.

This contract is not a financial instrument based on (1) ASC paragraph 480-10-25-8, which outlines the characteristics necessary for a financial instrument to be classified as a liability in circumstances when a company has an obligation to repurchase its shares by transferring assets, and (2) the definition of a financial instrument in ASC Section 480-10-20. It does not impose on the company a contractual obligation to acquire shares and does not convey to the broker a contractual right to receive cash, until the point in time when the broker executes the contract (i.e., acquires the shares on the open market). Only at the time that the broker acquires the shares does the company have an obligation to pay cash to the broker in exchange for the shares. If the liability is outstanding at the end of a reporting period (for instance, if the transaction has not yet settled), the company should record a liability for that specific obligation.

ASC Topic 815 also is not applicable because the contract does not represent a financial instrument.
5. Certain Obligations to Issue a Variable Number of Shares

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INTRODUCTION

5.000 This section discusses the third, and final, class of freestanding financial instruments that is within the scope of ASC Topic 480--instruments that embody obligations that the issuer can settle by issuing its equity shares. Obligations that the issuer can or must settle by issuing its equity shares do not meet the current definition of liabilities because, although those instruments embody an obligation and the obligation arises from a past event, the issuer can avoid having to transfer assets. Despite this, ASC Topic 480 requires that a financial instrument that embodies an unconditional obligation (or a financial instrument other than an outstanding share that embodies a conditional obligation) that the issuer must or may settle by issuing a variable number of its equity shares be classified as a liability (or an asset in some circumstances) if, at inception, the monetary value of the obligation is based solely or predominantly on any one of the following: (1) a fixed monetary amount known at inception, (2) variations in something other than the fair value of the issuer’s equity shares, or (3) variations inversely related to changes in the fair value of the issuer’s equity shares.

INSTRUMENTS WITHIN THE SCOPE OF ASC TOPIC 480

5.001 ASC paragraph 480-10-25-14 describes freestanding instruments that embody an obligation that the issuer can settle by issuing its equity shares that are within its scope.

A financial instrument that embodies an unconditional obligation, or a financial instrument other than an outstanding share that embodies a conditional obligation, that the issuer must or may settle by issuing a variable number of its equity shares shall be classified as a liability (or an asset in some circumstances) if, at inception, the monetary value of the obligation is based solely or predominantly on any one of the following:

a. A fixed monetary amount known at inception (for example, a payable settleable with a variable number of the issuer’s equity shares)

b. Variations in something other than the fair value of the issuer’s equity shares (for example, a financial instrument indexed to the S&P 500 and settleable with a variable number of the issuer’s equity shares)

c. Variations inversely related to changes in the fair value of the issuer’s equity shares (for example, a written put option that could be net share settled).

5.002 ASC paragraph 480-10-25-14 indicates that a financial instrument is required to be classified as a liability if (1) it embodies an unconditional obligation or, if it is not an outstanding share, a conditional obligation, (2) it requires or may require the issuer to settle the obligation by issuing a variable number of its equity shares, and (3) the monetary value, at inception, is based solely or predominantly on one of three factors.
The first characteristic of a freestanding financial instrument that is within the scope of ASC paragraph 480-10-25-14 is that the instrument embodies an obligation. If a financial instrument contains a duty or responsibility on the part of the issuer, the instrument meets this requirement. That duty or responsibility can be a conditional obligation or an unconditional obligation. If that duty or responsibility is an unconditional obligation, the financial instrument can be an outstanding share of the issuer or any other financial instrument and meet the first characteristic. However, if that duty or responsibility is a conditional obligation and the financial instrument is an outstanding share of the issuer, the financial instrument is not within the scope of ASC paragraph 480-10-25-14. The following example illustrates the application of the first characteristic ASC paragraph 480-10-25-14:

Example 5.1: Puttable Preferred Shares

Background

Company A issues preferred shares on January 1, 20X1. After December 31, 20X5, the holder can put the preferred shares back to Company A and receive a variable number of Company A’s common shares with a fair value of $1,000 at the settlement date.

Analysis

The instruments are not within the scope of ASC paragraph 480-10-25-14 because, while the instruments contain an obligation (to deliver a variable number of the issuer’s shares), it is a conditional obligation. Conditional obligations embodied within an outstanding share (preferred shares, in this case) are not within the scope of ASC paragraph 480-10-25-14.

The second characteristic of a freestanding financial instrument that is within the scope of ASC paragraph 480-10-25-14 is that the instrument requires or may require the issuer to settle the obligation by issuing a variable number of its equity shares. Obligations that the issuer can or must settle by issuing its equity shares do not meet the current definition of liabilities in Concepts Statement 6 because, although those instruments embody an obligation and the obligation arises from a past event, the issuer can avoid transferring assets.

Certain share-settled obligations establish relationships that have little, if anything, in common with ownership interests. For that reason, the Board decided that certain share-settled obligations should be classified as liabilities rather than as equity. That is, a financial instrument could be within the scope of ASC paragraph 480-10-25-14 if it requires or permits the issuer to settle its obligation by issuing a variable number of its equity shares in which the holder is not exposed to the risks and benefits that are similar to those that a holder of an outstanding share of the issuer’s equity is exposed.
Including this characteristic within ASC paragraph 480-10-25-14 represents a fundamental change to existing guidance. Prior to ASC Topic 480, financial instruments embodying obligations that required, or gave the issuer the discretion, to settle in its equity shares may have been classified as equity instruments (e.g., in accordance with the provisions of ASC Subtopic 815-40, Derivatives and Hedging - Contracts in Entity's Own Equity; ASC paragraph 480-10-55-63). Previous accounting guidance rationalized equity classification because a transfer of assets was not required even though the benefits and risks associated with an ownership interest did not exist.

Obligations that require the issuer to issue its equity shares were classified as equity under the original definitions in Concepts Statement 6. However, to be classified in equity, the Board generally believes that an obligation must expose the holder of the instrument that embodies that obligation to certain risks and benefits that are similar to those to which an owner (that is, a holder of an outstanding share of the entity’s equity) is exposed. In determining whether an owner benefits, one must consider whether the owner’s investment increases in value, not whether the entity is profitable. The value of an owner’s investment changes in response to changes in the fair value of the entity’s equity shares. Therefore, the Board believes that exposure to changes in the fair value of the issuer’s equity shares is a characteristic of an ownership relationship because that fair value reflects the realizable benefits of owners that are within their control. Therefore, for purposes of classifying an obligation that requires settlement by issuance of the issuer’s equity shares, the distinction between obligations that are liabilities under ASC Topic 480 and similar obligations that are not within the scope of ASC Topic 480 is based on the relationship between the value that the holder of the instrument that embodies the obligation is entitled to receive upon settlement of the obligation and the value of the underlying equity shares. The Board developed the notion of monetary value to assist in determining whether the risks or benefits from changes in fair value of the issuer’s equity shares to which a holder of a financial instrument that embodies an obligation is exposed are similar to those to which a holder of outstanding shares is exposed.

As discussed in Paragraphs 1.021–1.024 of Section 1, monetary value is what the fair value of the cash, shares, or other instruments that a financial instrument obligates the issuer to convey to the holder would be at the settlement date under specified market conditions. That is, the focus of the monetary value of a financial instrument is on the fair value the holder receives at settlement of the financial instrument and not on the amount of cash or other assets the holder is required to pay, under the terms of the financial instrument, at settlement.

The third characteristic of a freestanding financial instrument that is within the scope of ASC paragraph 480-10-25-14 is that the monetary value, at inception, of the obligation is based solely or predominantly on one or more of the following:

- A fixed monetary amount at inception;
- Variations in something other than the fair value of the issuer’s equity shares; or
• Variations inversely related to changes in the fair value of the issuer’s equity shares.

5.010 Generally, instruments within the scope of ASC paragraph 480-10-25-14 are akin to a debtor/creditor relationship, provide the holder with a return unrelated to changes in the fair value of the issuer’s equity shares, or establish a relationship opposite that of an ownership relationship.

Fixed Monetary Amount at Inception

5.011 If the monetary value of a financial instrument is based upon a fixed monetary amount such that the value the holder will receive (in shares) is solely or predominantly fixed at inception of the contract and the holder will receive a variable number of shares that will equal that fixed amount at the settlement date of the contract, the obligation is within the scope of ASC paragraph 480-10-25-14(a). Because the number of shares to be issued varies based on the fair value of those shares such that the holder will receive a fixed dollar amount in value that is known at inception, the instrument does not establish an ownership relationship. That is, the holder does not benefit like an existing ownership interest if the fair value of the issuer’s equity shares increases and the holder does not bear the risk like an existing ownership interest if the fair value of those shares decreases. In addition, even though the obligation will be settled by issuance of equity shares, the instrument has more characteristics of a liability than of equity because the holder’s return is fixed, and, thus, unrelated to changes in the fair value of the issuer’s equity shares.

5.012 Some share-settled obligations of this kind require that the variable number of shares to be issued be based on an average market price for the shares over a stated period of time, such as the average over the last 30 days prior to settlement, instead of the fair value of the issuer’s equity shares on the date of settlement. Thus, if the average market price differs from the share price on the date of settlement, the monetary value of the obligation is not entirely fixed at inception and is based, in small part, on variations in the fair value of the issuer’s equity shares. Although the monetary amount of the obligation at settlement may differ from the initial monetary value because it is tied to the change in fair value of the issuer’s equity shares over the last 30 days prior to settlement, the monetary value of the obligation is predominantly based on a fixed monetary amount known at inception and the obligation is classified as a liability under ASC paragraph 480-10-25-14(a).

5.013 The following example illustrates the application of ASC paragraph 480-10-25-14(a)
Example 5.2: Stock Settled Debt

Background

On January 1, 20X1, Company A issues a debt instrument to Company B in exchange for $95,000. The terms of the instrument require Company A to deliver on December 31, 20X1 a variable number of its common shares to Company B that have a fair value of $100,000.

Analysis

The instrument is within the scope of ASC paragraph 480-10-25-14 because the financial instrument (1) embodies an unconditional obligation, (2) requires Company A to settle the unconditional obligation by issuing a variable number of its common shares, and (3) has a monetary value, at inception, that is based solely on a fixed monetary amount known at inception (i.e., the holder will receive $100,000 in Company A common shares on December 31, 20X1).

Regardless of changes in the fair value of Company A common shares, Company B will receive $100,000 of value at settlement—that is, the monetary value of the obligation does not change. The holder of the instrument does not benefit if the fair value of the issuer’s equity shares increases and does not bear the risk that the fair value of those shares might decrease. Such instruments are classified as a liability under the provisions of ASC paragraph 480-10-25-14 because they do not establish an ownership relationship. That is, even though the obligation will be settled by issuance of equity shares, the instrument has more characteristics of a liability than of equity because the holder’s return is fixed and, thus, unrelated to changes in the fair value of the issuer’s equity shares.

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

5.014 If the monetary value is based upon variations in something other than the issuer’s equity shares (such that the value the holder will receive (in shares) is based solely or predominantly on variations in something other than the fair value of the issuer’s equity shares) and the holder will receive a variable number of shares that will equal that variation at the settlement date of the contract, the obligation is within the scope of ASC paragraph 480-10-25-14(b). In such instruments, the fair value of what the holder receives is unrelated to changes in the fair value of the issuer’s equity shares and the holder does not benefit like an existing ownership interest if the fair value of the issuer’s equity shares increases and the holder does not bear the risk like an existing ownership interest if the fair value of those shares decreases. That is, even though the obligation will be settled by issuance of equity shares, the instrument has more characteristics of a
liability than of equity because the holder’s return is unrelated to changes in the fair value of the issuer’s equity shares.

5.015 An entity’s guarantee of the value of an asset, liability, or equity security of another entity may require or permit settlement in the guarantor’s equity shares. For example, an entity may guarantee that the value of a counterparty’s equity investment in another entity will not fall below a specified level. The guarantee contract requires that the guarantor stand ready to issue a variable number of its shares whose fair value equals the deficiency, if any, on a specified date between the guaranteed value of the investment and its current fair value. Upon issuance, unless the guarantee is accounted for as a derivative, the obligation to stand ready to perform is a liability addressed by ASC Subtopic 460-10, Guarantees - Overall. If, during the period the contract is outstanding, the fair value of the guaranteed investment falls below the specified level, absent an increase in value, the guarantor will be required to issue its equity shares. At that point in time, the liability recognized in accordance with ASC Subtopic 460-10 would be subject to the requirements of ASC Topic 450, Contingencies. Even though the loss contingency is settleable in equity shares, the obligation under ASC Topic 450 is a liability under ASC paragraph 480-10-25-14(b) until the guarantor settles the obligation by issuing its shares. The liability exists because the guarantor’s conditional obligation to issue shares is based on the value of the counterparty’s equity investment in another entity and not on changes in the fair value of the guarantor’s equity instruments.

5.016 If the example in the previous paragraph were changed so that the monetary value of the obligation is based on (1) the deficiency on a specified date between the guaranteed value of the investment in another entity and its current fair value plus (2) .005 times the change in value of 100 of the guarantor’s equity shares, the monetary value of the obligation would not be solely based on variations in something other than the fair value of the issuer’s (guarantor’s) equity shares. However, the monetary value of the obligation generally would be predominantly based on variations in something other than the fair value of the issuer’s (guarantor’s) equity shares and, therefore, the obligation generally would be classified as a liability under ASC paragraph 480-1025-14(b). That obligation differs in degree from the obligation under a contract that is indexed in part to the issuer’s shares and in part (but not predominantly) to something other than the issuer’s shares (commonly called a dual-indexed obligation). The latter contract is not within the scope of ASC Topic 480. That is, ASC paragraph 480-10-25-14(b) applies only if the monetary value of an obligation to issue equity shares is based solely or predominantly on variations in something other than the fair value of the issuer’s equity shares.

5.017 The following example illustrates the application of ASC paragraph 480-10-25-14(b):
Example 5.3: S&P Option

Background

On January 1, 20X1, Company A writes an option contract to Company B. The terms of the option contract provide that, upon exercise by Company B, Company A will deliver a variable number of its common shares to Company B that will have a fair value equal to any decrease in the S&P 500 Index from January 1, 20X1 to June 30, 20X1.

Analysis

The instrument is within the scope of ASC paragraph 480-10-25-14 because the financial instrument (1) embodies a conditional obligation and is not an outstanding share of stock (i.e., it is an option contract), (2) requires Company A to settle the conditional obligation by issuing a variable number of its common shares, and (3) has a monetary value, at inception, that is based solely on variations in something other than the fair value of Company A’s common shares (i.e., the holder will receive a variable number of Company A common shares with a fair value equal to the decrease in the S&P 500 Index).

Even though the obligation will be settled by issuance of equity shares, the instrument is within the scope of ASC paragraph 480-10-25-14. The holder of the instrument does not benefit if the fair value of the issuer’s equity shares increases and does not bear the risk if the fair value of those shares decreases. Such instruments are classified as liabilities under the provisions of ASC paragraph 480-10-25-14 because they do not establish an ownership relationship. That is, even though the obligation will be settled by issuance of equity shares, the instrument has more characteristics of a liability than of equity because the holder’s return is not based on, and is unrelated to, changes in the fair value of the issuer’s equity shares.

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

5.018 If the monetary value is based upon variations inversely related to changes in the fair value of the issuer’s equity shares such that the value the holder will receive (in shares) is (1) based solely or predominantly on variations inversely related to changes in the fair value of the issuer’s equity shares and (2) the holder will receive a variable number of shares that will equal that variation at the settlement date of the contract, the obligation is within the scope of ASC paragraph 480-10-25-14(c). In such instruments, the fair value of what the holder receives generally increases as the issuer’s equity shares decrease in value and the fair value of what the holder receives generally decreases as the
issuer’s equity shares increase in value. Said another way, the holder generally bears an inverse risk to the risk borne by an existing ownership interest in the entity.

5.019 For example, forward purchase contracts, written put options, or net written (or purchased or zero-cost) options or collars that require or permit net share settlement are instruments in which the monetary value may vary inversely with changes in the fair value of the issuer’s equity shares. Even though the issuer’s equity shares will be issued in settlement of the obligation, the obligation is within the scope of ASC paragraph 480-10-25-14(c) because the instrument does not establish an ownership relationship. That occurs even though the obligation will be settled by issuance of equity shares because the interests of holders of those instruments are opposite to those of holders of the issuer’s equity shares.

5.020 Instruments within the scope of ASC paragraph 480-10-25-14 may be net share settled. As discussed in Paragraph 1.015 of Section 1, net share settlement is a form of settling a financial instrument in 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. The following examples illustrate the application of ASC paragraph 480-10-25-14(c) to financial instruments that are net share settled:

**Example 5.4: Forward Purchase Contract**

**Background**

On March 1, 20X3, Company A enters into a forward contract to purchase its own shares on March 1, 20X4. The terms of the contract require that if the common share price of Company A on March 1, 20X4 is greater than $20, Company A will receive from the counterparty a variable number of its shares with a fair value equal to 50 times the amount above $20; however, if the common share price of Company A on March 1, 20X4 is less than $20, Company A will deliver to the counterparty a variable number of its shares with a fair value equal to 50 times the amount below $20.

**Analysis**

The instrument is within the scope of ASC paragraph 480-10-25-14 because the instrument (1) embodies a conditional obligation and is not an outstanding share of stock, (2) may require Company A to settle the conditional obligation by delivering a variable number of its common shares, and (3) has a monetary value, at inception, that is based solely on variations inversely related to changes in the fair value of its common shares (i.e., if Company A’s common share price is less than $20, Company A is required to transfer a variable number of its shares).

Even though Company A may not be required to settle the instrument by transferring a variable number of its common shares in all cases (i.e., Company A will receive a variable number of its common shares if its common share price is greater than $20 at settlement), the instrument is within the scope of ASC paragraph 480-10-25-14(c).
paragraph 480-10-25-14(c) because, at inception, the contract may require Company A to settle by transferring a variable number of its shares.

Example 5.5: Forward Sales Contract

Background

On March 1, 20X3, Company A enters into a forward contract to sell its own shares on March 1, 20X4. The terms of the contract require that if the common share price of Company A on March 1, 20X4 is less than $20, Company A will receive from the counterparty a variable number of its shares with a fair value equal to 50 times the amount below $20; however, if the common share price of Company A on March 1, 20X4 is greater than $20, Company A will deliver to the counterparty a variable number of its common shares with a fair value equal to 50 times the amount above $20.

Analysis

The instrument is not within the scope of ASC paragraph 480-10-25-14 because while the instrument (a) embodies a conditional obligation and is not an outstanding share of stock, and (b) may require the issuer to settle the obligation by transferring a variable number of its common shares (i.e., if Company A’s share price is greater than $20, Company A is required to transfer a variable number of its common shares with a fair value equal to 50 times the amount above $20), the monetary value, at inception, is based solely on variations directly related to changes in the fair value of its common shares.

While this instrument is not within the scope of ASC Topic 480, other authoritative guidance is required to be evaluated to determine the appropriate classification, measurement, and disclosure of the financial instrument (e.g., ASC Topic 815 and ASC Subtopic 815-40; ASC paragraph 480-10-55-63).

Example 5.6: Written Put Option Contract

Background

On March 1, 20X3, Company A writes an option contract. The terms of the contract allow the counterparty, at its option, to sell (put) 50 shares of Company A’s common stock to Company A at any time during the next year. If the counterparty exercises the option, the terms of the contract require that if the common share price of Company A on the exercise date is less than $20, then Company A will deliver to the counterparty a variable number of its common shares with a fair value equal to 50 times the amount below $20.
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Analysis

The instrument is within the scope of ASC paragraph 480-10-25-14 because the instrument (1) embodies a conditional obligation and is not an outstanding share of the issuer (i.e., it is an option contract), (2) may require Company A to settle the obligation by delivering a variable number of its common shares if the holder exercises the option, and (3) has a monetary value, at inception, that is based solely on variations inversely related to changes in the fair value of its common shares (i.e., if the option is exercised and Company A’s common share price is less than $20, Company A is required to transfer a variable number of its shares).

Example 5.7: Written Call Option Contract

Background

On March 1, 20X3, Company A writes an option contract. The terms of the contract allow the counterparty, at its option, to buy (call) 50 shares of Company A’s common stock from Company A at any time during the next year. If the counterparty exercises the option, the terms of the contract require that if the common share price of Company A on the exercise date is greater than $20, then Company A will deliver to the counterparty a variable number of its common shares with a fair value equal to 50 times the amount above $20.

Analysis

The instrument is not within the scope of ASC paragraph 480-10-25-14, because, while the instrument (1) embodies a conditional obligation and is not an outstanding share of the issuer, and (2) may require the issuer to settle the obligation by transferring a variable number of its common shares if the holder exercises the option (i.e., if Company A’s share price is greater than $20, Company A is required to transfer a variable number of its common shares with a fair value equal to 50 times the amount above $20), the monetary value, at inception, is based solely on variations directly related to changes in the fair value of its common shares.

While this instrument is not within the scope of ASC Topic 480, other authoritative guidance is required to be evaluated to determine the appropriate classification, measurement, and disclosure of the financial instrument (e.g., ASC Topic 815 and ASC Subtopic 815-40; ASC paragraph 480-10-55-63).

5.021 Written put options on an issuer’s own shares and forward purchase contracts on an issuer’s own shares are often entered into to manage the risk of price fluctuations during the course of share repurchase programs. Some believe those instruments should be classified as equity because they are directly associated with the costs related to treasury shares. However, efforts to manage the risks of share repurchase programs would merit...
accounting recognition only if those efforts meet the criteria for hedge accounting. Among its other requirements, ASC Topic 815 permits hedge accounting only if the hedging instrument is a derivative instrument and is classified as a liability or asset and only if either the hedged item is an asset or liability or the forecasted transaction presents an exposure to variations in cash flows that could affect reported earnings, none of which is the case with share repurchase programs. As a result, written put options on an issuer’s own shares and forward purchase contracts on an issuer’s own shares are always within the scope of ASC paragraphs 480-10-25-8 through 25-10 and 25-12 (such instruments are within the scope of ASC paragraphs 480-10-25-8 through 25-10 and 25-12 if they are physically or net cash settled and are within the scope of ASC paragraph 480-10-25-14 if they are net share settled).

**SOLELY OR PREDOMINANTLY BASED ON**

5.022 The scope of ASC Topic 480 is limited because the Board has not completed its redeliberations on several major issues raised in the Liabilities and Equity Project, one of which is the separation of instruments with characteristics of both liabilities and equity into components. Most issues affecting compound instruments, including dual-indexed share-settled instruments (instruments whose value is tied not only to an issuer’s equity shares but also to something else), therefore, are beyond the scope of ASC Topic 480. Because of that limitation, the Board initially decided that the requirements of ASC paragraph 480-10-25-14 should be limited to instruments that embody obligations, the monetary value of which is based solely on (a) a fixed monetary amount known at inception, (b) variations in something other than the fair value of the issuer’s equity shares, or (c) variations inversely related to changes in the fair value of the issuer’s equity shares.

5.023 The Board considered the issue further in light of suggestions that requiring the monetary value to be based solely on those factors might result in instruments constructed to avoid ASC Topic 480's scope, for example, by embedding a small amount of monetary value variation in response to changes in the fair value of the issuer’s equity shares even though the overall variations would predominantly respond to something else. Similar to the concept in ASC paragraph 480-10-25-1 that nonsubstantive or minimal features in a financial instrument should be ignored for purposes of determining whether an instrument is within its scope, the Board decided to extend the scope of ASC paragraph 480-10-25-14 to include instruments whose monetary value is based solely or predominantly on (a) a fixed monetary amount known at inception, (b) variations in something other than the fair value of the issuer’s equity shares, or (c) variations inversely related to changes in the fair value of the issuer’s equity shares.

5.024 As illustrated in the previous examples in this section, determining whether the monetary value of a financial instrument is based solely on one or more of the three factors in ASC paragraph 480-10-25-14 is relatively straightforward. However, judgment is required to distinguish instruments with monetary values predominantly based on one of those three factors from instruments with monetary values that are indexed both to the
Certain Obligations to Issue a Variable Number of Shares

issuer’s equity shares and to one or more other factors and, thus, would be excluded from ASC Topic 480's scope.

5.025 We believe the individual facts and circumstances of each financial instrument is required to be taken into account when determining whether the monetary value is predominantly based on one or more of the three factors described in ASC paragraph 480-10-25-14. Notwithstanding this, we believe the term predominantly is similar to the concept of more likely than not (i.e., greater than 50%) such that if, at inception, it is more likely than not the instrument will settle in such a way that the monetary value will equal (a) a fixed monetary amount known at inception, (b) variations in something other than the fair value of the issuer’s equity shares, or (c) variations inversely related to changes in the fair value of the issuer’s equity shares, the instrument may be within the scope of ASC paragraph 480-10-25-14. The following example illustrates the application of ASC paragraph 480-10-25-14 to a variable rate forward sale contract that will be settled by issuing a variable number of the issuer’s common shares:

**Example 5.8: Variable Share Forward Sale Contract**

**Background**

On January 1, 20X0, Company A enters into a forward sale agreement whereby it will issue a variable number of its common shares to the counterparty in exchange for a fixed amount of cash on December 31, 20X3. The number of shares to be delivered is variable and will be determined by reference to Company A’s common share price on December 31, 20X3 as follows:

- 1 share if the market price of the common share is less than or equal to $10
- 0.65 shares if the market price of the common share is greater than or equal to $15.38
- 

  \[ \frac{x}{y} \] shares if the market price of the common share is greater than $10 and less than $15.38 (whereby \( x \) is the implied price in the contract ($10) and \( y \) is the market value of the common share).

**Analysis**

In this example, the variable number of shares the counterparty will receive at maturity will have a fair value at maturity that predominantly moves in the same direction as market value changes of the underlying common shares of Company A from inception of the agreement. That is, the counterparty is exposed to similar risks and rewards as an existing shareholder in the entity. However, if Company A’s share price at settlement is greater than $10 and less than $15.38, Company A would have an obligation to issue a variable number of its shares based on a fixed monetary amount known at inception. Company A is required to analyze the instrument, at inception, to assess whether it is more likely than not that the
instrument will be settled by issuing a variable number of its shares based on a fixed monetary amount known at inception. That is, at inception, Company A is required to determine whether it is more likely than not that the common share price on December 31, 20X3 will be between $10 and $15.38.

If Company A determines that, at inception, it is not more likely than not that the common share price of Company A will be greater than $10 and less than $15.38 at settlement, the instrument is not within the scope of ASC paragraph 480-10-25-14 because, while the instrument (a) embodies an unconditional obligation, and (b) may require the issuer to settle the obligation by transferring a variable number of its common shares, the monetary value, at inception, is based predominantly on variations directly related to changes in the fair value of its common shares.

If Company A determines that it is more likely than not, at inception, that its common share price on December 31, 20X3 will be between $10 and $15.38, the monetary value is predominantly based upon a fixed monetary amount known at inception and the instrument would be within the scope of ASC paragraph 480-10-25-14(a).

CLASSIFICATION

5.026 While an instrument within the scope of ASC Topic 480 generally is classified as a liability, an instrument within the scope of ASC paragraph 480-10-25-14 may be classified, in certain circumstances, as an asset.

5.027 Certain contracts to repurchase an issuer’s equity shares embody conditional obligations for the issuer to transfer a variable number of its equity shares, for example, forward purchase contracts that must or can be net share settled. Such contracts require the issuer to transfer a variable number of its equity shares if the fair value of the forward purchase contract at the settlement date places the issuer in a loss position. However, if the fair value of the forward purchase contract at the settlement date places the issuer in a gain position, the issuer will receive a variable number of its equity shares and will not have to transfer anything. As a result, a forward purchase contract within the scope of ASC paragraph 480-10-25-14 that must or can be net share settled may be an asset or a liability for the issuer.

5.028 Other purchase contracts within the scope of ASC paragraph 480-10-25-14 also embody obligations that are conditional, but cannot be classified as assets. For example, the issuer might have to transfer a variable number of its equity shares if the holder of a put option exercises its option, but the issuer will not have to transfer a variable number of its equity shares if that put option expires unexercised. In either case, except for the premium received for writing the option, the issuer is not entitled to receive a variable number of its equity shares from the counterparty under any conditions. As a result, such contracts that are within the scope of ASC paragraph 480-10-25-14 that must or can be net share settled generally will be a liability for the issuer.
QUESTIONS AND ANSWERS

Q&A 5.1: ASC paragraph 480-10-25-14 indicates that certain financial instruments that the issuer must or may settle by issuing a variable number of its equity shares should be classified as a liability if the monetary value of the obligation is based on one of three factors.

Q. Is the focus of ASC paragraph 480-10-25-14 on the amount of cash or other assets the issuer will receive under the terms of the instrument?

A. No. In general, ASC paragraph 480-10-25-14 requires instruments in which the counterparty is not exposed to the risks and benefits that are similar to those of a holder of an outstanding share of the entity’s equity to be classified as a liability (or, in some cases, as an asset). That is, ASC paragraph 480-10-25-14 should be evaluated based on the fair value of the variable number of shares the counterparty will receive and not on the amount of cash or other assets the counterparty will pay under the terms of the instrument.

Q&A 5.2: Company A issues a financial instrument that will provide the counterparty with a variable number of Company A common shares that will have a fair value equal to a fixed dollar amount known at inception of the agreement.

Q. Is the financial instrument within the scope of ASC paragraph 480-10-25-14?

A. Yes. The instrument is within the scope of ASC paragraph 480-10-25-14 because the financial instrument (a) embodies an unconditional obligation, (b) requires Company A to settle the unconditional obligation by issuing a variable number of its common shares, and (c) has a monetary value, at inception, that is based solely on a fixed monetary amount known at inception.

If the value the counterparty will receive in shares is solely or predominantly fixed at inception of the contract (for example, $100) and the counterparty will receive a variable number of shares that will equal that fixed amount at the maturity date of the contract, the instrument is a liability under ASC paragraph 480-10-25-14(a). That is, the number of shares to be issued varies based on the fair value of those shares such that the counterparty will receive a fixed value known at inception (the counterparty receives $100 of value regardless of the stock price at the settlement date). In such instruments, the counterparty does not benefit like an existing ownership interest if the fair value of the issuer’s equity shares increases and the counterparty does not bear the risk like an existing ownership interest if the fair
value of those shares decreases. However, if the instrument is within the scope of ASC Topic 815, it is required to be accounted for as a derivative under the provisions of ASC Topic 815.

Q&A 5.3: Company A issues a mandatorily convertible preferred stock instrument on January 1, 20X1. The terms of the instrument indicate that the preferred stock will convert into 1,000 Company A common shares on March 15, 20X9.

Q. Is the financial instrument within the scope of ASC paragraph 480-10-25-14?

A. No. The instrument is not within the scope of ASC paragraph 480-10-25-14 because, while the financial instrument embodies an unconditional obligation, it (a) does not require or permit Company A to settle the unconditional obligation by issuing a variable number of its common shares, and (b) does not have a monetary value, at inception, that is based solely or predominantly on either a fixed monetary amount known at inception, variations in something other than the fair value of Company A’s equity shares, or variations inversely related to changes in the fair value of Company A’s equity shares. The monetary value, at inception, in this instrument is variable because the holder will receive a value at settlement equal to 1,000 times the then-current Company A common share price and, thus, the monetary value will vary directly with changes in the fair value of Company A’s common share price.

Q&A 5.4: Company A issues a mandatorily convertible preferred stock instrument on January 1, 20X1. The terms of the instrument indicate that the preferred stock will convert into a variable number of Company A common shares on March 15, 20X9 with a then-current value of $1,000,000.

Q. Is the financial instrument within the scope of ASC paragraph 480-10-25-14?

A. Yes. The instrument is within the scope of ASC paragraph 480-10-25-14 because it (a) embodies an unconditional obligation, (b) requires Company A to settle the unconditional obligation by issuing a variable number of its common shares, and (c) has a monetary value, at inception, that is based solely on a fixed monetary amount known at inception. It should be noted that the monetary value, at inception, in this instrument is fixed because the holder will receive a value at settlement equal to $1,000,000, regardless of the then-current Company A common share price.
Q&A 5.5: Company A issues a mandatorily convertible preferred stock instrument on January 1, 20X1 for $1,000,000. Preferred dividends are payable quarterly at an annual rate of return of 8%. The holder has the option of converting the instrument into 1,000 shares of Company A common stock throughout the life of the instrument. However, if the holder does not convert the preferred stock into 1,000 shares of Company A common stock by December 31, 20X9, Company A is required to redeem the instrument in exchange for a variable number of its common shares with a then-current value of $1,000,000, except that a minimum and a maximum of 1,000 shares and 1,200 shares, respectively, will be issued. Company A's stock price is $900 at inception of the contract.

Q. Should the share instrument described above be analyzed for predominance under ASC paragraph 480-10-25-14 to determine whether it is liability-classified as an unconditional obligation to issue a variable number of shares representing a fixed monetary amount known at inception of the contract?

A. Yes, the instrument must be analyzed under ASC paragraph 480-10-25-14 to determine whether settlement is based predominantly on a fixed monetary amount known at contract inception. The share instrument described above represents an unconditional obligation that must be settled by a certain date with a variable number of shares. Further, the fact that the holder may accelerate conversion does not change the unconditional nature of the obligation. If the stock price at the mandatory conversion date is between $833.33 and $1,000, the instrument will settle for a fixed monetary value of $1,000,000. If the stock price lies outside of this range at the mandatory conversion date, the holder will participate (to a greater or lesser extent) in the rise and fall of the company's equity. Therefore, Company A must analyze the instrument at inception to determine whether the fixed monetary value or the equity participation feature is predominant. It is our view that predominance should be assessed based on whether it is more-likely-than not that the instrument will settle for a fixed monetary amount known at inception (see paragraph 5.025). For the instrument described in this Q&A, we believe the assessment should be made considering (a) the range of stock prices for which settlement would be based on the fixed monetary amount, (b) the expected volatility and expected future value of the company's stock, and (c) the term of the instrument. Generally, a Monte Carlo analysis or some other simulation procedure will need to be performed to determine predominance rather than a risk neutral model such as Black-Scholes, which are oriented toward valuation rather than stock price path prediction, and will generally not produce relevant information. If the analysis indicates that there is more than a 50% chance (i.e., more likely than not) that the instrument will convert outside of the fixed monetary value range, Topic 480 would not apply and the instrument should be further analyzed under other accounting guidance to determine whether equity classification is appropriate. If it is more likely than not that the instrument will convert within the variable share range, Topic 480 would apply and the instrument should be carried as a liability.
and marked to fair value each period with changes in fair value recognized in earnings for that period. Fair value of the instrument in the example would consider the current fair value of the embedded cap and floor inherent in the range of conversion ratios and, as such, after issuance the value of the overall instrument could vary from par, accreted value, or intrinsic value depending on the fair value of those embedded features at each balance sheet date. Note that if the instrument is not a Topic 480 liability, it does not mean that permanent equity classification is necessarily appropriate. Instead, the company should consider whether it is fully capable of delivering equity shares under the arrangement at conversion. Factors to consider in making such an assessment include:

a. Does the entity have sufficient authorized and unissued shares available to satisfy its share obligations under the contract?

b. Is there a limit on the number of shares that might be issued under the contract? and;

c. Is there an obligation to deliver registered shares (delivery of which may not be in the entity's unilateral control)?

Although Subtopic 815-40 does not apply to a convertible share, the factors listed in ASC paragraph 815-40-25-10 should be considered in assessing whether delivery of shares at conversion is within the entity's control for purposes of applying Section 480-10-S99. If share settlement is not fully controlled by the entity, temporary equity classification for the instrument may be required under Section 480-10-S99. Further, the entity must also assess whether an equity-classified instrument (whether classified in permanent or temporary equity) contains embedded derivatives that require separation under Topic 815.
6. Freestanding Financial Instruments and Embedded Features

Introduction

Freestanding Financial Instruments

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In Conjunction with Some Other Transaction

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6. Freestanding Financial Instruments and Embedded Features

INTRODUCTION

6.000 This section discusses the applicability of ASC Topic 480 to freestanding financial instruments and features embedded within freestanding financial instruments.

FREESTANDING FINANCIAL INSTRUMENTS

6.001 ASC paragraphs 480-10-15-3 and 15-4 and 480-10-25-1 and 25-15 indicate that the Topic is only applicable to freestanding financial instruments.

ASC Topic 480 applies to freestanding financial instruments, including those that comprise more than one option or forward contract, and ASC paragraphs 480-10-25-4 through 25-14 shall be applied to a freestanding financial instrument in its entirety. For example, an instrument that consists of a written put option for an issuer’s equity shares and a purchased call option and nothing else is a freestanding financial instrument (ASC paragraphs 480-10-55-18 through 55-20 provide examples of such instruments). That freestanding financial instrument embodies an obligation to repurchase an entity’s equity shares and is subject to the requirements of ASC Topic 480.

A freestanding financial instrument that is within the scope of ASC Topic 480 shall not be combined with another freestanding financial instrument in applying ASC paragraphs 480-10-25-4 through 25-14, unless combination is specifically required under the provisions of ASC Topic 815 and related guidance. For example, a freestanding written put option that is classified as a liability under ASC Topic 480 shall not be combined with an outstanding equity share.

6.002 ASC Topic 480 only applies to freestanding financial instruments, including instruments that comprise more than one option or forward contract. As a result, the determination of whether a financial instrument is freestanding is critical. Due to the relative lack of interpretive guidance on what constitutes freestanding, that determination is one of the most challenging aspects of applying ASC Topic 480.

6.003 For purposes of applying ASC Topic 480, a freestanding financial instrument is a financial instrument that is entered into (1) separately and apart from any of the entity’s other financial instruments or equity transactions, or (2) that is entered into in conjunction with some other transaction and is legally detachable and separately exercisable. While ASC Topic 480 uses this definition to describe freestanding financial instruments, this definition was previously used in ASC Subtopic 815-40 and ASC paragraph 480-10-55-63 to describe freestanding derivative financial instruments and was carried forward from previous EITF Issues that were codified in ASC Subtopic 815-40 and ASC paragraph 480-10-55-63.
6.004 Despite the frequent use and longevity of the definition of a freestanding derivative financial instrument in the literature, users, preparers, and auditors have found it very difficult to apply that definition to the complex instruments that are currently issued. The difficulty in applying the definition results from the unanswered questions of when two financial instruments should be accounted for as a single unit and the lack of a framework for analysis. There is no comprehensive guidance or set of general principles to follow when applying the definition of a freestanding financial instrument.

6.005 Solely for purposes of applying the provisions of ASC Topic 480, we believe the definition of a freestanding financial instrument can be simplified as follows: a financial instrument is freestanding if it is entered into (1) separately and apart from other financial instruments or equity transactions, or (2) in conjunction with some other transaction and it can be legally detached and separately exercised. It is important to note that a financial instrument only needs to meet one of those criteria to be considered freestanding under ASC Topic 480.

Separately and Apart from Other Financial Instruments or Equity Transactions

6.006 A financial instrument is freestanding under ASC Topic 480 if it is entered into separately and apart from other financial instruments or equity transactions. Except in rare circumstances, we believe two or more contractually distinct instruments issued to separate, unrelated counterparties would be considered freestanding under this criterion for purposes of applying the provisions of ASC Topic 480, even if they are issued contemporaneously or within a very short time period. When multiple instruments are issued to the same counterparty (or related party group), we believe that two conditions must exist to conclude that one or more of those instruments has been entered into separately and apart from other financial instruments or equity transactions. First, the instruments must each be contractually distinct. That is, each instrument must be documented (e.g., papered) separately. Second, if multiple financial instruments are issued to the same counterparty (or related party group), there must be a reasonable period of time between the issuance of the financial instrument being evaluated and the issuance of the other financial instrument(s) to the same counterparty (or related party group). If an entity concludes that a financial instrument is not entered into separately and apart from other financial instruments or equity transactions (i.e., it does not meet the first criterion for a freestanding financial instrument as defined in ASC Topic 480), it is still possible that the instrument would be considered freestanding under the second criterion for a freestanding financial instrument as defined in ASC Topic 480. To make that determination, the entity must evaluate whether the instrument entered into in conjunction with some other transaction can be legally detached and separately exercised. See Paragraphs 6.007–6.010 below for information about performing that evaluation.
Example 6.1: Common Shares and Option Contract Issued to Separate, Unrelated Counterparties

Background

On March 1, 20X3, Company A issued 100 shares of its common stock to Company B at a price of $1,000. Company B has the ability to sell all or part of the 100 common shares of Company A it owns to other parties and is not restricted from purchasing other shares of Company A’s common stock in the future.

On March 1, 20X3, Company A also writes an option contract to Investment Bank that is required to be physically settled. The terms of the contract allow Investment Bank, at its option, to sell (put) 100 shares of Company A’s common stock to Company A in exchange for $1,000 cash ($10 per share) at any time during the next five years. Investment Bank is unrelated to Company B.

Analysis

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

Except in rare circumstances, we believe two or more contractually distinct instruments issued to separate, unrelated counterparties would be entered into “separately and apart” from other financial instruments or equity transactions. In this example, the common stock and the put option contract are issued to separate, unrelated counterparties (i.e., the common stock is issued to Company B and the put option contract is issued to Investment Bank). Therefore, the instruments would meet the “separately and apart” criterion of a freestanding financial instrument for purposes of applying the provisions of ASC Topic 480, even though they were issued to the respective parties on the same date.

As a result, each instrument is considered a freestanding financial instrument and the provisions of ASC Topic 480 would be applied to each separate instrument to determine whether the instrument is within its scope.

In Conjunction with Some Other Transaction

6.007 As indicated in the previous paragraph, a financial instrument that is not entered into separately and apart from other financial instruments or equity transactions is still considered freestanding for purposes of applying the provisions of ASC Topic 480 if it can be legally detached and separately exercised. We believe a financial instrument can be exercised separately from other financial instruments or transactions in various ways,
as described in the following paragraphs. One important factor to consider in evaluating whether the financial instrument being evaluated can be legally detached and separately exercised is whether it is possible that the remaining financial instrument(s) would continue to exist unchanged when the other financial instrument is exercised. In general, we believe it is not necessary for the financial instrument being evaluated to be transferable to third parties in order for that instrument to be considered freestanding under ASC Topic 480.

6.008 For example, if one of the financial instruments can be net cash settled or net share settled by either party, we believe that instrument would generally meet the legally detachable and separately exercisable criterion because the remaining instrument(s) may continue to exist unchanged when the other instrument is exercised (e.g., if the net settlement alternative is elected). However, when physical settlement is required, the determination of whether a financial instrument can be legally detached and separately exercised requires a detailed analysis of the contracts and the facts and circumstances of the transaction. For financial instruments that require physical settlement, if an instrument is not specifically tied to the underlying or if exercise of one instrument does not cause the expiration or exercise of the remaining instrument(s), we believe that instrument generally would meet the legally detachable and separately exercisable criterion because the remaining instrument(s) may continue to exist unchanged. For many instruments that require physical settlement in an entity’s own shares (e.g., written put options and forward purchase contracts that require physical settlement), the shares or other financial instruments transferred at settlement of the contract are fungible. That is, the party required to deliver shares in physical settlement of a financial instrument (e.g., the holder of a written put option) can often use the shares it held when the put option was purchased, shares subsequently purchased from another investor, or shares subsequently purchased directly from the entity. In those instances, the physically-settled financial instrument is not linked to specifically identified shares, which may indicate that the instrument would be considered a freestanding financial instrument for purposes of applying ASC Topic 480. However, in situations where a financial instrument requires settlement by physical delivery of specifically identified shares or financial instruments, the financial instrument would not be considered legally detachable and separately exercisable. For example, the Board indicated in ASC paragraph 480-10-65-1 that if an entity issued shares that are required to be redeemed under related agreements such that the required redemption relates to those specific underlying shares, the shares and the separate redemption agreement should be viewed as a single unit; thus, the specific shares are deemed mandatorily redeemable financial instruments under ASC paragraphs 480-10-25-4 and 25-6. Because the Board indicated that the instruments should be viewed as a single unit if the redemption agreement relates to specific underlying shares, we believe that this guidance is consistent with our view that such financial instruments would not meet the legally detachable and separately exercisable criterion.

6.009 Some entities with one class of equity shares enter into arrangements whereby a purchaser of the entity’s equity shares, pursuant to a contractually separate arrangement that is executed concurrently with the share purchase, is permitted to sell (put) its shares back to the entity that issued the shares. If the equity shares and put option are in separate contracts and the put option can be net cash settled or net share settled, generally the put
option would meet the legally detachable and separately exercisable criterion because the equity shares may continue to exist unchanged when the put option is exercised (e.g., if a net share settlement alternative is elected). If the equity shares and put option are in separate contracts, physical settlement is required, and the holder is not required to deliver specifically identified equity shares (e.g., at settlement, the holder can deliver shares subsequently purchased from another investor or shares subsequently purchased from the company), these factors may indicate that the put option would meet the legally detachable and separately exercisable criterion because the equity shares may continue to exist unchanged when the put option is exercised.

6.010 Some consolidated subsidiaries enter into arrangements whereby a purchaser of the subsidiary’s equity shares, pursuant to a contractually separate arrangement that is executed concurrently with the share purchase, is permitted to sell (put) its shares back to the subsidiary. These types of arrangements may be entered into with a third-party shareholder of that subsidiary’s equity (i.e., a noncontrolling interest in the consolidated financial statements of the parent). A detailed analysis of all relevant facts and circumstances is necessary when determining whether a put option (or other feature) is a freestanding financial instrument for purposes of applying the provisions of ASC Topic 480 in both the consolidated financial statements of the parent and the separate financial statements of the consolidated subsidiary. The following factors may suggest that the feature can be legally detached and separately exercised: (1) the put option that is indexed to the subsidiary’s equity shares can be net settled such that the subsidiary’s equity shares continue to exist unchanged, (2) if physical settlement is required, the subsidiary’s equity shares that would be delivered upon settlement of the put option are not specifically identified in the put option contract or related agreements, (3) the subsidiary has only one class of equity shares on a standalone basis and the put option is conveyed to a limited sub-set of holders of the subsidiary’s equity shares (e.g., only the minority shareholders are entitled to exercise the put right), (4) the put option indexed to the subsidiary’s equity shares must be settled by the parent, rather than the subsidiary itself, and (5) if the subsidiary’s equity shares that are subject to the put feature are transferred, the put rights are not required to be transferred to the new holder of those shares (e.g., the put feature may be forfeited when the underlying shares are transferred or it may be retained by the original holder). The following factors may suggest that the feature cannot be legally detached and separately exercised: (1) physical settlement is required and the put option contract or related agreements identify specific equity shares of the subsidiary that must be delivered upon settlement, (2) the subsidiary has multiple classes of equity shares on a standalone basis and all holders of a specific class of equity shares are entitled to exercise the put right, (3) the subsidiary has only one class of equity shares on a standalone basis and the put option is conveyed to all holders of the subsidiary’s equity shares (e.g., including the parent company), and (4) if the equity shares of the subsidiary that are subject to the put feature are transferred by the holder, the put rights must be transferred concurrently to the new holder of those equity shares. These factors should be considered in the aggregate with other relevant facts and circumstances when determining whether a feature indexed to a subsidiary’s equity shares is a freestanding financial instrument for purposes of applying the provisions of ASC Topic 480. See further discussion of certain arrangements where features are indexed to the equity shares of a consolidated subsidiary in Paragraphs 13.058–13.065 of Section 13.
Notwithstanding the general guidance provided in this section of the book, the determination of whether the components of an arrangement are freestanding financial instruments requires a comprehensive analysis of the overall transaction and its specific facts and circumstances. The following examples illustrate the general evaluation of whether certain types of financial instruments are freestanding for purposes of applying the provisions of ASC Topic 480:

Example 6.2: Common Shares and Option Contract

Background

On March 1, 20X3, Company A issued 100 shares of its common stock to Company B at a price of $1,000. Company B has the ability to sell all or part of the 100 common shares of Company A it owns to other parties and is not restricted from purchasing other shares of Company A’s common stock in the future.

On March 1, 20X3, Company A also writes an option contract to Company B that is required to be physically settled. The terms of the contract allow Company B, at its option, to sell (put) 100 shares of Company A’s common stock to Company A in exchange for $1,000 cash ($10 per share) at any time during the next five years.

Analysis

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

When multiple instruments are issued to the same counterparty (or related party group), we believe that two conditions must exist to conclude that one or more of those instruments has been entered into separately and apart from other financial instruments or equity transactions. First, each instrument must be contractually distinct. That is, each instrument must be documented (e.g., papered) separately. Second, if multiple financial instruments are issued to the same counterparty (or related party group), there must be a reasonable period of time between the issuance of the financial instrument being evaluated and the issuance of the other financial instrument(s) to the same counterparty (or related party group). In this example, the first condition is met because the common stock and option contract are in separate documents; however, the second condition is not met because the common stock and option contract were issued concurrently to the same counterparty. Therefore, Company A must evaluate whether the instrument meets the second criterion of a freestanding financial instrument; that criterion is whether the instrument that is entered into in conjunction with some other transaction can be legally detached and separately exercised.

For financial instruments that require physical settlement, if an instrument is not specifically tied to the underlying or if exercise of one instrument does not cause
the expiration or exercise of the remaining instrument(s), we believe that instrument generally would meet the legally detachable and separately exercisable criterion because the remaining instrument(s) may continue to exist unchanged. In this example, the equity shares and put option are in separate contracts, physical settlement is required, and Company B is not required to deliver specifically identified equity shares to Company A (i.e., at settlement, Company B may deliver the shares it currently holds, shares subsequently purchased from another investor, or shares subsequently purchased from Company A). Therefore, the put option meets the legally detachable and separately exercisable criterion because the specific equity shares presently held by Company B may continue to exist unchanged when the put option is exercised.

As a result, each instrument is considered a freestanding financial instrument and the provisions of ASC Topic 480 would be applied to each separate instrument to determine whether the instrument is within its scope.

Example 6.3: Common Shares and Option Contract

Background

On March 1, 20X3, Company A issued 100 shares of its common stock to Company B at a price of $1,000. The common stock certificates are numbered sequentially from 1,001 to 1,100.

On March 1, 20X3, Company A also writes an option contract to Company B that is required to be physically settled. The terms of the contract allow Company B, at its option, to sell (put) the specific 100 shares of Company A’s common stock numbered 1,001 to 1,100 to Company A in exchange for $1,000 cash at any time in the future. If Company B sells the common shares, the option contract concurrently is required to be sold to the same counterparty.

Analysis

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

When multiple instruments are issued to the same counterparty (or related party group), we believe that two conditions must exist to conclude that one or more of those instruments has been entered into separately and apart from other financial instruments or equity transactions. First, each instrument must be contractually distinct. That is, each instrument must be documented (e.g., papered) separately. Second, if multiple financial instruments are issued to the same counterparty (or related party group), there must be a reasonable period of time between the issuance of the financial instrument being evaluated and the issuance of the other
financial instrument(s) to the same counterparty (or related party group). The first condition is met because the common stock and option contract are in separate documents; however, the second condition is not met because the common stock and option contract were issued concurrently to the same counterparty. Therefore, Company A must evaluate whether the instrument meets the second criterion of a freestanding financial instrument; that criterion is whether the instrument that is entered into in conjunction with some other transaction can be legally detached and separately exercised.

For financial instruments that require physical settlement, if an instrument is not specifically tied to the underlying or if exercise of one instrument does not cause the expiration or exercise of the remaining instrument(s), we believe that instrument generally would meet the legally detachable and separately exercisable criterion because the remaining instrument(s) may continue to exist unchanged. In this example, the equity shares and put option are in separate contracts and physical settlement is required. However, Company B is required to deliver specifically identified equity shares to Company A (i.e., at settlement, Company B is required to deliver 100 shares of Company A’s common stock numbered 1,001 to 1,100). Therefore, the put option does not meet the legally detachable and separately exercisable criterion because the specific equity shares presently held by Company B will not continue to exist unchanged when the put option is exercised (i.e., those specific shares are directly linked to the exercise of the option contract).

As a result, the instruments are not considered freestanding financial instruments and should be viewed as a single unit for purposes of applying the provisions of ASC Topic 480. That is, the single unit would be considered a puttable share and would not be within the scope of ASC Topic 480 (see Example 3.3 for further discussion).

Example 6.4: Common Shares and Option Contract

Background

On March 1, 20X3, Company A issued 100 shares of its common stock to Company B at a price of $1,000. Company B has the ability to sell all or part of the 100 shares of common stock of Company A it owns to other parties and is not restricted from purchasing other shares of Company A’s common stock in the future.

On March 1, 20X3, Company A also writes an option contract to Company B that may be physically settled, net cash settled, or net share settled. The terms of the contract allow Company B, at its option, to sell (put) 100 shares of Company A’s common stock to Company A in exchange for $1,000 cash ($10 per share) at any time during the next five years.
Analysis

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

When multiple instruments are issued to the same counterparty (or related party group), we believe that two conditions must exist to conclude that one or more of those instruments has been entered into separately and apart from other financial instruments or equity transactions. First, each instrument must be contractually distinct. That is, each instrument must be documented (e.g., papered) separately. Second, if multiple financial instruments are issued to the same counterparty (or related party group), there must be a reasonable period of time between the issuance of the financial instrument being evaluated and the issuance of the other financial instrument(s) to the same counterparty (or related party group). The first condition is met because the common stock and option contract are in separate documents; however, the second condition is not met because the common stock and option contract were issued concurrently to the same counterparty. Therefore, Company A must evaluate whether the instrument meets the second criterion of a freestanding financial instrument; that criterion is whether the instrument that is entered into in conjunction with some other transaction can be legally detached and separately exercised.

For financial instruments that permit net cash settlement or net share settlement, we believe that instrument generally would meet the legally detachable and separately exercisable criterion because the remaining instrument(s) may continue to exist unchanged when the other instrument is exercised (e.g., if the net settlement alternative is elected). In this example, the put option can be net settled, so it meets the legally detachable and separately exercisable criterion because the specific equity shares presently held by Company B may continue to exist unchanged when the put option is exercised.

As a result, each instrument is considered a freestanding financial instrument and the provisions of ASC Topic 480 would be applied to each separate instrument to determine whether the instrument is within its scope.

**COMBINING SEPARATE INSTRUMENTS**

6.012 ASC paragraph 480-10-25-15 indicates that, for freestanding instruments that comprise two or more option or forward components, its requirements should be applied to the freestanding instrument in its entirety rather than to the separate components of those instruments. However, in applying the classification and measurement provisions of ASC Topic 480, freestanding financial instruments that are within its scope should not be combined with other freestanding instruments unless combination is required under ASC Topic 815 and its related guidance. The Board believes that these application
requirements conform to provisions of ASC Topic 815 and its related guidance that prohibit separating a compound derivative into risk components or, generally, combining separate freestanding instruments into synthetic instruments for accounting purposes. Specifically, the Board noted that there are certain circumstances in which ASC Topic 815 and its related guidance require separate transactions to be viewed in combination. Those circumstances generally arise if it is determined that one or more transactions were entered into separately to circumvent the requirements of ASC Topic 815 and the Board believes, in those circumstances, it would be appropriate to incorporate that guidance in ASC Topic 815 and ASC Topic 480.

6.013 However, the Board otherwise prohibited the combining of instruments within the scope of ASC Topic 480 to avoid comparability and representational faithfulness problems from inadvertent or planned circumvention of the requirements of ASC Topic 480. The Board saw no justification for combining an instrument that, in itself, is a liability within the scope of ASC Topic 480 with another freestanding instrument, because that combination might (1) cause a freestanding instrument to be considered outside the scope of ASC Topic 480, (2) change the reported amount of the liability, or (3) change the required measurement method. For example, combining a freestanding instrument that is a liability under ASC Topic 480 with a freestanding instrument that is equity under other guidance might have been considered sufficient to change the nature of the liability instrument such that it would be outside the scope of ASC Topic 480 and a liability (and any gains or losses resulting from fair value changes in that liability) would not be recognized. Also, permitting freestanding instruments to be combined might have circumvented a requirement to measure those instruments at fair value. For example, combining a written put option and purchased call option might have allowed the combination to be accounted for as a physically-settled forward purchase contract (subject to the measurement method described in Paragraphs 9.008–9.018 of Section 9). Additionally, the Board noted that allowing or requiring the combining of instruments to create components with differing characteristics might have led to accounting changes that would be reversed in the next phase of its Liabilities and Equity project.

6.014 In applying the classification and measurement provisions of ASC Topic 480, freestanding financial instruments that are within its scope should not be combined with other freestanding instruments unless they are required to be combined under ASC Topic 815 and its related guidance. The general guidance on combination of instruments for purposes of applying the provisions of ASC Topic 815 is addressed in ASC paragraphs 815-10-15-8 and 15-9, 815-10-55-176 through 180, and 815-10-25-7 through 25-13.

6.015 ASC paragraph 815-10-15-9 indicates that if two or more separate transactions are entered into in an attempt to circumvent the provisions of ASC Topic 815, the transactions should be combined under certain circumstances. ASC paragraph 815-10-15-9 specifies that the following indicators should be considered in the aggregate and, if present, should cause the transactions to be viewed as a unit and not separately in order to determine whether the combination of transactions meets the definition of a derivative under ASC Topic 815:
Freestanding Financial Instruments and Embedded Features

(1) The transactions were entered into contemporaneously and in contemplation of one another.

(2) The transactions were executed with the same counterparty (or structured through an intermediary).

(3) The transactions relate to the same risk.

(4) There is no apparent economic need or substantive business purpose for structuring the transactions separately that could not also have been accomplished in a single transaction.

6.016 If an entity concludes that two or more separate transactions were entered into in an attempt to circumvent the provisions of ASC Topic 815, the transactions should be combined as a single arrangement for purposes of determining whether the provisions of ASC Topic 815 are applicable. If that arrangement meets the definition of a derivative and is within the scope of ASC Topic 815, it is required to be accounted for under ASC Topic 815 and the arrangement would be accounted for as an asset or liability. However, if that arrangement is not within the scope of ASC Topic 815, ASC Topic 480 should be applied to the combined instruments as a single unit of accounting. If financial instruments are entered into separately and apart from one another and each is within the scope of ASC Topic 480, each financial instrument should be separately accounted for under the provisions of ASC Topic 480.

6.017 ASC paragraphs 815-10-25-7 and 25-8 address when purchased and written options should be considered to be two separate option contracts or a single forward contract for purposes of applying the provisions of ASC Topic 815. ASC paragraphs 815-10-25-7 through 25-13 provide the following guidance:

(1) A combination of an embedded (nontransferable) purchased call (put) option and an embedded (nontransferable) written put (call) option in a single hybrid instrument that have the same terms and same underlying and that are entered into contemporaneously with the same counterparty should be considered as a single forward contract for purposes of applying the provisions of ASC Topic 815 and its related guidance.

(2) A combination of a freestanding purchased call (put) option and a freestanding or embedded (nontransferable) written put (call) option that have the same terms and same underlying and that are entered into contemporaneously with the same counterparty at inception should be considered as separate option contracts.

(3) A combination of a freestanding purchased call (put) option and a freestanding or embedded (nontransferable) written put (call) option that have the same terms and same underlying and that are entered into contemporaneously with different counterparties at inception should be considered as separate option contracts.

(4) A combination of a freestanding written call (put) option and a freestanding or embedded (nontransferable) purchased put (call) option that have the same
terms and same underlying and that are entered into contemporaneously with
different counterparties at inception should be considered as separate option
contracts.

6.018 Under the provisions of ASC paragraph 815-10-25-10, the only time contractually
separate options are required to be combined and accounted for as a single unit is if there
is an embedded (nontransferable) purchased call (put) option and an embedded
(nontransferable) written put (call) option in a single hybrid instrument. However, a share
of stock that is puttable by the holder and callable by the issuer under the same terms
does not render the stock mandatorily redeemable under the provisions of ASC Topic
480. This combination is discussed, together with the implications of applying the

EMBEDDED FEATURES

6.019 ASC paragraphs 480-10-15-5 and 15-7 and 480-10-25-2 specify that their
provisions do not apply to features embedded in a nonderivative contract and that its
classification provisions are not applicable when analyzing embedded features under
ASC Topic 815.

ASC Topic 480 does not apply to features embedded in a financial instrument that
is not a derivative in its entirety. An example is an option on the issuer’s equity
shares that is embedded in a nonderivative host contract. For purposes of applying
ASC paragraph 815-10-15-74(a) in analyzing an embedded feature as though it
were a separate instrument, ASC paragraphs 480-10-25-4 through 25-14 shall
not be applied to the embedded feature. Embedded features shall be analyzed by
applying other applicable guidance.

6.020 During the deliberations that led to the issuance of ASC Topic 480, the Board
discussed whether the classification requirements in ASC Topic 480 should be applied to
features embedded in a financial instrument that is not a derivative in its entirety. Such a
requirement would have had the effect of mandating separate accounting–bifurcation–for
some embedded features now exempt from that accounting because they are considered
not to be derivatives under the existing requirements of ASC Topic 815. As a result of
those deliberations, concerns arose about the complexity of those requirements, the
measurability of certain embedded features, the possibility of a further required change in
accounting in the next phase of the Liabilities and Equity project, and the SEC
requirements to present redeemable preferred stocks outside of permanent equity in
registrants’ statements of financial position. In view of those concerns, the Board decided
not to apply the classification requirements of ASC Topic 480 to embedded derivatives.
However, other standards and guidance (for example, the embedded derivative provisions

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1 ASC paragraphs 815-15-05-1 and 815-15-25-1 and 25-14 require an entity to identify derivative
instruments that are embedded in contracts that do not meet the definition of a derivative instrument in their
whether such embedded derivative instruments are required to be separated from the host contract and
accounted for separately as derivative instruments. One of those criteria, inASC paragraph 815-15-25-1,
requires an embedded derivative instrument to be analyzed as though it were a separate instrument.
of ASC Topic 815) already require certain compound instruments to be analyzed and separated into components and that guidance continues to apply to those embedded derivatives. As a result of its decision, the Board included ASC paragraphs 480-10-15-5, 15-7, and 480-10-25-2, and amended ASC paragraph 815-15-25-14. For similar reasons, ASC paragraphs 480-10-25-8 through 25-10 and 25-12 excluded outstanding shares from their scope, and ASC paragraph 480-10-25-14 excludes outstanding shares embodying conditional obligations that the issuer must or may settle in shares.

6.021 ASC paragraphs 815-15-05-1, 815-15-25-1, and 25-14 provide guidance on when an embedded feature is required to be separated from its host and accounted for as a derivative instrument. ASC paragraph 815-15-25-14 was amended by ASC Topic 480 to indicate that when determining whether a separate instrument with the same terms as the embedded feature would be a derivative instrument, the classification provisions of ASC Topic 480 should be disregarded. For example, a freestanding written put option on an issuer’s own shares is within the scope of ASC Topic 480, regardless of the settlement method. However, a written put option embedded within an issuer’s own shares is not within the scope of ASC Topic 480. Instead, the issuer is required to determine whether that embedded written put option should be separated under the provisions of ASC Topic 815. When making that determination, the issuer would not look to the classification guidance in ASC Topic 480 to determine whether an embedded feature would be a derivative instrument subject to the requirements of ASC Topic 815. That is, the embedded feature would not be a derivative instrument subject to the requirements of ASC Topic 815 if a separate instrument with the same terms as the embedded feature would be classified as a liability (or an asset in some circumstances) under the provisions of ASC Topic 480 but would be classified in stockholders’ equity absent the provisions of ASC Topic 480. Even though the amendment did not impact the response in ASC paragraphs 815-10-15-76 and 815-15-55-82, the Board referenced this amendment in ASC Topic 480 in ASC paragraph 815-10-17-76 and in ASC paragraph 815-15-55-82 because some instruments previously classified in temporary equity may be classified as liabilities pursuant to ASC Topic 480 and to indicate that for purposes of analyzing the application of ASC paragraph 815-10-15-74(a) to an embedded derivative financial instrument as though it were a separate instrument, ASC paragraphs 480-10-25-4 through 25-14 should be disregarded.

6.022 Because the classification provisions of ASC Topic 480 affect freestanding financial instruments, the Board nullified certain related EITF Issues that were affected by ASC Topic 480. However, because the classification provisions of ASC Topic 480 do not affect the bifurcation decision for embedded features under ASC Topic 815, the Board partially nullified other EITF Issues. That is, if an entity is determining whether a freestanding financial instrument that is subject to an EITF Issue is within the scope of ASC Topic 480, the entity should review the provisions of ASC Topic 480 in combination with the revisions to the EITF Issue when applying the classification, measurement, and disclosure provisions of ASC Topic 480. However, if an entity is determining whether an embedded feature is required to be bifurcated under the provisions of ASC Topic 815, the entity should review any related EITF Issue without regard to the revisions to the EITF Issue as a result of issuing ASC Topic 480.
6.023 ASC Topic 815 specifies when embedded features are required to be bifurcated from a compound financial instrument and accounted for separately at fair value each reporting period. Pursuant to ASC paragraph 815-10-15-74(a), an embedded feature that is both (1) indexed to an entity’s own stock and (2) classified in stockholders’ equity in its statement of financial position, if freestanding, is not considered a derivative for purposes of ASC Topic 815. When determining whether an embedded feature meets the exception in ASC paragraph 815-10-15-74(a), entities are subject to the requirements of ASC paragraphs 815-40-15-5 through 15-8, and 15-13, and ASC paragraphs 815-40-55-20 through 55-25, and ASC Subtopic 815-40; ASC paragraph 480-10-55-63, which provide guidance for determining whether a derivative is indexed to a company’s own stock and when such a derivative would be classified in stockholders’ equity if freestanding. Although ASC paragraphs 815-40-15-5 through 15-8, and 15-13 and ASC paragraphs 815-40-55-20 through 55-25 and ASC Subtopic 815-40; ASC paragraph 480-10-55-63 have been partially nullified by ASC Topic 480 with respect to certain freestanding financial instruments, the guidance in ASC paragraphs 815-40-15-5 through 15-8, and 15-13 and ASC paragraphs 815-40-55-20 through 55-25 (EITF 01-6) and ASC Subtopic 815-40; ASC paragraph 480-10-55-63 (EITF 00-19) continues to apply when evaluating embedded features under ASC Topic 815.

6.024 For example, since the original consensuses in ASC paragraphs 815-40-15-5 through 15-13 and ASC paragraphs 815-40-55-20 through 55-25 (EITF 01-6) and ASC Subtopic 815-40; ASC paragraph 480-10-55-63 (EITF 00-19) are still applicable in evaluating an embedded feature under ASC Topic 815, an embedded written put option that is considered indexed to the issuer’s own stock under ASC paragraphs 815-40-15-5 through 15-8, and 15-13 and ASC paragraphs 815-40-55-20 through 55-25 and that would have satisfied the equity classification requirements of ASC Subtopic 815-40 and ASC paragraph 480-10-55-63 prior to the issuance of ASC Topic 480 is still considered (1) indexed to an entity’s own stock and (2) classified in stockholders’ equity, if it were freestanding, for purposes of evaluating whether the embedded written put option should be bifurcated under ASC paragraphs 815-15-05-1, 815-15-25-1, and 25-14. However, for freestanding instruments within the scope of ASC Topic 480 (for example, written put options and forward purchase contracts), ASC paragraphs 815-40-15-5 through 15-8, and 15-13 (EITF 01-6) and 815-40-55-20 through 55-25 of ASC Subtopic 815-40, and ASC paragraph 480-10-55-63 (EITF 00-19) are nullified and the issuer is required to follow the classification, measurement, and disclosure requirements of ASC Topic 480.

6.025 The following examples illustrate the application of ASC paragraphs 480-10-15-3 through 15-5 and 15-7 and 480-10-25-1, 25-2, and 25-15:

Example 6.5: Three Freestanding Instruments with Same Counterparty

Background

On March 1, 20X3, Company A issues the following three instruments contemporaneously with Company B: (1) a written put option on the issuer’s equity shares, (2) a purchased call option on the issuer’s equity shares, and (3) outstanding
shares of common stock. The written put option and purchased call option require physical settlement, each have a term of five years, and are only exercisable at expiration.

Analysis

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

When multiple instruments are issued to the same counterparty (or related party group), we believe that two conditions must exist to conclude that one or more of those instruments has been entered into separately and apart from other financial instruments or equity transactions. First, each instrument must be contractually distinct. That is, each instrument must be documented (e.g., papered) separately. Second, if multiple financial instruments are issued to the same counterparty (or related party group), there must be a reasonable period of time between the issuance of the financial instrument being evaluated and the issuance of the other financial instrument(s) to the same counterparty (or related party group). The first condition is met because the put option, call option, and equity shares are in separate documents; however, the second condition is not met because the put option, call option, and equity shares were issued concurrently to the same counterparty. Therefore, Company A must evaluate whether the instrument meets the second criterion of a freestanding financial instrument; that criterion is whether the instrument that is entered into in conjunction with some other transaction can be legally detached and separately exercised.

For financial instruments that require physical settlement, if an instrument is not specifically tied to the underlying or if exercise of one instrument does not cause the expiration or exercise of the remaining instrument(s), we believe that instrument generally would meet the legally detachable and separately exercisable criterion because the remaining instrument(s) may continue to exist unchanged. In this example, the put option, call option, and equity shares are in separate contracts, physical settlement is required, and neither party is required to deliver specifically identified equity shares to the other party (i.e., at settlement of the put option contract, Company B may deliver the shares it currently holds, shares subsequently purchased from another investor, or shares subsequently purchased from Company A). Therefore, the put option and call option meet the legally detachable and separately exercisable criterion because the specific equity shares presently held by Company B may continue to exist unchanged when the put option or call option is exercised.

As a result, each instrument is considered a freestanding financial instrument and the provisions of ASC Topic 480 would be applied to each separate instrument to determine whether the instrument is within its scope.
Because ASC Topic 815 does not require the purchased call option or the shares of stock to be combined with the written put option, ASC paragraph 480-10-25-15 indicates they should not be combined for purposes of applying its provisions.

The physically settled written put option is within the scope of ASC paragraphs 480-10-25-8 through 25-10 and 25-12 because (a) it is not an outstanding share of the issuer (i.e., it is an option contract), (b) it embodies an obligation, at inception, such that Company A may be required to repurchase its own shares (i.e., in this case it represents a conditional obligation that may be exercised by the holder), and (c) may require Company A to settle the obligation by transferring its assets. The physically-settled purchased call option is not within the scope of ASC Topic 480 because (a) the instrument is not considered a mandatorily redeemable financial instrument under the provisions of ASC paragraphs 480-10-25-4 and 25-6 because it is not issued in the form of shares and does not embody an unconditional obligation to redeem the instrument by transferring assets, (b) the instrument is not within the scope of ASC paragraphs 480-10-25-8 through 25-10 and 25-12 because it does not embody an obligation to repurchase the issuer’s equity shares that may require settlement by transferring assets, and (c) the instrument is not within the scope of ASC paragraph 480-10-25-14 because it does not contain an obligation that the issuer must or may settle by issuing a variable number of its equity shares.

The outstanding shares of common stock also are not within the scope of ASC Topic 480 because (1) the instrument is not considered a mandatorily redeemable financial instrument under the provisions of ASC paragraphs 480-10-25-4 and 25-6 because, while the instrument is issued in the form of shares (i.e., common shares), it (i) does not embody an unconditional obligation that requires the issuer to redeem the instrument by transferring assets, and (ii) does not indicate a specified or determinable date (or dates), or an event certain to occur, upon which the issuer’s assets are required to be transferred, (2) the instrument is not within the scope of ASC paragraphs 480-10-25-8 through 25-10 and 25-12 because it is an outstanding share of stock of the issuer, and (3) the instrument is not within the scope of ASC paragraph 480-10-25-14 because it does not contain an unconditional obligation for the issuer that must or may be settled by issuing a variable number of its equity shares.

Example 6.6: Two Freestanding Instruments with Same Counterparty

Background

On March 1, 20X3, Company A issues the following two financial instruments contemporaneously to Company B: (1) a contract that combines a written put option at one strike price and a purchased call option at another strike price on the
issuer’s equity shares, and (2) outstanding shares of common stock. The option contract requires physical settlement, has a term of five years, and is only exercisable at expiration.

**Analysis**

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

When multiple instruments are issued to the same counterparty (or related party group), we believe that two conditions must exist to conclude that one or more of those instruments has been entered into separately and apart from other financial instruments or equity transactions. First, each instrument must be contractually distinct. That is, each instrument must be documented (e.g., papered) separately. Second, if multiple financial instruments are issued to the same counterparty (or related party group), there must be a reasonable period of time between the issuance of the financial instrument being evaluated and the issuance of the other financial instrument(s) to the same counterparty (or related party group). The first condition is met because the option contract and equity shares are in separate documents; however, the second condition is not met because the option contract and equity shares were issued concurrently to the same counterparty. Therefore, Company A must evaluate whether the instrument meets the second criterion of a freestanding financial instrument; that criterion is whether the instrument that is entered into in conjunction with some other transaction can be legally detached and separately exercised.

For financial instruments that require physical settlement, if an instrument is not specifically tied to the underlying or if exercise of one instrument does not cause the expiration or exercise of the remaining instrument(s), we believe that instrument generally would meet the legally detachable and separately exercisable criterion because the remaining instrument(s) may continue to exist unchanged. In this example, the option contract and equity shares are in separate contracts, physical settlement is required, and neither party is required to deliver specifically identified equity shares to the other party (i.e., at settlement of the option contract, Company B may deliver the shares it currently holds, shares subsequently purchased from another investor, or shares subsequently purchased from Company A). Therefore, the option contract meets the legally detachable and separately exercisable criterion because the specific equity shares presently held by Company B may continue to exist unchanged when the option contract is exercised.

As a result, each instrument is considered a freestanding financial instrument and the provisions of ASC Topic 480 would be applied to each separate instrument to determine whether the instrument is within its scope.
Because ASC Topic 815 does not require the option arrangement to be combined with the outstanding shares of stock, ASC paragraph 480-10-25-15 indicates they should not be combined for purposes of applying the provisions of ASC Topic 480.

In accordance with ASC paragraphs 480-10-15-3 and 15-4; ASC paragraph 480-10-25-1, the option contract in its entirety (i.e., the combination of the written put option at one strike price and the purchased call option at another strike price) is a freestanding financial instrument for purposes of applying ASC Topic 480. The physically-settled option contract is within the scope of ASC paragraphs 480-10-25-8 through 25-10 and 25-12 because (1) it is not an outstanding share of the issuer (i.e., it is an option contract), (2) it embodies an obligation, at inception, such that Company A may be required to repurchase its own shares (i.e., in this case it represents a conditional obligation that may be exercised by the holder via the written put option), and (3) may require Company A to settle the obligation by transferring its assets.

The outstanding shares of common stock are not within the scope of ASC Topic 480 because (1) the instrument is not considered a mandatorily redeemable financial instrument under the provisions of ASC paragraphs 480-10-25-4 and 25-6 because, while the instrument is issued in the form of shares (i.e., common shares), it (i) does not embody an unconditional obligation that requires the issuer to redeem the instrument by transferring assets, and (ii) does not indicate a specified or determinable date (or dates), or an event certain to occur, upon which the issuer’s assets are required to be transferred, (2) the instrument is not within the scope of ASC paragraphs 480-10-25-8 through 25-10 and 25-12 because it is an outstanding share of stock of the issuer, and (3) the instrument is not within the scope of ASC paragraph 480-10-25-14 because it does not contain an unconditional obligation for the issuer that must or may be settled by issuing a variable number of its equity shares.

**Example 6.7: One Instrument That Is an Outstanding Share of Stock Containing Multiple Embedded Features**

**Background**

On March 1, 20X3, Company A issues a share of stock that is not mandatorily redeemable. However, the stock is (1) puttable for cash by the holder any time after five years or upon a change in control and (2) callable for cash by the issuer any time after five years. Assume that components (1) and (2) cannot be legally detached and separately exercised from the share of stock.

**Analysis**

A financial instrument that is entered into in conjunction with some other transaction is considered freestanding for purposes of applying ASC Topic 480 if it can be legally detached and separately exercised. When determining whether a
financial instrument is legally detachable and separately exercisable, an entity is required to review the components of the contract to determine if the components can be both legally detached from the contract and separately exercised such that it is possible that the remaining financial instrument(s) would continue to exist unchanged when the other financial instrument is exercised (except for the legally detached and separately exercised feature). In this example, it is assumed that the single contract that combines an outstanding share of stock, a put option, and a call option is a single freestanding financial instrument because the embedded features cannot be legally detached from the share of stock and separately exercised. As such, the share of puttable and callable stock is a single freestanding instrument for purposes of applying ASC Topic 480.

The instrument as a whole is not mandatorily redeemable under ASC paragraphs 480-10-25-4 and 25-6, because the redemption is optional, not unconditional. That is, a written put option and a purchased call option issued together with the same terms differ from a forward purchase contract because the combination of options may expire at the money, unexercised. Because the instrument is an outstanding share, it is not within the scope of ASC paragraphs 480-10-25-8 through 25-10 and 25-12. Lastly, the instrument is not within the scope of ASC paragraph 480-10-25-14 because it only contains a conditional obligation that is embedded in an outstanding share of stock that Company A cannot settle by issuing a variable number of its equity shares.

Therefore, the instrument is not within the scope of ASC Topic 480 and other guidance should be evaluated to determine the appropriate accounting treatment (e.g., ASR 268, ASC paragraph 480-10-S99-3, and ASC Topic 815).

QUESTIONS AND ANSWERS

Q&A 6.1: Company A issues a freestanding financial instrument that consists of more than one option or forward contract.

Q. Is an individual financial instrument comprised of more than one option or forward contract considered a freestanding financial instrument under ASC Topic 480?

A. Yes. ASC paragraphs 480-10-15-3 and 15-4; ASC paragraph 480-10-25-1 specify that such instruments are considered freestanding financial instruments and the classification guidance in ASC paragraphs 480-10-25-4 through 25-14 should be applied to those instruments in their entirety. ASC paragraphs 480-10-55-29 through 55-32 and 55-42 through 55-52 provide a number of examples that illustrate the application of ASC Topic 480 to freestanding financial instruments comprised of more than one option or forward contract (see Paragraphs 13.012–13.024 of Section 13 for additional information).
Q&A 6.2: Company A issues three financial instruments to the same counterparty on the same day. Company A determines each of these is a freestanding financial instrument and two are within the scope of ASC Topic 480.

Q. When applying the classification and measurement guidance in ASC Topic 480, can freestanding financial instruments that are within its scope be combined with any other freestanding financial instrument?

A. Generally, no. Any freestanding financial instrument that is within the scope of ASC Topic 480 should not be combined with other freestanding financial instruments unless combination is required under ASC Topic 815 and its related guidance. ASC paragraphs 815-10-15-8 and 15-9; ASC paragraphs 815-10-55-176 through 180 indicate that if two or more separate transactions are entered into in an attempt to circumvent the provisions of ASC Topic 815, the transactions should be combined under certain circumstances. ASC paragraphs 815-10-25-7 through 25-13 and 480-20-25-43 indicate that a combination of options are required to be accounted for as a single unit if there is an embedded (nontransferable) purchased call (put) option and an embedded (nontransferable) written put (call) option in a single hybrid instrument. This combination is discussed, together with the implications of applying the provisions of ASC Topic 480, in Paragraphs 3.016–3.018 of Section 3.

Q&A 6.3: Company A issues a share of common stock. The share of common stock contains an embedded put option that permits the holder to put the share of stock to Company A at any time during the next five years.

Q. Do the classification guidelines in ASC Topic 480 apply when analyzing features embedded in a financial instrument that is not a derivative in its entirety?

A. No. ASC Topic 480 does not apply to features embedded in a financial instrument that is not a derivative in its entirety. An example is an option on the issuer’s equity shares that is embedded in a nonderivative host contract. For purposes of applying ASC paragraph 815-10-15-74(a) in analyzing an embedded feature as though it were a separate instrument, the classification provisions of ASC Topic 480 are not applied to the embedded feature. Embedded features should be analyzed by applying other applicable guidance (e.g., ASC Topic 815, ASC Subtopic 815-40, and ASC paragraph 480-10-55-63).
7. Scope Limitations

Introduction

Contingent Consideration in a Business Combination

Share-Based Compensation Arrangements

   ESOP Shares

Questions and Answers
7. Scope Limitations

INTRODUCTION

7.000 This section discusses instruments that may have been within the scope of ASC Topic 480 but were specifically excluded from its provisions.

CONTINGENT CONSIDERATION IN A BUSINESS COMBINATION

7.001 ASC paragraphs 480-10-15-9 and 15-10, and 480-10-35-4A prescribe the relationship between Topic 480 and ASC Topic 805, Business Combinations. Section 6 of KPMG’s Accounting for Business Combinations and Noncontrolling Interests Handbook discusses how to determine the classification of contingent consideration in a business combination and provides a detailed analysis of the interaction between ASC Topics 480 and 805.

7.002 Paragraphs 7.002 through 7.011 are not used.

SHARE-BASED COMPENSATION ARRANGEMENTS

7.012 ASC paragraph 480-10-15-8 prescribes the relationship between the Topic and share-based compensation arrangements. Section 3 of KPMG’s Share-Based Payment Handbook provides a detailed analysis of the interaction between ASC Topics 480 and 718.

7.013 Paragraphs 7.013 through 7.016 are not used.

ESOP Shares

7.017 By law, employers with an employee stock ownership plan (ESOP) are required to provide the employee with a put option or other redemption feature if the shares are not readily tradable; often, the plan requires that upon death, retirement, or the employee’s reaching a certain age the shares are required to be sold back to the employer at fair value. Other ESOPs may provide employees with a put option or other redemption feature regardless of whether the shares are not readily tradable. ASC paragraph 480-10-15-8 specifies that ESOP shares or freestanding agreements to repurchase those shares are not within the scope of ASC Topic 480 because those shares are accounted for under ASC Subtopic 718-40 and ASC Subtopic 718-740 or their related guidance through the point of redemption. ASC paragraph 480-10-15-8 is reproduced below:

Background

As defined in ASC Subtopic 718-40, Compensation—Stock Compensation—Employee Stock Ownership Plans; an employee stock ownership plan (ESOP) is “an employee benefit plan that is described by the Employee Retirement Income Security Act of 1974 (ERISA) and the Internal Revenue Code (IRC) of 1986 as a
stock bonus plan, or combination stock bonus and money purchase pension plan, designed to invest primarily in employer stock.” By law, employers with ESOPs must provide the employee with a put option or other redemption feature if the shares are not readily tradable; often, the plan requires that upon death, retirement, or the employee’s reaching a certain age the shares must be sold back to the employer at fair value. If the employer must redeem, then the shares meet the definition of mandatorily redeemable shares under ASC Topic 480. Although ASC Topic 480 “does not apply to obligations under stock-based compensation arrangements if those arrangements are accounted for under APB Opinion No. 25, Accounting for Stock Issued to Employees; ASC Topic 718, Compensation—Stock Compensation; ASC Subtopic 718-40, Compensation—Stock Compensation—Employee Stock Ownership Plans; ASC Subtopic 718-740, Compensation—Stock Compensation—Income Taxes; or related guidance,” it includes within its scope a “freestanding financial instrument that was issued under a stock-based compensation arrangement but is no longer subject to Opinion 25, ASC Topic 718, ASC Subtopic 718-40, ASC Subtopic 718-740, or related guidance” (paragraph 17).

Q. Are ESOP shares that are mandatorily redeemable or freestanding agreements to repurchase ESOP shares within the scope of ASC Topic 480?

A. No, ESOP shares or freestanding agreements to repurchase those shares are not within the scope of ASC Topic 480, because those shares are accounted for under ASC Subtopic 718-40 and ASC Subtopic 718-740 or its related guidance through the point of redemption. For example, ASC Subtopic 718-40 and ASC Subtopic 718-740 provide accounting guidance for dividends on allocated shares, redemption of shares, recognition of expense, and computing earnings per share. However, ESOP shares that are mandatorily redeemable or freestanding agreements to repurchase those shares continue to be subject to other applicable guidance related to ASC Subtopic 718-40 and ASC Subtopic 718-740; for example, ASC paragraph 480-10-S99-4. As discussed in ASC paragraph 480-10-S99-4, SEC registrants are required to comply with SEC Accounting Series Release No. 268, Presentation in Financial Statements of “Redeemable Preferred Stocks,” which requires certain amounts to be classified outside of permanent equity.

QUESTIONS AND ANSWERS

Q&A 7.1: Company A incurs an obligation for contingent consideration related to a business combination.

Q. Does ASC Topic 480 impact the timing of recognition of financial instruments issued as contingent consideration in a business combination?

A. No. The accounting for contingent consideration issued in business combinations is addressed in ASC Topic 805 and related guidance (for example,
EITF 97-8 and EITF 97-15). ASC Topic 480 does not alter the measurement guidance for contingent consideration set forth in the applicable business combination literature. However, when recognized, a financial instrument within the scope of ASC Topic 480 that was issued as consideration (whether contingent or noncontingent) in a business combination should be accounted for pursuant to the requirements of ASC Topic 480.

Q&A 7.2: Company A has obligations under stock-based compensation arrangements that are separately accounted for under either APB 25, ASC Topic 718, ASC Subtopic 718-40, or ASC Subtopic 718-740.

Q. Do the classification guidelines of ASC Topic 480 apply to obligations under stock-based compensation arrangements accounted for under APB 25, Statement 123, ASC Topic 718, ASC Subtopic 718-40, ASC Subtopic 718-740, or related guidance?

A. It depends. ASC Topic 480 does not apply to obligations that are currently accounted for under ASC Topic 718, ASC Subtopic 718-740, or related guidance. However, certain share-based payment awards accounted for under ASC Topic 718 may be subject to the classification provisions of ASC Topic 480 unless ASC paragraphs 718-10-25-8 through 25-19 require otherwise. Additionally, ASC Topic 480 does apply to a freestanding financial instrument that was issued under a stock-based compensation arrangement but is no longer subject to ASC Topic 480, ASC Subtopic 718-40, ASC Subtopic 718-740, or related guidance. Notwithstanding this, ASC paragraph 480-10-15-8 clarifies that ESOP shares and freestanding agreements to repurchase those shares are not within the scope of ASC Topic 480 because those shares are accounted for under ASC Subtopic 718-40, ASC Subtopic 718-740 or its related guidance through the point of redemption.
8. Presentation

Introduction

Classification of Freestanding Financial Instruments

Assets or Liabilities

Interaction with ASR 268

Interaction with ASC Subtopic 815-40 and ASC Paragraph 480-10-55-63

Balance Sheet Classification

Presentation if All Shares Are Mandatorily Redeemable

Questions and Answers
8. Presentation

INTRODUCTION

8.000 This Section discusses the financial statement presentation of instruments within the scope of ASC Topic 480.

CLASSIFICATION OF FREESTANDING FINANCIAL INSTRUMENTS

8.001 ASC paragraph 480-10-45-1 indicates the following:

Items within the scope of [ASC Topic 480] shall be presented as liabilities (or assets in some circumstances). Those items shall not be presented between the liabilities section and the equity section of the statement of financial position.

8.002 All freestanding financial instruments within the scope of ASC Topic 480 are required to be classified as liabilities (or assets in some circumstances); as such, instruments within the scope of ASC Topic 480 may not be presented in the “temporary equity” or “mezzanine” section of the balance sheet (between liabilities and equity). Certain financial instruments were presented between the liabilities and equity sections of the statement of financial position before the issuance of ASC Topic 480. Because Concepts Statement 6 does not accommodate classification of items outside the elements of assets, liabilities, and equity, developing a model that permits the continued practice of presenting “temporary equity” would have required the Board to define a new element of financial statements. The Board elected not to pursue that course of action, in part, because, among other concerns, adding another element would set an undesirable precedent of adding elements whenever new instruments are created that are difficult to classify.

8.003 The Board instead elected to develop an approach that would address the issues related to determining the appropriate classification of financial instruments with characteristics of liabilities, equity, or both. Because the Board believes that the provisions of ASC Topic 480 sufficiently address those issues for the items within its scope, the Board concluded that presentation of the items within the scope of ASC Topic 480 between the liabilities and equity sections of the statement of financial position was prohibited.

ASSETS OR LIABILITIES

8.004 An instrument within the scope of ASC paragraphs 480-10-25-4 and 25-6 is always classified in the statement of financial position as a liability (see Paragraph 3.006 for additional information). However, instruments within the scope of ASC paragraphs 480-10-25-8 through 25-10, 25-12 and 25-14 may, under certain circumstances, be classified...
in the statement of financial position as an asset or a liability (see Paragraphs 4.010–4.013 and Paragraphs 5.026–5.028 for additional information).

8.005 Entities that issue freestanding financial instruments within the scope of ASC Topic 480 should consider the potential impact of those instruments on the statements of financial position, operations and cash flows, especially the effect on any debt covenant requirements.

INTERACTION WITH ASR 268

8.006 SEC registrants are subject to ASR 268 and its related interpretations. That guidance requires securities with redemption features outside the control of the issuer to be classified outside of permanent equity. Such instruments are frequently classified between the liabilities and equity sections in the statement of financial position. While the presentation and measurement requirements in ASR 268 and its related interpretations do not apply to instruments within the scope of ASC Topic 480 (see Paragraph 2.004 for additional information), ASR 268 and its related interpretations continue to apply to instruments that are outside the scope of ASC Topic 480 (e.g., puttable shares). As a result, an entity subject to the provisions of ASR 268 is required to continue to classify instruments in its scope that are outside the scope of ASC Topic 480 between the liabilities and equity sections in the statement of financial position.

INTERACTION WITH ASC SUBTOPIC 815-40 AND ASC PARAGRAPH 480-10-55-63

8.007 Any freestanding derivative equity instrument that was in the scope of ASC Subtopic 815-40 or ASC paragraph 480-10-55-63 prior to issuance of ASC Topic 480 and was classified as temporary equity under ASR 268 would be classified as a liability under ASC Topic 480 (see discussion of such instruments in Section 4 of this book). Additionally, certain freestanding equity instruments that were within the scope of ASC Subtopic 815-40 and ASC paragraph 480-10-55-63 prior to ASC Topic 480 and were classified as permanent equity (e.g., a net share settled written put option) may require liability classification under ASC Topic 480 (see discussion of such instruments in Section 5 of this book).

BALANCE SHEET CLASSIFICATION

8.008 For entities that present a classified balance sheet, assets and liabilities are required to be presented as current or long-term. When determining the appropriate balance sheet classification for freestanding financial instruments within the scope of ASC Topic 480, issuers should refer to relevant current authoritative guidance. ASC Topics that provide guidance on balance sheet classification include, but are not limited to, the following:

- ASC Section 210-10-45 of ASC Topic 210, Balance Sheet;
- ASC Topic 470, Debt;
• ASC paragraph 470-10-45-12;
• ASC paragraphs 470-10-55-34 through 55-36 and 470-10-45-15;
• ASC paragraphs 470-10-45-2 and 470-10-50-3;
• ASC paragraphs 470-10-45-9 and 45-10;
• ASC paragraphs 470-10-55-3 through 55-6 and 470-10-45-1;
• ASC paragraphs 470-10-45-4 through 45-6; and
• ASC paragraph 470-10-55-1.

PRESENTATION IF ALL SHARES ARE MANDATORILY REDEEMABLE

8.009 ASC paragraph 480-10-45-2 indicates the following:

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

8.010 After an entity applies the provisions of ASC Topic 480 to its freestanding financial instruments, the entity may determine that all of its outstanding equity shares meet the definition of a mandatorily redeemable financial instrument and are within the scope of ASC paragraphs 480-10-25-4 and 25-6. For example, an entity that issues equity shares that are required to be redeemed upon the death of the holder would conclude that its equity shares are mandatorily redeemable under the provisions of ASC paragraphs 480-10-25-4 and 25-6. The Board concluded that, while special situations may exist when all of an entity’s equity instruments meet the definition of a mandatorily redeemable financial instrument, the definition does not change and an entity cannot classify them differently from other mandatorily redeemable financial instruments as there is no adequate basis for any exception to the definition. However, the Board acknowledged the need for special reporting when equity is not reported by the issuer. Therefore, the Board concluded that entities that have no outstanding equity instruments but have financial instruments in the form of shares (all of which are mandatorily redeemable financial instruments required to be classified as liabilities) should describe those instruments as shares subject to mandatory redemption to distinguish them from other liabilities. Payments to holders of such instruments should be presented separately from payments to and interest due to other creditors in statements of cash flows and income.

8.011 In addition to separate presentation for entities that have financial instruments in the form of shares that are all mandatorily redeemable, ASC Topic 480 requires a related
disclosure that displays the nature and composition of the mandatorily redeemable instruments. See Paragraphs 11.004–11.006 for additional information.

8.012 Instruments issued by a non-SEC registrant that are mandatorily redeemable on fixed dates for amounts that are fixed or are determinable by reference to an interest rate index, currency index, or another external index, are subject to the classification, measurement, or disclosure requirements of ASC Topic 480. However, ASC paragraphs 480-10-15-7A through 15-7F provide a scope exception to the classification, measurement, and disclosure requirements of ASC Topic 480 for all other mandatorily redeemable financial instruments issued by non-SEC registrants. Accordingly, non-SEC registrants do not account for shares that are required to be redeemed upon the holder’s death or termination of employment as mandatorily redeemable financial instruments under ASC Topic 480. It should be noted that some SEC registrants have issued shares, all of which are required to be redeemed upon an event certain to occur, and are subject to the provisions of ASC Topic 480 for those instruments. See Section 12 of this book for additional information.

8.013 The following exemplifies a summary presentation of shares subject to mandatory redemption in the statement of financial position for an SEC registrant:

**Example 8.1: Presentation If All Shares Are Mandatorily Redeemable**

**Background**

Company A meets the definition of a *nonpublic entity* because (1) it does not have equity securities traded in a public market or in the over-the-counter market, (2) it has not made a filing with a regulatory agency in preparation for the sale of equity securities in a public market, and (3) it is not controlled by an entity covered by (1) or (2). However, Company A meets the definition of an *SEC registrant* because it is required to file financial statements with the SEC.

The Company has issued one class of common shares, which are all held by employees and are required to be redeemed at their fair value for cash upon the holder’s death or termination of employment.

**Analysis**

Company A common shares are considered mandatorily redeemable financial instruments under ASC paragraphs 480-10-25-4 and 25-6 because they (1) are issued in the form of shares, (2) embody an unconditional obligation that requires Company A to redeem the instrument by transferring assets (i.e., cash), and (3) contain an event certain to occur upon which the assets are required to be transferred (i.e., death or termination of the employee).

Because Company A meets the definition of a nonpublic entity and an SEC registrant, the provisions of ASC Topic 480 for mandatorily redeemable financial instruments apply to it. As such, these mandatorily redeemable financial
instruments (with uncertain redemption amounts and dates) are within the scope of Topic 480 and the scope exception provided in ASC paragraphs 480-10-15-7A through 15-7F does not apply. Because the mandatorily redeemable financial instruments represent the only shares in the entity, Company A should present them as shares subject to mandatory redemption in the liabilities section of its balance sheet. An example of this presentation follows:

Company A

Balance Sheet

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Assets</td>
<td>$100</td>
</tr>
<tr>
<td>Liabilities other than shares</td>
<td>$60</td>
</tr>
<tr>
<td>Shares subject to mandatory redemption</td>
<td>40</td>
</tr>
<tr>
<td>Total Liabilities</td>
<td>$100</td>
</tr>
</tbody>
</table>

(See Example 11.1 for the required disclosures for this example.)

8.014 A number of liability measurement issues have arisen for entities that have outstanding shares, all of which are subject to mandatory redemption on the occurrence of events that are certain to occur. These issues and the appropriate measurement guidance are further discussed in Section 9.

QUESTIONS AND ANSWERS

Q&A 8.1: Company A issues a mandatorily redeemable financial instrument that is within the scope of ASC Topic 480.

Q. Can an instrument within the scope of ASC Topic 480 be classified in the mezzanine section of the balance sheet (between liabilities and equity)?

A. No. Mandatorily redeemable financial instruments within the scope of ASC Topic 480 are required to be classified as liabilities. However, SEC registrants continue to be subject to the guidance in ASR 268 and its related interpretations for instruments that are not in the scope of ASC Topic 480 (e.g., puttable shares). ASR 268 requires securities with redemption features outside the control of the issuer to be classified outside of permanent equity.
Q&A 8.2: Company A is an SEC registrant and all of its equity shares are within the scope of ASC paragraphs 480-10-25-4 and 25-6.

Q. Are there special presentation requirements for an entity that has no equity instruments outstanding as a result of applying ASC Topic 480?

A. Yes. Entities that have no equity instruments outstanding but have financial instruments issued in the form of shares, all of which are mandatorily redeemable financial instruments required to be classified as liabilities, should describe those instruments as shares subject to mandatory redemption in statements of financial position to distinguish those instruments from other liabilities. Similarly, payments to holders of such instruments and related expenses should be presented separately (i.e., on a separate line) from payments to and interest due to other creditors in statements of cash flows and income. In addition, such entities should disclose the components of the liability that would otherwise be related to shareholders’ interests and other comprehensive income (if any) subject to the redemption feature. For example, par value and other paid-in amounts of mandatorily redeemable instruments are required to be disclosed separately from the amount of retained earnings or accumulated deficit. See Paragraphs 11.004–11.006 for additional information related to disclosures.
9. Initial and Subsequent Measurement

Introduction

Mandatorily Redeemable Financial Instruments and Certain Forward Contracts

Initial Measurement

Mandatorily Redeemable Financial Instruments
Certain Forward Contracts
Physical Settlement
Cash Delivery

Subsequent Measurement

Amendment to ASC Topic 815 for Forward Contracts
Subsequent Measurement if All Shares Are Mandatorily Redeemable
Book Value Redemption
Other Than Book Value Redemption

All Other Instruments

Initial Measurement
Subsequent Measurement

Questions and Answers
9. Initial and Subsequent Measurement

INTRODUCTION

9.000 This section discusses the initial and subsequent measurement requirements of freestanding financial instruments within the scope of ASC Topic 480.

MANDATORILY REDEEMABLE FINANCIAL INSTRUMENTS AND CERTAIN FORWARD CONTRACTS

9.001 There are specific initial and subsequent measurement requirements for mandatorily redeemable financial instruments that are within the scope of ASC paragraphs 480-10-25-4 and 25-6 (discussed in Section 3) and forward contracts that require physical settlement by repurchase of a fixed number of the issuer’s equity shares in exchange for cash that are within the scope of ASC paragraphs 480-10-25-8 through 25-10 and 25-12 (discussed in Section 4).

Initial Measurement

9.002 The initial measurement requirements as they relate to mandatorily redeemable financial instruments and certain forward purchase contracts on an entity’s equity shares are described in ASC paragraphs 480-10-30-1 and 30-3 through 30-5.

MANDATORILY REDEEMABLE FINANCIAL INSTRUMENTS

9.003 ASC paragraph 480-10-30-1 indicates:

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

9.004 Generally, a mandatorily redeemable financial instrument within the scope of ASC paragraphs 480-10-25-4 and 25-6 initially is required to be measured at fair value.

9.005 Mandatorily redeemable financial instruments may be issued in conjunction with detachable warrants. ASC Subtopic 815-40, ASC paragraph 480-10-55-63 and ASC Topic 815 require freestanding warrants within their scope to be initially recorded at fair value. As a result, if an entity issues a mandatorily redeemable financial instrument in conjunction with an instrument within the scope of ASC Subtopic 815-40, ASC paragraph 480-10-55-63, or ASC Topic 815, disparity exists between that accounting literature’s initial recognition requirement and ASC Topic 480’s, if the separate fair values of the individual instruments issued do not equal the amount of proceeds received.

9.006 If the detachable warrants are initially classified as an equity instrument and not subsequently remeasured through income under ASC Subtopic 815-40 and ASC paragraph 480-10-55-63, we believe entities generally should allocate the proceeds between the mandatorily redeemable financial instruments and detachable warrants on a
relative fair value basis, consistent with the provisions of ASC Subtopic 470-20, Debt – Debt with Conversion and Other Options. Recognition of the discount (or premium) on the mandatorily redeemable financial instruments attributable to the relative fair value allocation becomes a component of the interest rate implicit in the instrument and becomes incorporated within the application of the subsequent measurement guidance related to mandatorily redeemable financial instruments.

9.007 Mandatorily redeemable financial instruments also may be issued in conjunction with detachable warrants that are initially classified as an asset or liability and subsequently measured at fair value through income under ASC Subtopic 815-40, ASC paragraph 480-10-55-63, or ASC Topic 815. For example, if the detachable warrants do not meet the criteria for equity classification in ASC Subtopic 815-40 and ASC paragraph 480-10-55-63, the warrants are classified as liabilities and subsequently remeasured at fair value each reporting period in accordance with either ASC Subtopic 815-40, ASC paragraph 480-10-55-63, or ASC Topic 815. In such a situation, because an allocation of the proceeds based upon either a relative fair value approach or an approach that first allocates the proceeds to the mandatorily redeemable financial instrument based on its fair value at inception would result in an immediate income statement impact upon recording the transaction (i.e., the warrants are required to be subsequently remeasured at fair value), we believe the detachable warrants should be recognized at their fair value at issuance and the residual proceeds should be allocated to the mandatorily redeemable financial instruments. Recognition of the discount (or premium) on the mandatorily redeemable financial instruments attributable to this fair value allocation becomes a component of the interest rate implicit in the instrument and becomes incorporated within the application of the subsequent measurement guidance related to mandatorily redeemable financial instruments.

CERTAIN FORWARD CONTRACTS

9.008 ASC paragraphs 480-10-30-3 through 30-5 indicate:

> Forward contracts that require physical settlement by repurchase of a fixed number of the issuer’s equity shares in exchange for cash shall be measured initially at the fair value of the shares at inception, adjusted for any consideration or unstated rights or privileges.¹ Equity shall be reduced by an amount equal to the fair value of the shares at inception.

¹ One way to obtain that amount is by determining the amount of cash that would be paid under the conditions specified in the contract if the shares were repurchased immediately. Another way to obtain the same result is by discounting the settlement amount, at the rate implicit at inception after taking into account any consideration or unstated rights or privileges that may have affected the terms of the transaction.
Initial and Subsequent Measurement

9.009 ASC Topic 480 indicates that forward contracts that require physical settlement by repurchase of a fixed number of the issuer’s equity shares in exchange for cash be recognized as a liability and initially measured at fair value of the shares at inception, adjusted for any consideration or unstated rights or privileges, with an offset (i.e., debit) to equity (e.g., treasury shares). Alternatively, the same liability amount may be measured, at inception, by discounting the settlement amount at the rate implicit at inception, after taking into account any consideration or unstated rights or privileges that may have affected the terms of the transaction.

9.010 Forward purchase contracts that require physical settlement by repurchase of a fixed number of the issuer’s equity shares in exchange for cash embody an unconditional obligation to transfer cash to pay the full repurchase price for the shares. In the Board’s view, such forward contracts are more like a treasury stock purchase using borrowed funds than a derivative instrument because the contract effectively converts the shares that the counterparty is required to deliver into mandatorily redeemable instruments, which ASC Topic 480 classifies as liabilities (see Section 3 for additional information). Accounting for this arrangement like a borrowing requires the need to consider the effect of any unstated rights or privileges, for the same reasons discussed in ASC Subtopic 835-30, Interest – Imputation of Interest. The same reasoning also requires that the measurement provisions for forward contracts that require physical settlement by repurchase of a fixed number of the issuer’s equity shares apply only if the issuer will exchange cash for the shares. That is, in order to be initially measured and recorded under ASC paragraphs 480-10-30-3 through 30-5, a forward contract to repurchase a fixed number of an issuer’s entity shares is required to meet two requirements: (1) physical settlement is the only permitted settlement method, and (2) the issuer is required to deliver cash to settle the contract.

Physical Settlement

9.011 Forward contracts to repurchase a fixed number of an issuer’s equity shares with physical delivery as the only settlement alternative meet the first requirement to be initially measured and recorded under ASC paragraphs 480-10-30-3 through 30-5. Forward contracts to repurchase a fixed number of an issuer’s equity shares that permit or allow other settlement alternatives (e.g., net cash, net shares) are outside the scope of ASC paragraphs 480-10-30-3 through 30-5, regardless of which entity has the settlement choice and regardless of the intention of that entity as to how the contract will be settled. For example, assume Company A enters into a forward contract to repurchase a fixed number of its common shares and the contract specifies that Company A has the choice of physically settling the contract for cash or net share settling the contract. Company A explicitly states that its intention is to physically settle the contract, and Company A has a history of always physically settling similar contracts. Because the contract allows for another settlement alternative in addition to physical settlement, the contract is not initially measured and recorded under ASC paragraphs 480-10-30-3 through 30-5; however, the contract is within the scope of ASC paragraphs 480-10-25-8 through 25-10, 25-12, and 25-14. Therefore, it initially and subsequently is accounted for in accordance with the provisions of ASC paragraphs 480-10-30-2 and 30-7; 480-10-35-1, and 35-5. See Paragraphs 9.024–9.029 for additional information.
Cash Delivery

9.012 Forward contracts to repurchase a fixed number of an issuer’s equity shares with an exchange of cash meet the second requirement to be initially measured and recorded under ASC paragraphs 480-10-30-3 through 30-5. It should be noted that there is no requirement that a fixed amount of cash (e.g., a fixed financing cost) be exchanged in order to be within the scope of ASC paragraphs 480-10-30-3 through 30-5. As a result, a forward contract that requires an entity to deliver an amount of cash (e.g., $1,000) and interest at a variable rate (e.g., LIBOR) to be paid in cash in exchange for a fixed number of its shares is within the scope of ASC paragraphs 480-10-30-3 through 30-5.

9.013 In addition, instruments initially measured and recorded under ASC paragraphs 480-10-30-3 through 30-5 are not required to be settled in the functional currency of the issuing entity. That is, a U.S. dollar functional currency entity that enters into a physically-settled forward contract to repurchase a fixed number of its equity shares in exchange for a currency other than the U.S. dollar is subject to the measurement provisions of ASC paragraphs 480-10-30-3 through 30-5; 480-10-35-3; and 480-10-45-3 for that contract. Further, a requirement in the contract to settle in a currency different from the functional currency of the issuing entity would not need to be analyzed pursuant to the embedded derivative provisions of ASC Topic 815 since the embedded feature is exempt under ASC paragraphs 815-15-15-5, 15-6, 15-10, and 15-14 because the liability is remeasured to spot rates under ASC Topic 830, Foreign Currency Matters. However, any amounts paid or to be paid to holders of those instruments in excess of the initial measurement amount (including those attributable to changes in spot foreign currency rates) should be recognized in income.

9.014 While forward purchase contracts that are required to be physically settled by delivering assets other than cash in exchange for shares–barter contracts–embody an unconditional obligation, those contracts are not akin to a treasury stock purchase using borrowed funds since no cash is involved. As a result, those contracts are accounted for in the same manner as conditional obligations to purchase the issuer’s equity shares (see Paragraphs 9.023–9.029).

Subsequent Measurement

9.015 ASC paragraphs 480-10-35-3 and 480-10-45-3 indicate:

Forward contracts that require physical settlement by repurchase of a fixed number of the issuer’s equity shares in exchange for cash and mandatorily redeemable financial instruments shall be measured subsequently in one of two ways. If both the amount to be paid and the settlement date are fixed, those instruments shall be measured subsequently at the present value of the amount to be paid at settlement, accruing interest cost using the rate implicit at inception. If either the amount to be paid or the settlement date varies based on specified conditions, those instruments shall be measured subsequently at the amount of cash that would be paid under the conditions specified in the contract if settlement occurred at the reporting date, recognizing the resulting change in that amount.
from the previous reporting date as interest cost. Any amounts paid or to be paid to holders of those contracts in excess of the initial measurement amount shall be reflected in interest cost.

9.016 Financial instruments within the scope of ASC paragraphs 480-10-25-4 and 25-6; ASC paragraphs 480-10-25-8 through 25-10 and 25-12; and 480-10-30-3 through 30-5 are required to be subsequently measured in one of two ways, depending on the characteristics of the contract. If both the amount of cash and the settlement date are fixed, subsequent measurement is at the present value of the amounts to be paid at settlement, with interest accreted using the rate implicit at inception. If either the amount to be paid at settlement or the settlement date varies based on specified conditions, subsequent measurement is at the amount of cash that would be paid under the conditions specified in the contract as if the shares were redeemed or repurchased at each reporting date. The Board chose these two methods because they are generally used to subsequently measure liabilities for funds borrowed at fixed and floating rates. We believe the provisions of ASC Topic 835, Interest, apply to amounts classified as interest cost under ASC paragraph 480-10-35-3 and ASC paragraph 480-10-45-3.

9.017 For forward contracts to repurchase a fixed number of either an issuer’s preferred shares or common shares within the scope of ASC paragraphs 480-10-25-8 through 25-10 and 25-12; and 480-10-30-3 through 30-5 and mandatorily redeemable financial instruments related to preferred shares or common shares within the scope of ASC paragraphs 480-10-25-4 and 25-6; 480-10-35-3; and 480-10-45-3 require that any amount paid or to be paid to holders of those contracts in excess of the initial measurement amount be recognized as interest cost. Assuming the holder of the contract is entitled to the amount and is not required contractually to remit it back to the issuer, the following should be included in interest cost during the life of such contracts because it is consistent with reporting the contracts as liabilities:

- Dividends paid or declared on the stock;
- Accrued but undeclared cumulative dividends;
- The accretion of any difference between the carrying amount and the settlement amount; and
- Any other contractual amounts either (1) paid, or (2) earned, accrued, and required to be paid.

(If applicable, the amounts attributable to changes in spot foreign currency rates as discussed in Paragraph 9.013 are recognized in income and classified consistent with the entity’s policy for similar changes in other liabilities).

9.018 The following represent examples of the application of ASC Topic 480 to forward contracts to repurchase a fixed number of an issuer’s equity shares:
Example 9.1: Physically Settled Forward Purchase Contract With a Fixed Price

Background

On January 1, 20X1, Company A enters into a forward contract to repurchase 1 million shares of its common stock from another party on December 31, 20X3. At inception, the forward contract price per share is $30, and the current per share price (on January 1, 20X1) of the underlying shares is $25. The contract’s terms require the entity to pay cash to repurchase the shares (Company A is obligated to transfer $30 million on December 31, 20X3 and will receive 1 million of its shares).

Analysis

The forward contract is subject to the provisions of ASC paragraphs 480-10-25-8 through 25-10 and 25-12 because the instrument (a) is not an outstanding share of the issuer (i.e., it is a forward contract), (b) embodies an obligation, at inception, such that Company A is required to repurchase its own shares (i.e., in this case it represents an unconditional obligation), and (c) requires Company A to settle the obligation by transferring its assets (i.e., $30 million cash).

The forward contract is also within the scope of paragraphs ASC paragraphs 480-10-30-3 through 30-5; 480-10-35-3; and 480-10-45-3 because Company A is required to repurchase a fixed number of its shares (i.e., 1 million shares of its common stock) in exchange for cash, and physical settlement is required. As a result, the liability should be measured initially at the fair value of the shares at inception of the contract. In this case, the liability would be recognized at $25 million (1 million shares to be received multiplied by the share price of $25 per share on January 1, 20X1) with a corresponding reduction to equity.

In accordance with ASC paragraphs 480-10-35-3 and 480-10-45-3, because the amount to be paid and the settlement date are fixed, the forward contract is required to be subsequently measured at the present value of the amount to be paid at settlement, accruing interest cost using the rate implicit at inception. The rate implicit at inception of the contract in this example is 9.54% (the rate that equates a payment of $30 million in two years for an initial $25 million liability).
Example 9.2: Physically Settled Forward Purchase Contract With a Fixed Price and Other Consideration

Background

On January 1, 20X1, Company A enters into a forward contract to repurchase 1 million shares of its common stock from another party on December 31, 20X3. The current per share price (on January 1, 20X1) of the underlying shares is $30. The contract’s terms require the entity to pay $30 million cash to repurchase the shares (Company A is obligated to transfer $30 million on December 31, 20X3 and will receive 1 million of its shares). On January 1, 20X1, Company A sold to the same counterparty a product at a $5 million discount. That discount was not provided to any other customer and would not have been granted unless the counterparty simultaneously agreed to enter into the forward contract.

Analysis

The forward contract is within the scope of ASC paragraphs 480-10-25-8 through 25-10 and 25-12 because the instrument (a) is not an outstanding share of the issuer (i.e., it is a forward contract), (b) embodies an obligation, at inception, such that Company A is required to repurchase its own shares (i.e., in this case it represents an unconditional obligation), and (c) requires Company A to settle the obligation by transferring its assets (i.e., $30 million cash).

The forward contract is also subject to the provisions of ASC paragraphs 480-10-30-3 through 30-5; 480-10-35-3; and 480-10-45-3 because Company A is required to repurchase a fixed number of its shares (i.e., 1 million shares of its common stock) in exchange for cash, and physical settlement is required. As a result, the liability should be measured initially at the fair value of the shares at inception of the contract, adjusted for any consideration or unstated rights or privileges. In this case, the liability would be recognized at $25 million with a corresponding reduction to equity. The $25 million is calculated by multiplying 1 million shares to be received by the share price of $30 per share on January 1, 20X1 less the $5 million discount Company A provided to the counterparty when Company A simultaneously sold its product.

In accordance with ASC paragraph 480-10-35-3 and ASC paragraph 480-10-45-3, because the amount to be paid and the settlement date are fixed, the forward contract is required to be subsequently measured at the present value of the amount to be paid at settlement, accruing interest cost using the rate implicit at inception. The rate implicit at inception of the contract (after adjustment for any consideration or unstated rights or privileges) in this example is 9.54% (the rate that equates a payment of $30 million in two years for an initial $25 million liability).
Example 9.3: Physically Settled Forward Purchase Contract With a Fixed Price and an Exchange of Cash at Inception

Background
On January 1, 20X1, Company A enters into a forward contract to repurchase 1 million shares of its common stock from another party on December 31, 20X3. The current per share price (on January 1, 20X1) of the underlying shares is $20. At inception of the contract, Company A receives $5 million cash from the counterparty and the contract’s terms require the entity to pay $30 million cash to repurchase the shares (Company A is obligated to transfer $30 million on December 31, 20X3 and will receive 1 million of its shares).

Analysis
The forward contract is within the scope of ASC paragraphs 480-10-25-8 through 25-10 and 25-12 because the instrument (a) is not an outstanding share of the issuer (i.e., it is a forward contract), (b) embodies an obligation, at inception, such that Company A is required to repurchase its own shares (i.e., in this case it represents an unconditional obligation), and (c) requires Company A to settle the obligation by transferring its assets (i.e., $30 million cash).

The forward contract is also subject to the provisions of ASC paragraphs 480-10-30-3 through 30-5; 480-10-35-3; and 480-10-45-3 because Company A is required to repurchase a fixed number of its shares (i.e., 1 million shares of its common stock) in exchange for cash, and physical settlement is required. As a result, the liability should be measured initially at the fair value of the shares at inception of the contract, adjusted for any consideration or unstated rights or privileges. In this case, the liability would be recognized at $25 million (1 million shares to be received multiplied by the share price of $20 per share on January 1, 20X1 plus the $5 million Company A received from the counterparty at inception of the contract), an asset would be recognized for $5 million for the cash received, and equity would be reduced by $20 million.

In accordance with ASC paragraphs 480-10-35-3 and 480-10-45-3, because the amount to be paid and the settlement date are fixed, the forward contract is required to be subsequently measured at the present value of the amount to be paid at settlement, accruing interest cost using the rate implicit at inception. The rate implicit at inception of the contract (after adjustment for any consideration or unstated rights or privileges) in this example is 9.54% (the rate that equates a payment of $30 million in two years for an initial $25 million liability).
Example 9.4: Physically Settled Forward Purchase Contract With a Variable Price

Background

On January 1, 20X1, Company A enters into a forward contract to repurchase 1 million shares of its common stock from another party on December 31, 20X3. The current per share price (on January 1, 20X1) of the underlying shares is $25. The contract’s terms require Company A to pay cash to repurchase the shares (Company A is obligated to transfer $25 million and interest of LIBOR plus 2% on December 31, 20X3, and Company A will receive 1 million of its shares).

Analysis

The forward contract is subject to the provisions of ASC paragraphs 480-10-25-8 through 25-10 and 25-12 because the instrument (a) is not an outstanding share of the issuer (i.e., it is a forward contract), (b) embodies an obligation, at inception, such that Company A is required to repurchase its own shares (i.e., in this case it represents an unconditional obligation), and (c) requires Company A to settle the obligation by transferring its assets (i.e., $30 million cash).

The forward contract is also within the scope of ASC paragraphs 480-10-30-3 through 30-5; 480-10-35-3; 480-10-45-3 because Company A is required to repurchase a fixed number of its shares (i.e., 1 million shares of its common stock) in exchange for cash, and physical settlement is required. As a result, the liability should be measured initially at the fair value of the shares at inception of the contract, adjusted for any consideration or unstated rights or privileges. In this case, the liability would be recognized at $25 million (1 million shares to be received multiplied by the share price of $25 per share on January 1, 20X1) with a corresponding reduction to equity.

In accordance with ASC paragraphs 480-10-35-3 and 480-10-45-3, because the amount to be paid at settlement varies based on LIBOR, the forward contract is required to be subsequently measured at the amount of cash that would be paid under the conditions specified in the contract if settlement occurred at the reporting date. As a result, at each reporting date, the liability should be reported on the balance sheet at $25 million plus accrued interest at LIBOR plus 2%. Any changes from the initial liability balance of $25 million should be recognized as interest cost.
AMENDMENT TO ASC TOPIC 815 FOR FORWARD CONTRACTS

9.019 ASC Topic 815 requires derivative instruments within its scope to be initially and subsequently measured at fair value. Forward contracts to repurchase a fixed number of an issuer’s equity shares that are within the scope of ASC paragraphs 480-10-25-8 through 25-10 and 25-1; 480-10-30-3 through 30-5; 480-10-35-3; and 480-10-45-3 may be within the scope of ASC Topic 815. Because the subsequent measurement requirements in ASC Topic 480 for such contracts are different than those of ASC Topic 815, the Board amended the provisions of ASC Topic 815 by adding ASC paragraph 815-10-15-74(d) to ASC Topic 815. The amendment indicates that forward contracts to repurchase a fixed number of an issuer’s equity shares in exchange for cash that are accounted for under ASC paragraphs 480-10-30-3 through 30-5; 480-10-35-3; and 480-10-45-3 are outside the scope of ASC Topic 815. Accordingly, such arrangements are required to be accounted for under ASC Topic 480, regardless of whether they would otherwise meet the definition of a derivative under ASC Topic 815. In addition, even though the amendment did not impact the responses in ASC paragraphs 815-10-55-84 through 55-89; 815-10-15-3; 815-10-25-2 and 25-3; 815-20-25-47 through 25-49; and 815-10-45-8, the Board referenced this amendment in that issue because some of its examples may no longer be subject to the provisions of ASC Topic 815.

SUBSEQUENT MEASUREMENT IF ALL SHARES ARE MANDATORILY REDEEMABLE

9.020 ASC paragraph 480-10-15-7A states that ASC Topic 480 does not apply to non-SEC registrants with respect to mandatorily redeemable financial instruments for which the redemption date is not fixed or the redemption amount is not determined by reference to certain indices. However, a number of unique measurement issues arise for SEC registrants that have no equity instruments outstanding but have financial instruments issued in the form of shares, all of which are mandatorily redeemable and classified as liabilities under ASC Topic 480. See Section 12 for additional information.

Book Value Redemption

9.021 If an SEC registrant has no equity instruments outstanding but has financial instruments issued in the form of shares that are required to be redeemed at the book value of the shares on a redemption date that is not fixed, ASC Topic 480 requires the mandatorily redeemable shares to be reported as a liability and subsequently measured at the amount of cash that would be paid under the conditions specified in the contract if settlement occurred at the reporting date, in accordance with ASC paragraphs 480-10-35-3 and 480-10-45-3. That is, the liability is the book value of the entity’s assets net of its other liabilities, with the change from the previous period being recognized as interest cost (separately from other interest). Therefore, while the entity may report an amount of income before interest on mandatorily redeemable shares, the net income (loss) in the statement of income always would be zero, provided net book value is positive. For example, if an SEC registrant has no equity instruments outstanding but has financial instruments issued in the form of shares that are required to be redeemed at the book value of the shares upon the death of the holder, those liabilities would be measured at
the amount of cash that would be paid under the conditions specified in the contract if settlement occurred at the reporting date and changes in those liabilities (i.e., changes in the book value of the entity) would be recognized as interest cost in the income statement resulting in zero net income each period.

Other Than Book Value Redemption

9.022 If an SEC registrant has no equity instruments outstanding but has financial instruments issued in the form of shares that are required to be redeemed at an amount other than the book value (e.g., fair value) of the shares on a redemption date that is not fixed, ASC Topic 480 requires the mandatorily redeemable shares to be reported as a liability and subsequently measured at the amount of cash that would be paid under the conditions specified in the contract if settlement occurred at the reporting date, in accordance with ASC paragraphs 480-10-35-3 and 480-10-45-3. ASC paragraphs 480-10-45-2A and 45-2B were issued to clarify this requirement. In such cases, subsequent changes in the liability could be greater than or less than net income for the period or the book value of the entity. If the redemption price of the mandatorily redeemable shares is less than (greater than) the book value of those shares, the entity should report the excess (deficit) of that book value over the liability reported for the mandatorily redeemable shares as an excess of assets over liabilities (excess of liabilities over assets) on the statement of financial position. ASC paragraphs 480-10-45-2A and 45-2B are reproduced below:

ASC paragraphs 480-10-45-2A and 45-2B

Some companies have outstanding shares, all of which are subject to mandatory redemption on the occurrence of events that are certain to occur. Assume on the date of adoption that the redemption price of the shares is more than the book value of those shares (which is the difference between the recorded amounts of the company’s assets and its liabilities other than the shares subject to mandatory redemption).2 On the date of adoption, the company would recognize a liability for the redemption price of the shares that are subject to mandatory redemption, reclassifying the amounts previously recognized in the equity accounts. Any difference between the redemption price on the date of adoption and the amounts previously recognized in equity is reported in the statement of income as a cumulative effect transition adjustment loss. The redemption price may be a fixed amount or may vary based on specified conditions.

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2 If the redemption price is the book value of the shares on the redemption date, ASC Topic 480 requires the mandatorily redeemable shares to be reported as a liability, measured at that book value. At the date of adoption of ASC Topic 480, all amounts previously recognized in the equity accounts are eliminated (as shown in ASC paragraph 480-10-55-20). Subsequently, the liability is the book value of the entity’s assets net of its other liabilities, with the change from the previous period being reported as interest cost (separately from other interest). Therefore, while the entity may report an amount of income before interest on mandatorily redeemable shares (change in redemption amount), the net income (loss) in the statement of income would be zero.
Q. How should the cumulative transition adjustment and subsequent adjustments to reflect changes in the redemption price of the shares be reported if they exceed the company’s equity balance?

A. The cumulative transition adjustment and any subsequent adjustments should be reported as an excess of liabilities over assets (a deficit) and changes thereto even though the mandatorily redeemable shares are reported as a liability.

If the redemption price of the mandatorily redeemable shares is less than the book value of those shares, the company should report the excess of that book value over the liability reported for the mandatorily redeemable shares as an excess of assets over liabilities (equity).

Depending on the settlement terms, ASC Topic 480 requires that mandatorily redeemable shares be measured at either the present value of the amount to be paid at settlement or the amount of cash that would be paid under the conditions specified in the contract if settlement occurred at the reporting date, recognizing the resulting change in that amount as interest cost (change in redemption amount).

Paragraph A30 of Statement 150 indicates that, for mandatorily redeemable shares measured initially at present value using the rate implicit at inception of the contract, the cumulative transition adjustment is the difference between the carrying amount and the present value of the liability. For mandatorily redeemable shares that will be redeemed at a variable amount (fair value in the examples presented), the initial measure of the liability is the amount that would be paid under the conditions specified in the contract if settlement occurred at the reporting date (the fair value of the shares on that date). Therefore, the cumulative transition adjustment for shares redeemable at fair value is the difference between the carrying amount and fair value at transition. The carrying amount of the mandatorily redeemable shares is their book value, which includes all amounts attributable to those shares.

Transition

The guidance in ASC paragraphs 480-10-45-2A and 45-2B is effective immediately for mandatorily redeemable shares of entities for which the requirements of ASC Topic 480 have already been applied. The guidance should be applied for other entities as part of the adoption of ASC Topic 480. If this guidance results in changes to previously reported information, the cumulative effect shall be reported according to the provisions of ASC Topic 480, in the first period beginning after the effective date of ASC paragraphs 480-10-45-2A and 45-2B.
Illustrations of Accounting for Mandatorily Redeemable Shares with a Redemption Value That Differs from the Company’s Book Value

Example 1

Assume a company adopts ASC Topic 480 on January 1, 20XX, and that the fair value (which equals the redemption value) of the mandatorily redeemable shares is $20 million and the book value of those shares is $15 million, of which $10 million is paid-in capital. On the date of adoption, the company would recognize a liability of $20 million by transferring $15 million out of equity and recognizing a cumulative transition adjustment loss of $5 million. Subsequently, net income attributable to the mandatorily redeemable shares is $1 million for the year 20XX and the fair value of those shares at the reporting date of December 31, 20XX is $21.2 million. Also assume that the company did not pay any cash dividends.

The following illustrates the statement of position at January 1, 20XX and December 31, 20XX, and the statement of income for the year ended December 31, 20XX (income tax considerations have been disregarded):

Statements of Financial Position:

<table>
<thead>
<tr>
<th></th>
<th>January 1, 20XX</th>
<th>December 31, 20XX</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Assets</td>
<td>$25,000,000</td>
<td>$26,000,000</td>
</tr>
<tr>
<td>Liabilities other than shares</td>
<td>$10,000,000</td>
<td>$10,000,000</td>
</tr>
<tr>
<td>Shares subject to mandatory redemption*</td>
<td>$20,000,000</td>
<td>$21,200,000</td>
</tr>
<tr>
<td>Total Liabilities</td>
<td>$30,000,000</td>
<td>$31,200,000</td>
</tr>
<tr>
<td>Excess of Liabilities over Assets (Deficit)</td>
<td>$(5,000,000)</td>
<td>$(5,200,000)</td>
</tr>
<tr>
<td>Total</td>
<td>$25,000,000</td>
<td>$26,000,000</td>
</tr>
</tbody>
</table>
Notes to Financial Statements:

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

- **Common stock**—$100 par value, 200,000 shares authorized, issued and outstanding: $10,000,000
- **Retained earnings attributable to those shares**: 5,000,000
- **Excess of redemption amount over common stock and retained earnings attributable to those shares**: 5,000,000

<table>
<thead>
<tr>
<th></th>
<th>Common stock</th>
<th>Retained earnings</th>
<th>Excess of redemption</th>
</tr>
</thead>
<tbody>
<tr>
<td>Authorized, issued, and</td>
<td>$10,000,000</td>
<td>5,000,000</td>
<td>5,000,000</td>
</tr>
<tr>
<td>outstanding</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Partial Statement of Income (for the Year Ended December 31, 20XX):**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income before interest on mandatorily redeemable shares</td>
<td>$1,000,000</td>
</tr>
<tr>
<td>Less: Interest on mandatorily redeemable shares (change in redemption amount)</td>
<td>1,200,000</td>
</tr>
<tr>
<td>Income (loss) before cumulative effect of a change in accounting principle</td>
<td>$(200,000)</td>
</tr>
<tr>
<td>Cumulative effect of change in accounting principle</td>
<td>(5,000,000)</td>
</tr>
<tr>
<td>Net loss</td>
<td>$(5,200,000)</td>
</tr>
</tbody>
</table>

**Example 2**

Assume the same facts as in Example 1 except that the shares are to be redeemed at an amount ($11 million) that is less than their book value. On the date of adoption, January 1, 20XX, the company would recognize a liability of $11 million by transferring $11 million out of equity.

The following illustrates the statement of position at January 1, 20XX:

**Statement of Financial Position (as of January 1, 20XX):**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Assets</td>
<td>$25,000,000</td>
</tr>
<tr>
<td>Liabilities other than shares</td>
<td>$10,000,000</td>
</tr>
<tr>
<td>Shares subject to mandatory redemption*</td>
<td>11,000,000</td>
</tr>
<tr>
<td>Total Liabilities</td>
<td>$21,000,000</td>
</tr>
<tr>
<td>Excess of Assets over Liabilities (Equity)</td>
<td>$4,000,000</td>
</tr>
<tr>
<td>Total</td>
<td>$25,000,000</td>
</tr>
</tbody>
</table>
Notes to Financial Statements:

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

- Common stock—$100 par value, 200,000 shares authorized, 100,000 shares issued and outstanding: $10,000,000
- Retained earnings attributable to those shares: 5,000,000
- Excess of common stock and retained earnings attributable to those shares over redemption amount: (4,000,000)

\[ \text{Total} = 11,000,000 \]

**ALL OTHER INSTRUMENTS**

9.023 Generally, instruments within the scope of ASC Topic 480 that were not addressed in the previous paragraphs of this section are initially measured at fair value and subsequently adjusted to fair value each period with changes recognized in income. Some contracts to repurchase the issuer’s equity shares embody conditional obligations. For example, forward purchase contracts that must or can be net cash settled embody obligations that are indexed to a repurchase of the equity shares. Such contracts require the issuer of the underlying shares to transfer assets if the fair value of the contract at the settlement date places the issuer in a loss position. If, however, prices move in the issuer’s favor, the issuer will receive assets and will not have to transfer anything. Option contracts also embody obligations that are conditional, whether settled by physical exchange or net cash payment. The issuer might have to transfer assets if, for example, the holder of a put option exercises its option, but the issuer will not have to transfer assets if that put option expires unexercised. Because those contracts contain obligations that are conditional, they are not akin to a treasury stock purchase using borrowed funds and they do not effectively convert the shares that the counterparty might or might not deliver into mandatorily redeemable shares. As a result, those contracts should not be accounted for as if they did.

**Initial Measurement**

9.024 ASC paragraphs 480-10-30-2 and 30-7 indicate:

- All other financial instruments within the scope of ASC Topic 480 shall be measured initially at fair value. If a conditionally redeemable instrument becomes mandatorily redeemable, upon reclassification the issuer shall measure that liability initially at fair value and reduce equity by the amount of that initial measure, recognizing no gain or loss.
9.025 As discussed in Paragraph 9.004, generally, a mandatorily redeemable financial instrument within the scope of ASC paragraphs 480-10-25-4 and 25-6 initially is required to be measured at fair value. As discussed in Paragraphs 9.008–9.010, forward contracts that require physical settlement by repurchase of a fixed number of the issuer’s equity shares in exchange for cash should be recognized as a liability and initially measured at the fair value of the underlying shares at inception, adjusted for any consideration or unstated rights or privileges. All other financial instruments within the scope of ASC Topic 480 are required to be measured initially at fair value.

9.026 As discussed in Paragraph 3.040 of Section 3, if an instrument contains a contingent redemption feature, the financial instrument is required to be assessed at each reporting period to determine whether circumstances have changed such that the contingency has been resolved and the instrument currently meets the definition of a mandatorily redeemable financial instrument (i.e., redemption is no longer contingent because the condition has occurred or the contingency has been resolved such that redemption is required to occur). In such cases, the instrument should be reclassified as a liability and should be initially measured at fair value. The issuer should reduce equity by the amount of that initial fair value measurement such that no gain or loss is recognized. The Board believes that this requirement is consistent with its other initial measurement decisions in ASC Topic 480 and believes that recognition of a liability to a former owner on removal of a contingency about redemption is, like other distributions to owners, not an event for recognizing gain or loss. However, the difference between the fair value and the previous carrying amount of the instrument should be added to or subtracted from net earnings available to common shareholders in the calculation of earnings per share. See Paragraphs 10.014–10.016 of Section 10 for additional information.

Subsequent Measurement

9.027 ASC paragraphs 480-10-35-1 and 35-5 indicate:

Financial instruments within the scope of ASC Topic 815 shall be measured subsequently as required by the provisions of ASC Topic 815. All remaining financial instruments within the scope of ASC Topic 480 not covered by the guidance in ASC paragraphs 480-10-35-3 and 480-10-45-3 shall be measured subsequently at fair value with changes in fair value recognized in earnings, unless either ASC Topic 480 or other accounting guidance specifies another measurement attribute.

9.028 As discussed in Paragraph 9.016, mandatorily redeemable financial instruments within the scope of ASC paragraphs 480-10-25-4 and 25-6 and forward contracts that require physical settlement by repurchase of a fixed number of the issuer’s equity shares in exchange for cash within the scope of ASC paragraphs 480-10-25-8 through 25-10 and 25-12 and 480-10-30-3 through 30-5 should be subsequently measured in one of two ways, as prescribed by ASC paragraphs 480-10-35-3 and 480-10-45-3. If other existing accounting guidance currently addresses the subsequent measurement of any other liability within the scope of ASC Topic 480, then that subsequent measurement guidance
should be used. All other instruments are required to be measured subsequently at fair value with changes in the fair value recognized in income.

9.029 Certain instruments may be within the scope of ASC Topic 480 and within the scope of ASC Topic 815 (as amended by ASC Topic 480). In that case, the subsequent measurement provisions of ASC Topic 815 should be followed; those provisions also require subsequent measurement at fair value. In addition, an instrument within the scope of ASC Topic 815 may be designated in a hedging relationship (if all the applicable requirements of ASC Topic 815 are met); however, an instrument within the scope of ASC Topic 480 that is outside the scope of ASC Topic 815 may not be designated as a hedging instrument.

QUESTIONS AND ANSWERS

Q&A 9.1: Company A enters into a forward contract that requires physical settlement by repurchase of a fixed number of its common shares in exchange for cash; the forward contract is within the scope of ASC paragraphs 480-10-25-8 through 25-10 and 25-12.

Q. Should such a forward contract be measured at the contract’s fair value at inception?

A. No. Forward contracts that require physical settlement by repurchase of a fixed number of the issuer’s equity shares in exchange for cash are initially measured at the fair value of the underlying shares at inception, adjusted for any consideration or unstated rights and privileges. There are two methods for determining that initial measurement: (1) discount the settlement amount at the rate implicit in the contract after taking into account any consideration or unstated rights or privileges that may have affected the terms of the transaction, or (2) determine the amount of cash that would be paid under the conditions specified in the contract if the shares were repurchased immediately, adjusted for any consideration or unstated rights or privileges.

Q&A 9.2: Company A enters into a forward contract that is within the scope of ASC paragraphs 480-10-25-8 through 25-10 and 25-12. The contract requires Company A to repurchase a fixed number of its own common shares (physical settlement) in exchange for specified U.S. government securities with a fair value of $1 million on the settlement date of the contract.

Q. Should such a forward contract be measured at the contract’s fair value at inception and in subsequent periods?
A. Yes. There are specific initial and subsequent measurement requirements in ASC Topic 480 for mandatorily redeemable financial instruments and forward contracts that require physical settlement by repurchase of a fixed number of the issuer’s equity shares in exchange for cash (i.e., not cash equivalents). All other instruments within the scope of ASC Topic 480 (including forward purchase contracts on an entity’s equity shares that permit net cash or net share settlement and forward purchase contracts on an entity’s equity shares that are settled through the issuance of noncash assets) are initially measured at fair value and subsequently adjusted to fair value each period with changes recognized as interest cost in the statement of income.

Q&A 9.3: Company A is an SEC registrant. The Company has no equity instruments outstanding but has financial instruments issued in the form of shares, all of which are mandatorily redeemable financial instruments under ASC paragraphs 480-10-25-4 and 25-6.

Q. If an SEC registrant has no equity instruments outstanding but has financial instruments issued in the form of shares, all of which are mandatorily redeemable financial instruments under ASC paragraphs 480-10-25-4 and 25-6, is there a special method for subsequent measurement of the instruments?

A. No. The method for subsequent measurement of mandatorily redeemable financial instruments within the scope of ASC Topic 480 is the same regardless of whether the entity has no equity instruments. If both the amount to be paid and the settlement date are fixed, the mandatorily redeemable financial instruments should be measured subsequently at the present value of the amount to be paid at settlement, accruing interest cost using the rate implicit at inception. If either the amount to be paid or the settlement date varies based on specified conditions, those instruments should be measured subsequently at the amount of cash that would be paid under the conditions specified in the contract if settlement occurred at the reporting date, recognizing the resulting change in that amount from the previous reporting date as interest cost. See Section 12 for a discussion about Part II of ASU 2017-11, which provides a scope exception of ASC Topic 480 for mandatorily redeemable instruments issued by non-SEC registrants unless the redemption date is fixed and the redemption amount is fixed or determined by reference to certain indices.
Q&A 9.4: Company A is an SEC registrant. The Company has no equity instruments outstanding but has financial instruments issued in the form of shares, all of which are mandatorily redeemable financial instruments under ASC paragraphs 480-10-25-4 and 25-6 and are required to be redeemed at book value at an uncertain date in the future.

Q. If an SEC registrant has no equity instruments outstanding but has financial instruments issued in the form of shares, all of which are mandatorily redeemable financial instruments under ASC paragraphs 480-10-25-4 and 25-6 and are required to be redeemed at book value at an uncertain date in the future (e.g., upon death of the counterparty), can that entity ever have net income during the periods the instrument is outstanding and net book value is positive?

A. No. In such a case, the mandatorily redeemable financial instruments (reported as liabilities) are subsequently measured at the amount of cash that would be paid under the conditions specified in the contract if settlement occurred at the reporting date. When that liability balance is adjusted, the offset is to the income statement. Because the instruments are redeemable at book value, the entity will never report net income for accounting purposes. See Section 12 for a discussion about Part II of ASU 2017-11, which provides a scope exception of ASC Topic 480 for mandatorily redeemable financial instruments issued by non-SEC registrants unless the redemption date is fixed and the redemption amount is fixed or determined by reference to certain indices.

Q&A 9.5: Company A is an SEC registrant. The Company has no equity instruments outstanding but has financial instruments issued in the form of shares, all of which are mandatorily redeemable financial instruments under ASC paragraphs 480-10-25-4 and 25-6 and are required to be redeemed at their fair value at an uncertain date in the future.

Q. If an SEC registrant has no equity instruments outstanding but has financial instruments issued in the form of shares, all of which are mandatorily redeemable financial instruments under ASC paragraphs 480-10-25-4 and 25-6 and are required to be redeemed at an amount other than book value (e.g., fair value in this case) at an uncertain date in the future (e.g., upon death of the counterparty), is there special subsequent presentation guidance in the Topic?

A. Yes. The guidance in ASC paragraphs 480-10-45-2A and 45-2B should be applied in these circumstances. ASC paragraphs 480-10-45-2A and 45-2B indicate that subsequent changes in the liability could be greater than or less than net income for the period or the book value of the entity. If the redemption price of the
mandatorily redeemable shares is less than (greater than) the book value of those
shares, the entity should report the excess (deficit) of that book value over the
liability reported for the mandatorily redeemable shares as an excess of assets over
liabilities (excess of liabilities over assets) on the balance sheet. See Section 12 for
a discussion about Part II of ASU 2017-11, which provides a scope exception of
ASC Topic 480 for mandatorily redeemable financial instruments issued by non-
SEC registrants unless the redemption date is fixed and the redemption amount is
fixed or determined by reference to certain indices.

Q&A 9.6: Company A has issued outstanding warrants held by
Company B. The warrants are exercisable into shares of Series X
puttable preferred stock, and accordingly are classified as liabilities
as required by ASC paragraph 480-10-55-33 and measured at fair value
each period under ASC paragraph 480-10-35-5. Company A issues
Series Y preferred stock. As consideration, Company B pays cash and
agrees to the termination of its warrants for shares of Series X
preferred stock.

Q: What is the issuer's accounting for the termination of the warrants when those
warrants are terminated through the issuance of preferred stock to the holder?

A: Company A initially records the Series Y preferred stock at fair value. Fair
value is determined as the cash received plus the fair value of the warrants at the
time they are terminated. Because the warrants were measured at fair value at the
time they were extinguished, Company A recognized the reversal of the liability in
equity as part of initial recorded amount of the preferred stock.

Q&A 9.7: Company A issues a debt instrument that is within the scope
of ASC subparagraph 480-10-25-14(a), which requires liability
classification for certain obligations to issue a variable number of
shares, in exchange for $100,000. The terms of the instrument require
Company A to deliver a variable number of its common shares that
have a fair value equal to $110,000 on a specified maturity date.
Company A initially measures the debt instrument at fair value, which
is the $100,000 proceeds received by Company A on issuance of the
debt instrument.

Q. Should Company A subsequently measure stock-settled debt within the scope of
ASC subparagraph 480-10-25-14(a) at accreted value or fair value?

A. Stock-settled debt instruments within the scope of ASC paragraph 480-10-25-14
should be measured subsequently at their accreted value under ASC Topic 835,
*Interest*. Company A should subsequently measure the debt instrument at the
Initial and Subsequent Measurement

The present value of the $110,000 settlement amount, accruing interest cost using the rate implicit at inception.

ASC paragraph 480-10-35-1 specifies that financial instruments that are outside the scope of Topic 815 and are not physically settled forward purchase contracts or mandatorily redeemable financial instruments covered by ASC paragraph 480-10-35-3 should be subsequently measured at fair value with changes in fair value recognized in earnings, unless other accounting guidance specifies another measurement attribute. Although the obligation will be settled by issuing common shares, the debt instrument is, in substance, subject to the guidance of ASC Topic 835.

Q&A 9.8: On January 1, 20X6, Company A issues preferred stock with a par value of $1 million for cash proceeds of $600,000. The shares are mandatorily redeemable at par on the earlier of (1) December 31, 20X9, (2) a change in control, or (3) completion of an initial public offering.

Q. How should a mandatorily redeemable financial instrument that is within the scope of ASC paragraph 480-10-25-6 be measured subsequent to issuance, if redemption occurs on the earlier of a specific date or a specified event?

A. Because the instrument is within the scope of ASC Topic 480, Company A should account for the mandatorily redeemable financial instrument as a liability at fair value of $600,000 at the issuance date.

This is based on the requirement for Company A to initially measure the preferred shares at fair value as required by ASC paragraph 480-10-30-1.

In this fact pattern, we believe the subsequent measurement of the preferred shares should be based on the provisions of Topic 835, Interest, using the effective interest method. The preferred shares, in substance, represent an obligation similar to debt. Therefore, we believe this instrument should subsequently be measured and accounted for like debt (i.e., using the effective interest method to accrete the initial carrying amount of the instrument to the redemption amount based on the final redemption date of December 31, 20X9). If the preferred shares are redeemed before the final redemption date, Company A should account for the difference between the carrying amount of the instrument and the redemption amount consistent with the accounting for an early extinguishment of debt (i.e., by recognizing the difference as an extinguishment loss in the income statement).
10. Earnings Per Share

Introduction

Impact of ASC Topic 480 on the Provisions of ASC Topic 260

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Income Available to Common Stockholders
Undeclared Dividends
Participation and Similar Rights
Redemption of Stock
Contingently Redeemable Shares That Become Mandatorily Redeemable

Application of ASC Topic 260 to Instruments within the Scope of ASC Topic 480 That Are Not Subject to the Guidance in ASC Paragraph 480-10-45-4

Questions and Answers
10. Earnings Per Share

INTRODUCTION

10.000 ASC Topic 480 provides specific earnings per share guidance for mandatorily redeemable shares of common stock and forward contracts that require physical settlement by repurchase of a fixed number of the issuer’s common shares in exchange for cash. All other instruments within the scope of ASC Topic 480 are reflected in an entity’s earnings per share calculations in accordance with the existing provisions of ASC Topic 260, Earnings per Share, and its related interpretations, including ASC paragraphs 260-10-55-32 through 55-34, 55-36; 55-77; and 260-1-45-22, and ASC paragraphs 260-10-45-60 through 45-68; 260-10-55-24 through 55-30, and 55-71 through 55-75.

IMPACT OF ASC TOPIC 480 ON THE PROVISIONS OF ASC TOPIC 260

10.001 ASC paragraph 480-10-45-4 discusses the effect of the Topic on the calculation of earnings per share.

Entities that have issued mandatorily redeemable shares of common stock or entered into forward contracts that require physical settlement by repurchase of a fixed number of the issuer’s equity shares of common stock in exchange for cash shall exclude the common shares that are to be redeemed or repurchased in calculating basic and diluted earnings per share. Any amounts, including contractual (accumulated) dividends and participation rights in undistributed earnings, attributable to shares that are to be redeemed or repurchased that have not been recognized as interest costs in accordance with ASC paragraphs 480-10-35-3 and 480-10-45-3, shall be deducted in computing income available to common shareholders (the numerator of the earnings per share calculation), consistently with the “two-class” method set forth in ASC paragraph 260-10-45-60B of ASC Topic 260, Earnings per Share.

10.002 In its deliberations related to mandatorily redeemable shares of common stock and forward contracts that require physical settlement by repurchase of a fixed number of the issuer’s common shares in exchange for cash, the Board discussed the implications for calculating diluted and basic earnings per share. ASC paragraphs 260-10-45-45 and 45-46 indicate that if a contract can be settled in cash or common shares of an entity, it is presumed to be settled in common shares and the resulting potential common shares are included in diluted EPS, if the effect is more dilutive. In order to be consistent with the general principle that the settlement alternatives of an instrument are not the determinative factor of whether that instrument is within the scope of ASC Topic 480, the Board considered amending the guidance in ASC paragraphs 260-10-45-45 and 45-46 of ASC Topic 260 so that the dilutive earnings per share calculation and numerator adjustments in that calculation would no longer be based on the settlement alternatives of a contract. However, the Board noted that such a conclusion applies to a broader class of
contracts than those included within the scope of ASC Topic 480. See Paragraph 10.020 of this section regarding a proposed change in the requirements of ASC paragraphs 260-10-45-45 and 45-46.

10.003 ASC paragraphs 260-10-45-35 and 45-36 indicate contracts that require the reporting entity to repurchase its own stock (such as written put options and forward purchase contracts within the scope of ASC Topic 480) be included in the computation of diluted EPS if the effect is dilutive. If those contracts are “in-the-money” from the perspective of the holder during the reporting period (the exercise price is above the average market price for that period), the potential dilutive effect on EPS is computed using the reverse treasury stock method. Under that method, (1) issuance of sufficient common shares is assumed at the beginning of the period to raise enough proceeds to satisfy the contract, (2) those proceeds are assumed to be used to satisfy the contract (i.e., buy back the shares), and (3) the incremental shares are included in the denominator of the diluted EPS computation. The Board considered amending ASC Topic 260 to treat obligations to repurchase an issuer’s equity shares that were previously classified as equity but would now be classified as liabilities under the provisions of ASC Topic 480 differently in calculating dilutive earnings per share under the reverse treasury stock method. The Board decided that including the effect of certain instruments previously classified as equity but now classified as liabilities and measured at fair value in the dilutive earnings per share calculation could be appropriate even though those instruments might be “out-of-the-money” from the holder’s perspective. The Board noted that being out-of-the-money is a calculation issue, not a flaw in the dilutive earnings per share model. Consequently, the Board decided not to change that requirement under ASC Topic 260.

REQUIREMENTS

10.004 ASC Topic 480 requires that (1) mandatorily redeemable shares of common stock within the scope of ASC paragraphs 480-10-25-4 and 25-6, and (2) shares of common stock under a forward contract that requires physical settlement by repurchase of a fixed number of the issuer’s common shares in exchange for cash within the scope of ASC paragraphs 480-10-25-8 through 25-10 and 25-12, 480-10-30-3 through 30-5, 480-10-35-3, and 480-10-45-3 are excluded from the denominator in the calculation of basic and diluted earnings per share. In essence, the Board decided that the number of outstanding shares associated with physically-settled forward purchase contracts measured at the present value of the contract amount should be removed from the denominator in computing basic and diluted earnings per share in the same way as required for mandatorily redeemable shares classified as liabilities. The Board reasoned that, because the accounting for physically-settled forward contracts reduced equity even though the shares are still outstanding, they are effectively accounted for as if retired. Like mandatorily redeemable shares accounted for as liabilities, shares subject to forward purchase contracts that must be physically settled in exchange for cash should not be treated as outstanding in basic and diluted earnings per share calculations. Also, the Board noted that amounts paid to holders of the instruments in excess of the initial
measurement amount are interest costs reflected in earnings available to common shareholders, the numerator in calculating earnings per share.

10.005 In order to accomplish these requirements, the Board amended the provisions of ASC Topic 260 to indicate that forward contracts that require physical settlement by repurchase of a fixed number of the issuer’s equity shares in exchange for cash accounted for under are not subject to the requirements of ASC paragraphs 260-10-45-35 and 45-36.

Income Available to Common Stockholders

10.006 For (1) forward contracts that require physical settlement by repurchase of a fixed number of either the issuer’s common or preferred shares in exchange for cash within the scope of ASC paragraphs 480-10-25-8 through 25-10 and 25-12, and 480-10-30-3 through 30-5 and (2) for mandatorily redeemable financial instruments related to preferred or common shares within the scope of ASC paragraphs 480-10-25-4 and 25-6, 480-10-35-3, and 480-10-45-3, require that any amount paid or to be paid to holders of those contracts in excess of the initial measurement amount is required to be recognized as interest cost. As discussed in Paragraph 9.017 of Section 9, assuming the holder of the contract is entitled to the payment amount and is not required to remit it back to the issuer, the following should be included in interest cost during the life of such contracts because it is consistent with reporting the contracts as liabilities:

- Dividends paid or declared on the stock;
- Accrued but undeclared cumulative dividends;
- The accretion of any difference between the carrying amount and the settlement amount; and
- Any other contractual amounts either (1) paid, or (2) earned, accrued, and required to be paid.

10.007 Because the above amounts are recognized as interest costs during the life of the contract, they are already reflected within earnings available to common shareholders (i.e., the numerator in the calculation of EPS). Accordingly, there is no need to further adjust the numerator in the basic and diluted EPS calculations for the above items. However, unless the forward contract specifies that all dividends declared on the underlying shares during the period of the forward contract will revert back to the issuer, an additional numerator adjustment may be required in the basic and diluted EPS calculations when a fixed number of the issuer’s shares will be repurchased for cash under a physically-settled forward purchase contract within the scope of ASC paragraphs 480-10-25-8 through 25-10 and 25-12. If dividends on the shares underlying the forward contract do not revert back to the issuer (i.e., the current holders of the shares underlying the forward contract are entitled to any dividends on those shares that are declared during the term of the forward contract), the “two-class method” of computing EPS under ASC Topic 260 and ASC paragraphs 260-10-45-60 through 45-68, 260-10-55-24 through 55-30, and 55-71 through 55-75 should be applied (see further discussion of the two-class method of computing EPS in Paragraphs 10.011 and 10.012 of this section). Under the
two-class method, earnings available to common shareholders is reduced in the basic and diluted EPS calculations for the undistributed earnings that are allocable to the holders of the shares underlying the forward contract (any dividends paid to holders of the shares underlying the forward contract would already be recorded as interest cost, so no further numerator adjustment is required for actual distributions in the EPS calculation). As a result of this numerator adjustment under the two-class method, the exclusion of underlying shares from the denominator of the basic and diluted EPS calculations generally would not impact the actual per share amounts (see Example 10.2). However, if all dividends declared on the shares underlying the forward contract revert back to the issuer during the period of the forward contract, the two-class method would generally not be required and the exclusion of the underlying shares from the denominator of the basic and diluted EPS calculations generally would impact the actual per share amounts (see Example 10.1).

10.008 The following example illustrates the requirements of ASC Topic 480 as they relate to the EPS calculation for a forward contract that requires physical settlement by repurchase of a fixed number of the issuer’s equity shares in exchange for cash:

**Example 10.1: Earnings Per Share Impact of Forward Purchase Contract That Requires Physical Settlement in Cash; Dividends on the Underlying Shares Revert Back to the Company During the Period of the Forward Contract**

**Background**

Company A has 10,000 shares of common stock outstanding during 20X4 and has net income of $115,000. The Company has no outstanding securities or contracts that may entitle the holder to obtain common stock. In the prior year, Company A entered into a forward purchase contract on 1,000 shares of its common stock that will be settled in two years for a price of $20 per share. The forward contract requires physical settlement in cash. Any dividends declared on the shares underlying the forward contract revert back to Company A as per the contractual terms of the forward contract. Company A determined that the forward contract was within the scope of ASC paragraphs 480-10-25-8 through 25-10 and 25-12, 480-10-30-3 through 30-5, 480-10-35-3, and 480-10-45-3. During 20X4, Company A recognized $1,000 of interest cost related to the forward contract based on its application of the measurement provisions in ASC paragraphs 480-10-35-3 and 480-10-45-3 (which require interest cost to be accreted at the rate implicit at inception of the contract). The weighted-average price of Company A’s stock during 20X4 was $12.50 per share (assume this was also the weighted-average stock price during each interim period of 20X4). No dividends were declared on Company A’s common stock during 20X4.
Analysis

Basic and diluted earnings per share for 20X4 would be computed as follows:

Income available to common shareholders $115,000
Weighted-average common shares 10,000
Less: Weighted-average common shares to be repurchased for cash under forward contract (1,000)
Adjusted weighted-average common shares 9,000

Basic and Diluted EPS = $115,000 / 9,000 shares = $12.78 per share

The basic and diluted EPS calculations are not adjusted for (i) the interest cost related to the forward purchase contract because that amount is already included in income available to common shareholders, (ii) the price to be paid upon settlement of the forward purchase contract because total equity was reduced at inception of the contract based on the then-current common stock price, or (iii) the weighted-average price of the Company’s common stock for the year because the contract is not subject to the provisions of ASC paragraphs 260-10-45-35 and 45-36.

Example 10.2: Earnings Per Share Impact of Forward Purchase Contract That Requires Physical Settlement in Cash; Dividends on the Underlying Shares Do Not Revert Back to the Company During the Period of the Forward Contract

Background

Company A has 10,000 shares of common stock outstanding during 20X4 and has net income of $115,000. The Company has no outstanding securities or contracts that may entitle the holder to obtain common stock. In the prior year, Company A entered into a forward purchase contract on 1,000 shares of its common stock that will be settled in two years for a price of $20 per share. The forward contract requires physical settlement in cash. Dividends declared on the shares underlying the forward contract do not revert back to Company A as per the contractual terms of the forward contract. Company A determined that the forward contract was within the scope of ASC paragraphs 480-10-25-8 through 25-10 and 25-12, 480-10-30-3 through 30-5, 480-10-35-3, and 480-10-45-3. During 20X4, Company A recognized $1,000 of interest cost related to the forward contract based on its application of the measurement provisions in ASC paragraphs 480-10-35-3 and...
480-10-45-3, which require interest cost to be accreted at the rate implicit at inception of the contract. The weighted-average price of Company A’s stock during 20X4 was $12.50 per share (assume this was also the weighted-average stock price during each interim period of 20X4). No dividends were declared on Company A’s common stock during 20X4.

**Analysis**

Dividends on the shares underlying the forward contract do not revert back to Company A (i.e., the current holder of those shares would retain any dividends during the period of the forward contract), so the two-class method of computing basic and diluted EPS must be applied. Under the two-class method, earnings available to common shareholders is reduced in the basic and diluted EPS calculations for the undistributed earnings that are allocable to the holders of the shares underlying the forward contract (any dividends paid to holders of the shares underlying the forward contract would already be recorded as interest cost, so no further numerator adjustment is required for actual distributions in the EPS calculation for the shares underlying the forward contract).

Basic and diluted earnings per share for 20X4 would be computed as follows under the two-class method (assume net income equals net income available to common shareholders):

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net income available to common shareholders</td>
<td>$115,000</td>
</tr>
<tr>
<td>Less dividends paid (other than for the shares underlying the forward contract)</td>
<td>0</td>
</tr>
<tr>
<td>Undistributed 20X4 earnings</td>
<td>$115,000</td>
</tr>
</tbody>
</table>

Because dividends on common shares underlying the forward contract do not revert back to Company A, holders of those shares are entitled to Company A’s undistributed earnings on a share for share basis with all other holders of common stock. That amount would equal $11,500 \[\frac{((100\% \times 1,000 \text{ common shares underlying the forward contract}) \times 100\% \times 9,000 \text{ outstanding common shares not underlying the forward contract})}{(100\% \times 1,000 \text{ common shares underlying the forward contract}) + (100\% \times 9,000 \text{ outstanding common shares not underlying the forward contract})} \times 115,000 \text{ undistributed earnings}\] for the holders of the 1,000 common shares underlying the forward contract.

Common shareholders are entitled to their share of the undistributed earnings for 20X4. That amount would equal $103,500 \[\frac{((100\% \times 9,000 \text{ outstanding common shares not underlying the forward contract}) \times 100\% \times 1,000 \text{ common shares underlying the forward contract})}{(100\% \times 1,000 \text{ common shares underlying the forward contract}) + (100\% \times 9,000 \text{ outstanding common shares not underlying the forward contract})} \times 115,000 \text{ undistributed earnings}\] for the
Earnings Per Share

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income available to common shareholders</td>
<td>$115,000</td>
</tr>
<tr>
<td>Less: Income allocated to holders of common shares underlying the forward contract</td>
<td>(11,500)</td>
</tr>
<tr>
<td>Income allocated to outstanding common shares not underlying the forward contract</td>
<td>$103,500</td>
</tr>
<tr>
<td>Weighted-average common shares</td>
<td>10,000</td>
</tr>
<tr>
<td>Less: Weighted-average common shares to be repurchased for cash under the forward contract</td>
<td>(1,000)</td>
</tr>
<tr>
<td>Adjusted weighted-average common shares</td>
<td>9,000</td>
</tr>
</tbody>
</table>

Basic and Diluted EPS = $103,500 / 9,000 shares = $11.50 per share

It should be noted that basic and diluted EPS of $11.50 under the two-class method in this example is equal to the basic and diluted EPS amount that would have been computed if (a) the two-class method were not applied and (b) the shares underlying the forward contract were not deducted from the denominator in the EPS calculation ($115,000 / 10,000 shares = $11.50 per share).

The basic and diluted EPS calculations are not adjusted for (i) the interest cost related to the forward purchase contract because that amount is already included in income available to common shareholders, (ii) the price to be paid upon settlement of the forward purchase contract because total equity was reduced at inception of the contract based on the then-current common stock price, or (iii) the weighted-average price of the Company’s common stock for the year because the contract is not subject to the provisions of ASC paragraphs 260-10-45-35 and 45-36.

Undeclared Dividends

10.009 Cumulative dividends on shares underlying instruments within the scope of ASC paragraphs 480-10-25-4 and 25-6 or ASC paragraphs 480-10-25-8 through 25-10 and 25-12, 480-10-30-3 through 30-5, 480-10-35-3, and 480-10-45-3, are required to be recognized as interest costs, whether or not the dividends are declared if the holder is entitled to the dividends either during the life of the contract or at settlement of the contract. In that case, it is not relevant as to whether the issuer declares them. However, if the holder is not entitled to undeclared dividends during the life of the contract or at settlement of the contract, those amounts should not be recognized as interest costs unless
and until they are declared. Accordingly, undeclared non-cumulative dividends should not be recognized in interest cost each period unless and until they are declared.

**10.010** Provided the holder is not entitled to undeclared non-cumulative dividends there are no adjustments to the numerator in the EPS calculation for these potential amounts during the life of the contract, unless the two-class method is required (see Paragraphs 10.007, 10.011, and 10.012 of this section). However, as discussed in Section 11, the rights embodied in those instruments should be adequately disclosed.

**Participation and Similar Rights**

**10.011** The Board noted that some amounts attributable to shares that are to be redeemed or repurchased, for example, amounts associated with participation rights such as a preferred instrument that entitles the holder to participate in 50% of all future declared dividends on common shares, are not recognized as interest costs until the dividend is declared under existing Topics. However, the Board concluded that income available to common shareholders should be reduced by amounts attributable to participation rights as those rights are earned, consistent with the “two-class method” required by ASC Topic 260 and ASC paragraphs 260-10-45-60 through 45-68, 260-10-55-24 through 55-30, and 55-71 through 55-75. See discussion of the application of the two-class method for shares underlying certain forward purchase contracts within the scope of ASC Topic 480 in Paragraph 10.007 and Example 10.2 of this section.

**10.012** ASC paragraph 260-10-45-60B describes the two-class method as an earnings allocation formula that determines earnings per share for each class of common stock and participating security according to dividends declared (or accumulated) and participation rights in undistributed earnings. Under the two-class method, (1) income is reduced by the amount of dividends declared in the current period for each class of stock and by the contractual amount of dividends that are required to be paid for the current period, (2) the remaining earnings are allocated to common stock and participating securities to the extent each security shares in earnings as if all of the earnings for the period had been distributed, and (3) total earnings allocated to each security is divided by the number of outstanding shares of the security to which the earnings are allocated to determine the earnings per share for that security.

**10.013** The following example illustrates the application of ASC Topic 480’s requirements related to the two-class method:

**Example 10.3: Earnings Per Share Impact of Mandatorily Redeemable Preferred Stock With Participation Rights**

**Background**

Company A has 10,000 shares of common stock and 5,000 shares of mandatorily redeemable preferred stock outstanding during 20X4. Company A has no securities or contracts that may entitle the holder to obtain common stock during the reporting period or after the end of the reporting period. The mandatorily redeemable
preferred stock has a carrying amount of $100 per share and is entitled to a non-cumulative annual dividend of $5 per share before any dividend is paid on common stock. The preferred shares are mandatorily redeemable on December 31, 20X9 for a redemption amount equal to a $100 liquidation preference for each share. After the common stock has been paid a dividend of $2 per share, the mandatorily redeemable preferred stockholders participate in any additional dividends on a 40:60 per share ratio with the common stock. For 20X4, the common shareholders were paid dividends of $26,000 (or $2.60 per share) and the preferred shareholders were paid dividends of $27,000 per share (or $5.40 per share which consists of the $5 per share non-cumulative annual dividend and $0.40 per share attributed to the participation dividend).

During 20X4, Company A generated income of $115,000 before considering the $27,000 of distributions to holders of mandatorily redeemable preferred stock. Those distributions are required to be recognized as interest cost under ASC paragraphs 480-10-35-3 and 480-10-45-3. After deducting these distributions to holders of mandatorily redeemable preferred stock, net income was $98,800, determined as follows (this illustration assumes the preferred stock distributions are tax deductible):

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Income before distributions to holders of mandatorily redeemable preferred stock</td>
<td>$115,000</td>
</tr>
<tr>
<td>Less: Distributions to holders of mandatorily redeemable preferred stock</td>
<td>(27,000)</td>
</tr>
<tr>
<td>Add: Tax effect of distributions to holders of mandatorily redeemable preferred stock (40% rate)</td>
<td>10,800</td>
</tr>
<tr>
<td><strong>Net income</strong></td>
<td><strong>$98,800</strong></td>
</tr>
</tbody>
</table>

**Analysis**

Basic and diluted earnings per share under the two-class method for 20X4 is computed as follows (assume the Company has no other preferred stocks and net income equals net income available to common shareholders):
Earnings Per Share

Net income available to common shareholders $98,800
Less dividends paid (excludes dividends recorded as interest cost since these amounts are already deducted to arrive at net income available to common shareholders):

<table>
<thead>
<tr>
<th></th>
<th>Common</th>
<th>Preferred</th>
</tr>
</thead>
<tbody>
<tr>
<td>$26,000</td>
<td>0</td>
<td>26,000</td>
</tr>
</tbody>
</table>

Undistributed 20X4 earnings $72,800

Preferred shareholders are entitled to their share of 40% of the undistributed earnings for 20X4. That amount would equal $18,200 [((40% × 5,000 preferred shares) / ((40% × 5,000 preferred shares) + (60% × 10,000 common shares))) × $72,800 undistributed earnings] for all preferred shareholders or $3.64 per preferred share [$18,200 allocation of undistributed earnings / 5,000 preferred shares].

Common shareholders are entitled to their share of 60% of the undistributed earnings for 20X4. That amount would equal $54,600 [((60% × 10,000 common shares) / ((40% × 5,000 preferred shares) + (60% × 10,000 common shares))) × $72,800 undistributed earnings] for all common shareholders or $5.46 per common share [$54,600 allocation of undistributed earnings / 10,000 common shares].

The basic and diluted earnings per share amounts are as follows:

<table>
<thead>
<tr>
<th></th>
<th>Common</th>
</tr>
</thead>
<tbody>
<tr>
<td>Distributed earnings</td>
<td>$2.60</td>
</tr>
<tr>
<td>Undistributed earnings</td>
<td>5.46</td>
</tr>
<tr>
<td>Totals</td>
<td>$8.06</td>
</tr>
</tbody>
</table>

Redemption of Stock

10.014 If an instrument is classified as a liability under the provisions of ASC Topic 480, the entity should apply liability extinguishment accounting for any redemption or extinguishment of that instrument. However, if an instrument is classified as an equity instrument and is redeemed or extinguished, the issuer should apply extinguishment accounting for an equity instrument. For example, if an entity induces conversion of its preferred stock that is classified as equity (or temporary equity), the guidance in ASC paragraph 260-10-S99-2 should be applied. In addition, for purposes of calculating the excess of the fair value of the consideration transferred to the holders of the preferred stock over the carrying amount of the preferred stock in the entity’s balance sheet, the carrying amount of the preferred stock should be reduced by the issuance costs of the preferred stock, regardless of where in the stockholders’ equity section those costs were initially classified on issuance.
Contingently Redeemable Shares That Become Mandatorily Redeemable

10.015 When a contingently redeemable instrument becomes mandatorily redeemable because the contingent event has occurred or becomes certain to occur, the freestanding financial instrument is reclassified to a liability at its fair value with an offset to equity (no gain or loss is recognized). Because conditionally or contingently redeemable shares are outside of the scope of ASC Topic 480, the guidance in ASC paragraph 480-10-S99-3 is still applicable to those instruments before the contingency is met. When a conditionally redeemable instrument becomes mandatorily redeemable because the event has occurred, the condition is resolved, or the event becomes certain to occur, the features of the instrument should be reevaluated to distinguish substantive, nonminimal features from nonsubstantive or minimal features. See Paragraphs 2.007–2.009 in Section 2 for additional information.

10.016 When a conditionally redeemable share becomes mandatorily redeemable (i.e., the uncertain event occurs, the condition is resolved, or the event becomes certain to occur), the shares become mandatorily redeemable under ASC Topic 480 and would require reclassification to a liability. ASC paragraphs 480-10-30-2 and 30-7 require the issuer to measure the liability upon reclassification initially at fair value and reduce equity by the amount of that fair value, recognizing no gain or loss. Since this reclassification of equity to a liability is like the redemption of shares by issuance of debt, the SEC staff amended ASC paragraph 480-10-S99-3 to indicate that, similar to the accounting for the redemption of preferred shares in ASC paragraph 260-10-S99-2, to the extent that the fair value of the liability upon reclassification differs from the recorded amount of preferred shares (i.e., recorded in equity or temporary equity), that difference should be deducted from or added to net income available to common shareholders in the calculation of earnings per share.

APPLICATION OF ASC TOPIC 260 TO INSTRUMENTS WITHIN THE SCOPE OF ASC TOPIC 480 THAT ARE NOT SUBJECT TO THE GUIDANCE IN ASC PARAGRAPH 480-10-45-4

10.017 Except for mandatorily redeemable shares of common stock within the scope of ASC paragraphs 480-10-25-4 and 25-6 and shares of common stock that will be repurchased under a forward contract that requires physical settlement by repurchase of a fixed number of the issuer’s common shares in exchange for cash within the scope of ASC paragraphs 480-10-25-8 through 25-10 and 25-12, 480-10-30-3 through 30-5, 480-10-35-3, and 480-10-45-3, entities should apply the guidance in ASC Topic 260 when determining the earnings per share treatment of instruments within the scope of ASC Topic 480. When applying the provisions of ASC Topic 260 to those other instruments within the scope of ASC Topic 480, the following observations should be noted. First, ASC paragraphs 260-10-45-35 and 45-36 require application of the reverse treasury stock method to determine the potential dilutive effect of contracts that require an entity to repurchase its own stock, such as written put options and forward purchase contracts. Second, ASC paragraphs 260-10-45-45 and 45-46 indicate that a contract that is reported
as an asset or liability for accounting purposes may require an adjustment to the numerator for any changes in net income or loss that would result if the contract were reported as an equity instrument during the period and that adjustment would include adding back the amounts included in net income or loss to the numerator in the EPS calculation, net of any tax effects. See discussion in Paragraph 10.020 of this section regarding a proposed change in the requirements of ASC paragraphs 260-10-45-45 and 45-46.

10.018 Lastly, ASC paragraphs 260-10-55-32 through 55-34, 55-36, and 55-77, and paragraph 260-10-45-22 summarize the effect of ASC Topic 480, ASC Subtopic 815-40, and ASC paragraph 480-10-55-63 on ASC Topic 260 and indicate that for contracts classified as equity instruments, the numerator in the EPS calculation may require an adjustment related to any changes in income or loss that would result if the contract had been reported as an asset or liability for accounting purposes during the period, if cash settlement is assumed for EPS purposes under ASC paragraphs 260-10-45-45 and 45-46 (see Paragraph 10.020 of this section regarding a proposed change in the requirements of ASC paragraphs 260-10-45-45 and 45-46).

10.019 For instruments that are not affected by the earnings per share guidance in ASC paragraph 480-10-45-4, the computation of diluted earnings per share depends on whether the contract will be settled in stock or cash. ASC Topic 260 specifies that, for contracts that can be settled in stock or cash at the option of the issuer, it is presumed a contract will be settled in stock unless past practice or a stated policy provides a reasonable basis to believe that the contract will be paid partially or wholly in cash. However, for contracts that can be settled in stock or cash at the option of the holder, past experience or a stated policy is not determinative; consequently, the more dilutive of cash or share settlement should be used.

10.020 At the time of this writing, the FASB issued an exposure draft to amend ASC Topic 260 and require that share settlement be assumed under all contracts that provide a choice of stock or cash settlement methods for earnings per share purposes.

10.021 The following example illustrates the calculation of EPS for a contract that is not within the scope of ASC paragraph 480-10-45-4:

Example 10.4: Earnings Per Share Impact of Forward Purchase Contract That Permits Net Settlement

**Background**

Company A has 10,000 shares of common stock outstanding during 20X4 and has net income of $112,000. Company A has no securities or contracts that may entitle the holder to obtain common stock during the reporting period or after the end of the reporting period. In the prior year, Company A entered into a forward purchase contract on 1,000 shares of its common stock that will be settled in two years for a price of $20 per share. The forward contract permits physical, net cash, and net share settlement at the Company’s option. Company A determined that the contract
is within the scope of ASC paragraph 480-10-25-14 because (a) the instrument is not a share of stock (i.e., it is a forward contract), (b) the instrument embodies a conditional obligation that the issuer may settle by issuing a variable number of its equity shares, and (c) at inception, the monetary value of the conditional obligation is based solely on variations inversely related to changes in the fair value of the issuer’s equity shares (see Paragraphs 13.007–13.008 in Section 13 for guidance on financial instruments that may be settled in stock or cash at the option of the issuer). Assume the fair value of Company A’s obligation under the forward contract increased by $4,000 during 20X4, so Company A recognized $4,000 of expense based on its application of the measurement provisions in ASC paragraphs 480-10-35-1 and 35-5 (which require the contract to be adjusted to fair value each period with changes recognized in earnings). The weighted-average price of Company A stock during 20X4 was $12.50 per share (assume this was also the weighted-average stock price during each interim period of 20X4). Also, Company A has no past practice or stated policy of settling such contracts in cash, so share settlement is assumed for EPS purposes (see Paragraph 10.020 of this section regarding a proposed change in the requirements of ASC paragraphs 260-10-45-45 and 45-46).

Analysis

The forward purchase contract does not require physical settlement in cash, so the earnings per share calculation is not affected by ASC Topic 480. ASC paragraphs 260-10-45-35 and 45-36 specify that contracts that require an entity to repurchase its own stock, such as written put options and forward purchase contracts, should be included in diluted EPS if the effect is dilutive. ASC Topic 260 does not provide for any adjustment to the basic EPS calculation for such contracts.

Basic earnings per share for 20X4 would be computed as follows:

Income available to common shareholders $112,000
Weighted-average common shares 10,000

$112,000 / 10,000 shares = $11.20 per share

The reverse treasury stock method should be applied to determine the diluted earnings per share impact of the forward purchase contract in this example. The following illustration assumes settlement in shares (i.e., physical settlement or net share settlement).

Diluted earnings per share for 20X4 would be computed as follows:
Earnings Per Share

Income available to common shareholders $112,000
Plus: Increase in fair value of liability 4,000
Adjusted income available to common shareholders $116,000

Weighted-average common shares 10,000
Plus: Incremental shares under forward contract 1
Adjusted weighted-average common shares 10,600

$116,000 / 10,600 shares = $10.94 per share

1 The contract price of the forward is $20 and the Company’s average common stock price for the period is $12.50. In applying the reverse treasury stock method, Company A assumes it issues 1,600 shares at $12.50 per share to satisfy its obligation of $20,000 under the forward contract. The difference between the 1,600 shares assumed issued and the 1,000 shares to be repurchased (600 incremental shares) is added to the denominator of diluted earnings per share since the effect on EPS is dilutive.

QUESTIONS AND ANSWERS

Q&A 10.1: Company A issues a forward contract that requires physical settlement by repurchase of a fixed number of its common shares in exchange for cash.

Q. Should the common shares that will be repurchased in such a forward contract be excluded in calculating basic and diluted earnings per share?

A. Yes. The number of common shares to be repurchased should be excluded from the denominator when calculating basic and diluted earnings per share because the forward contract is within the scope of ASC paragraphs 480-10-25-8 through 25-10 and 25-12, 480-10-30-3 through 30-5, 480-10-35-3, and 480-10-45-3. The shares are assumed to be repurchased and retired for purposes of the EPS calculation. Any amounts paid or to be paid (including declared dividends) to the counterparty of the contract in excess of the initial amount of the liability recorded should be recognized as interest cost. In addition, any amounts, including participation rights in undistributed earnings, attributed to shares that are to be redeemed that have not been recognized as interest costs should be deducted in computing income available to common shareholders consistent with the two-class method set forth in ASC paragraph 260-10-45-60B.
Q&A 10.2: On January 1, 20X0, Company A, an SEC registrant, issues mandatorily redeemable common shares within the scope of ASC paragraphs 480-10-25-4 and 25-6. Those shares are required to be redeemed for cash on January 1, 20X9.

Q. Should mandatorily redeemable common shares that are required to be redeemed for cash be excluded in calculating basic and diluted earnings per share?

A. Yes. The number of common shares to be repurchased should be excluded from the denominator when calculating basic and diluted earnings per share because the shares are within the scope of ASC paragraphs 480-10-25-4 and 25-6. Any amounts paid or to be paid (including declared dividends) to the counterparty of the contract in excess of the initial amount of the liability recorded should be recognized as interest cost. In addition, any amounts, including participation rights in undistributed earnings, attributed to shares that are to be redeemed that have not been recognized as interest costs should be deducted in computing income available to common shareholders consistent with the two-class method set forth in ASC paragraph 260-10-45-60B.

Q&A 10.3: Company A is in the process of calculating its basic and diluted EPS for the period. Company A has various instruments outstanding that are within the scope of ASC Topic 480 but not subject to the earnings per share guidance in ASC paragraph 480-10-45-4.

Q. Other than for mandatorily redeemable shares of common stock and forward contracts that require physical settlement by repurchase of a fixed number of the issuer’s common shares in exchange for cash, did ASC Topic 480 change the requirements for calculating basic and diluted earnings per share for instruments within its scope?

A. No. ASC Topic 260 was amended to indicate that mandatorily redeemable shares of common stock and forward contracts that require physical settlement by repurchase of a fixed number of the issuer’s common shares in exchange for cash should be excluded in calculating basic and diluted earnings per share. However, ASC Topic 480 did not amend any other provisions of ASC Topic 260. Consequently, all other freestanding financial instruments that require the reporting entity to repurchase its own stock, such as written put options and forward purchase contracts, should be included in the computation of diluted EPS, if the effect is dilutive, in accordance with ASC Topic 260 and its interpretations.
Q&A 10.4: Company A issues conditionally redeemable preferred shares that are conditioned on obtaining a new source of financing. During the current year, the instruments become mandatorily redeemable for cash because the conditionality has been resolved.

Q. When a conditionally redeemable instrument becomes mandatorily redeemable (because the condition is resolved or the contingent event has occurred or becomes certain to occur), the freestanding financial instrument is reclassified to a liability at its fair value with an offset to equity (no gain or loss is recorded). Does the difference between the fair value and the carrying amount at the reclassification date require an adjustment to the numerator of the earnings per share calculation?

A. Yes. ASC paragraph 480-10-S99-3 was amended to specify that the reclassification of preferred shares to a liability is like the redemption of the shares by issuance of a debt. Similar to the accounting for the redemption of preferred shares required by ASC paragraph 260-10-S99-2, to the extent that the fair value of the liability upon reclassification differs from the carrying amount of the preferred shares (i.e., recorded in equity or temporary equity), that difference should be deducted from or added to net income available to common shareholders in the calculation of earnings per share.
11. Disclosures

Introduction

Required Disclosures

Disclosures if All Shares Are Mandatorily Redeemable

Questions and Answers
11. Disclosures

INTRODUCTION

11.000 The existing disclosure requirements for liabilities and equity instruments, notably the requirements in ASC paragraphs 505-10-15-1; 505-10-50-3 through 50-5, and 50-11, provide users of financial statements with certain information to analyze an entity’s liabilities and equity. The Board decided that additional information would be helpful to users in evaluating the entity’s economic exposure to financial instruments that could be settled in an entity’s shares. The disclosure requirements for instruments that could be settled with an issuer’s shares established in ASC Subtopic 815-40 and ASC paragraph 480-10-55-63 provide that kind of information and the Board decided to require certain of the disclosures in ASC Subtopic 815-40 and ASC paragraph 480-10-55-63, in addition to the disclosures in ASC paragraphs 505-10-15-1; 505-10-50-3 through 50-5, and 50-11, for all instruments within the scope of ASC Topic 480.

REQUIRED DISCLOSURES

11.001 ASC paragraphs 480-10-50-1 through 50-4 address its disclosure requirements.

Issuers of financial instruments within the scope of ASC Topic 480 shall disclose the nature and terms of the financial instruments and the rights and obligations embodied in those instruments. That disclosure shall include information about settlement alternatives, if any, in the contract and identify the entity that controls the settlement alternatives.

Additionally, for all outstanding financial instruments within the scope of ASC Topic 480 and for each settlement alternative, issuers shall disclose:

a. The amount that would be paid, or the number of shares that would be issued and their fair value, determined under the conditions specified in the contract if the settlement were to occur at the reporting date

b. How changes in the fair value of the issuer’s equity shares would affect those settlement amounts (e.g., “the issuer is obligated to issue an additional x shares or pay an additional y dollars in cash for each $1 decrease in the fair value of one share”)

c. The maximum amount that the issuer could be required to pay to redeem the instrument by physical settlement, if applicable

d. The maximum number of shares that could be required to be issued, ¹ if applicable

¹ ASC paragraph 505-10-50-3 of ASC Topic 505, Equity, requires additional disclosures for actual issuances and settlements that occurred during the accounting period.
e. That a contract does not limit the amount that the issuer could be required to pay or the number of shares that the issuer could be required to issue, if applicable.

f. For a forward contract or an option indexed to the issuer’s equity shares, the forward price or option strike price, the number of issuer’s shares to which the contract is indexed, and the settlement date or dates of the contract, as applicable.

Some entities have no equity instruments outstanding but have financial instruments in the form of shares, all of which are mandatorily redeemable financial instruments required to be classified as liabilities. Those entities are required under ASC paragraph 480-10-45-2 to describe those instruments as shares subject to mandatory redemption in statements of financial position to distinguish those instruments from other liabilities. Those entities shall disclose the components of the liability that would otherwise be related to shareholders’ interest and other comprehensive income (if any) subject to the redemption feature (e.g., par value and other paid-in amounts of mandatorily redeemable instruments shall be disclosed separately from the amount of retained earnings or accumulated deficit).

11.002 ASC paragraphs 505-10-15-1; 505-10-50-3 through 50-5, and 50-11 require certain disclosures that are intended to provide users of financial statements with information useful in analyzing an entity’s liabilities and equity. The disclosures required by ASC paragraphs 480-10-50-1 through 50-4 are incremental to the existing requirements in ASC paragraphs 505-10-15-1; 505-10-50-3 through 50-5, and 50-11, and other authoritative literature. The additional information required by ASC Topic 480 is intended to help users evaluate an entity’s economic exposure to financial instruments that could be settled in an entity’s shares. Many of the disclosures required by ASC Topic 480 were derived from the required disclosures for instruments within the scope of ASC Subtopic 815-40 and ASC paragraph 480-10-55-63.

11.003 In addition to disclosures required under ASC paragraphs 505-10-15-1; 505-10-50-3 through 50-5, and 50-11, and other authoritative literature, the following should be disclosed for financial instruments within the scope of ASC Topic 480:

(1) The nature, terms, rights, obligations, and settlement alternatives (including the entity that controls the settlement alternatives) embodied in those financial instruments.

(2) For all outstanding financial instruments within the scope of ASC Topic 480 (and for each settlement alternative):

- The amount that would be paid, or the number of shares that would be issued and their fair value, determined under the conditions specified in the contract if the settlement were to occur at the reporting date.

- How changes in the fair value of the issuer’s equity shares would affect those settlement amounts. For example, “the issuer is obligated to issue
additional x shares or pay additional y dollars in cash for each $1 decrease in the fair value of one share.”

• The maximum amount that the issuer could be required to pay in cash to redeem the instrument by physical settlement, if applicable.

• The maximum number of shares that could be required to be issued, if applicable. (ASC paragraphs 505-10-15-1; 505-10-50-3 through 50-5, and 50-11 contain additional disclosure requirements for actual issuances and settlements during an accounting period.)

• The fact that a contract does not limit the amount the issuer could be required to pay or the number of shares that the issuer could be required to issue, if applicable.

• For a forward contract or an option indexed to the issuer’s equity shares, the forward price or option strike price, the number of issuer’s shares to which the contract is indexed, and the settlement date(s) of the contract, as applicable.

DISCLOSURES IF ALL SHARES ARE MANDATORILY REDEEMABLE

11.004 Entities that have no equity instruments outstanding but have financial instruments in the form of shares, all of which are mandatorily redeemable financial instruments required to be classified as liabilities, should describe those instruments as shares subject to mandatory redemption in statements of financial position to distinguish them from other liabilities. Those entities should disclose the components of the liability that would otherwise be related to shareholders’ interest and other comprehensive income (if any) subject to the redemption feature. For example, the par value and other paid-in amounts of mandatorily redeemable instruments should be disclosed separately from the amount of retained earnings or accumulated deficit. See Paragraphs 8.009–8.014 and 9.020–9.022 for additional information.

11.005 For companies that have financial instruments in the form of shares that are all mandatorily redeemable, a disclosure that includes the nature and composition of its mandatorily redeemable financial instruments is required. For example, such an entity would disclose:

• The event(s) triggering the redemption;
• The number of shares issued and outstanding;
• The value associated with those financial instruments; and
• Any retained earnings or accumulated other comprehensive income that would be distributed on redemption.

11.006 The following represents a continuation of Example 8.1 to illustrate the disclosure requirements for shares subject to mandatory redemption:
Example 11.1: Disclosures If All Shares Are Mandatorily Redeemable

Background

Company A meets the definition of a nonpublic entity because (1) it does not have equity securities traded in a public market or in the over-the-counter market, (2) it has not made a filing with a regulatory agency in preparation for the sale of equity securities in a public market, and (3) it is not controlled by an entity covered by (1) or (2). However, Company A meets the definition of an SEC registrant because it is required to file financial statements with the SEC.

The Company has issued one class of common shares, which are all held by employees and are required to be redeemed at their fair value for cash upon the holder’s death or termination of employment.

Analysis

Company A’s common shares are considered mandatorily redeemable financial instruments under ASC paragraphs 480-10-25-4 and 25-6 because they (1) are issued in the form of shares, (2) embody an unconditional obligation that requires Company A to redeem the instrument by transferring assets (i.e., cash), and (3) contain an event certain to occur upon which the assets are required to be transferred (i.e., death or termination of the employee).

Because Company A meets the definition of a nonpublic entity and an SEC registrant, the provisions of ASC Topic 480 for mandatorily redeemable financial instruments apply. As such, these mandatorily redeemable financial instruments (with uncertain redemption amounts and dates) are within the scope of Topic 480 because the scope exception provided in ASC paragraphs 480-10-15-7A through 15-7F does not apply. Because the mandatorily redeemable financial instruments represent the only shares in the entity, Company A should present them as shares subject to mandatory redemption in the liabilities section of its balance sheet. (An example of the statement of financial position presentation is included in Example 8.1.) The following represents an example of the required disclosures for those instruments:

Notes to Financial Statements

Shares, all of which are subject to mandatory redemption upon the holders’ death or termination of employment, consist of:
Common stock—$0.01 par value, 1,000 shares authorized, 100 shares issued and outstanding $1
Additional paid-in capital 24
Retained earnings attributable to those shares 10
Accumulated other comprehensive income attributable to those shares 5
Total $40

QUESTIONS AND ANSWERS

Q&A 11.1: Company A has instruments outstanding that are within the scope of ASC Topic 480. Company A includes all the disclosures required by ASC paragraphs 480-10-50-1 through 50-4.

Q. Are instruments within the scope of ASC Topic 480 subject to the disclosure requirements of other authoritative literature?

A. Yes. The disclosures required by ASC Topic 480 are incremental to the existing disclosure requirements of other authoritative literature. For example, entities are required to follow the disclosure requirements in ASC paragraphs 505-10-15-1; 505-10-50-3 through 50-5, and 50-11, if applicable.

Q&A 11.2: Certain requirements of ASC Topic 480 are not applicable to certain instruments and for certain entities.

Q. Are there any circumstances when the classification or measurement requirements of ASC Topic 480 do not apply, but the disclosure requirements are still applicable?

A. Yes. Although ASC Topic 480 provides a scope exception to the classification, measurement, and disclosure requirements for certain instruments and certain entities in ASC paragraphs 480-10-15-7A and 15-7E, ASC paragraph 480-10-15-7F specifies that SEC registrants are required to apply the disclosure requirements of ASC Topic 480 to (1) instruments issued by a subsidiary that are required to be redeemed only upon liquidation or termination of the subsidiary, and (2) instruments issued by a subsidiary before November 5, 2003 that are required to be
redeemed before liquidation or termination of the subsidiary. See Section 12 for additional information.
12. Scope Exception for Certain Provisions of ASC Topic 480

Introduction

Scope Exception for Certain Provisions of ASC Topic 480

Mandatory Redeemable Noncontrolling Interests (All Entities)

Noncontrolling Interests That Are Mandatory Redeemable upon Termination of a Limited-Life Entity

Mandatory Redeemable Noncontrolling Interests Issued before November 5, 2003

Mandatory Redeemable Noncontrolling Interests Issued on or after November 5, 2003

Mandatory Redeemable Financial Instruments of Non-SEC Registrants

Instruments Issued by Non-SEC Registrants That Are Required to Be Redeemed on Fixed Dates for Amounts That Are Either Fixed or Determined by Reference to Certain Indices

Other Mandatorily Redeemable Instruments Issued by Non-SEC Registrants

Initial Public Offerings
12. Scope Exception for Certain Provisions of ASC Topic 480

INTRODUCTION

12.000 This section discusses the scope exception for certain provisions of ASC Topic 480 related to mandatorily redeemable financial instruments.

12.001 Paragraphs 12.001 through 12.014 are not used.

SCOPE EXCEPTION FOR CERTAIN PROVISIONS OF ASC TOPIC 480

12.015 In response to difficulties implementing ASC Topic 480, the FASB deferred certain of its provisions by issuing FASB Staff Position 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 (codified as ASC paragraph 480-10-65-1) for:

(1) Mandatorily redeemable financial instruments of certain nonpublic entities
(2) Certain mandatorily redeemable noncontrolling interests.

In 2017, the FASB issued Part II of ASU 2017-11, which recharacterized the indefinite deferral guidance in ASC paragraph 480-10-65-1 to scope exceptions in ASC paragraphs 480-10-15-7A through 15-7F.

Background

ASC Topic 480 as issued was effective for mandatorily redeemable financial instruments of nonpublic entities for the first fiscal period beginning after December 15, 2003. For mandatorily redeemable instruments of other entities, ASC Topic 480 as issued was effective for financial instruments entered into or modified after May 31, 2003, and for all other instruments for interim periods beginning after June 15, 2003. ASC paragraphs 480-10-25-4 requires that “a mandatorily redeemable financial instrument shall be classified as a liability unless the redemption is required to occur only upon the liquidation or termination of the reporting entity” (emphasis added). However, that “only upon liquidation” exception in ASC paragraph 480-10-25-4 does not apply to financial instruments issued by subsidiaries in the consolidated financial statements of a parent of that entity. Many entities were concerned about the implications of applying those provisions of ASC Topic 480 and requested that the FASB either change or delay the provisions to allow companies to adapt to those provisions and educate users of their financial statements. Others had expressed concern about implementation issues that remained unresolved as financial reports...
adopting ASC Topic 480 were being completed. Those entities had also requested that the FASB change or delay those provisions of ASC Topic 480.

After the FASB’s Accounting Standards Codification became authoritative U.S. GAAP in place of the various legacy standards, the deferral of the effective date for certain instruments and certain entities provided in ASC 480-10-65-1 caused many constituents to note that the deferral created pending content in the FASB’s Accounting Standards Codification that made ASC Topic 480 difficult to navigate. For this reason, the FASB decided to replace the indefinite deferral in ASC paragraph 480-10-65-1 with the scope exception in ASC paragraphs 480-10-15-7A through 15-7F for the same instruments and entities. However, the FASB also indicated that this recharacterization did not mean that it had resolved the underlying issues that led to the indefinite deferral.

Because the ASU 2017-11 amendments do not change the accounting effect, they do not require transition guidance.

**Mandatorily Redeemable Financial Instruments of Certain Nonpublic Entities**

ASC paragraph 480-10-15-7A states that the classification, measurement, and disclosure guidance in ASC Topic 480 does not apply to mandatorily redeemable financial instruments issued by nonpublic entities that are not Securities and Exchange Commission (SEC) registrants,1 and that are mandatorily redeemable, but not on fixed dates or not for amounts that either are fixed or are determined by reference to an interest rate index, currency index, or another external index.

Mandatorily redeemable financial instruments issued by SEC registrants are not eligible for the scope exception, even if the entity meets the definition of a nonpublic entity in ASC Topic 480.

Some entities have issued shares that are required to be redeemed under related agreements. If the shares are issued with the redemption agreement and the required redemption relates to those specific underlying shares, the shares are mandatorily redeemable. If an entity with such shares and redemption agreement is a nonpublic entity that is not an SEC registrant, those mandatorily redeemable shares meet the scope exception in ASC paragraph 480-10-15-7A if they meet the conditions specified in that paragraph.

Although the disclosure requirements of ASC Topic 480 do not apply to those mandatorily redeemable instruments of certain nonpublic companies that meet the scope exception in ASC paragraph 480-10-15-7A, the requirements of ASC paragraph 505-10-15-1; ASC paragraphs 505-10-50-3 through 50-5 and 50-11 still apply. In particular, ASC paragraph 505-10-50-3 requires disclosure of information about the pertinent rights and privileges of the various securities

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1 For purposes of ASC paragraphs 480-10-15-7A, SEC registrants are entities, or entities that are controlled by entities, (a) that have issued or will issue debt or equity securities that are traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local or regional markets), (b) that are required to file financial statements with the SEC, or (c) that provide financial statements for the purpose of issuing any class of securities in a public market.
outstanding, which includes mandatory redemption requirements. ASC paragraph 505-10-50-11 also requires disclosure of the amount of redemption requirements for all issues of stock that are redeemable at fixed or determinable prices on fixed or determinable dates in each of the next five years.

**Certain Mandatorily Redeemable Noncontrolling Interests**

ASC paragraph 480-10-15-7E states that ASC Topic 480 does not apply to mandatorily redeemable noncontrolling interests (of all entities, public and nonpublic) as follows:

a. The classification and measurement provisions of ASC Topic 480 do not apply to mandatorily redeemable noncontrolling interests that would not have to be classified as liabilities by the subsidiary, under the “only upon liquidation” exception in ASC paragraphs 480-10-25-4 and 25-6, but would be classified as liabilities by the parent in consolidated financial statements.

b. The measurement provisions of ASC Topic 480 do not apply to other mandatorily redeemable noncontrolling interests that were issued before November 5, 2003, both for the parent in consolidated financial statements and for the subsidiary that issued the instruments that result in the mandatorily redeemable noncontrolling interest. For those instruments, the measurement guidance for redeemable shares and noncontrolling interests in other literature (e.g., in ASC paragraph 480-10-S99-3A) continues to apply.

All public entities and nonpublic entities that are SEC registrants are required to follow the disclosure requirements in ASC paragraphs 480-10-50-1 through 50-3 and disclosures required by other applicable guidance.

**12.016** In general, ASC paragraphs 480-10-15-7A through 7F provide a scope exception for non-SEC registrants, and eliminates the disclosure requirements for certain mandatorily redeemable instruments.

**12.017** Other financial instruments within the scope of ASC Topic 480, including obligations to repurchase the issuer’s shares by transferring assets and certain obligations to issue a variable number of shares, are not affected by ASC paragraphs 480-10-15-7A through 15-7F. The tables summarize the types of instruments affected by ASC paragraphs 480-10-15-7A through 15-7F and the nature of the effect.
Table 12.1: Scope Exception for Mandatorily Redeemable Noncontrolling Interests of All Entities

<table>
<thead>
<tr>
<th>Description of Instrument</th>
<th>ASC Topic 480 Classification Requirements</th>
<th>ASC Topic 480 Measurement Requirements</th>
<th>ASC Topic 480 Disclosure Requirements</th>
</tr>
</thead>
<tbody>
<tr>
<td>Instruments issued by a subsidiary that are required to be redeemed only on liquidation or termination of the subsidiary.</td>
<td>Scope exception</td>
<td>Scope exception</td>
<td>Subsidiary and parent are required to follow if an SEC registrant</td>
</tr>
<tr>
<td>Instruments issued before November 5, 2003 by a subsidiary that are required to be redeemed before liquidation or termination of the subsidiary.</td>
<td>Subsidiary and parent are required to follow (subject to the scope exception summarized in Table 12.2 for non-SEC registrants)</td>
<td>Scope exception</td>
<td>Subsidiary and parent are required to follow if an SEC registrant</td>
</tr>
<tr>
<td>Instruments issued on or after November 5, 2003 by a subsidiary that are required to be redeemed before liquidation or termination of the subsidiary.</td>
<td>Subsidiary and parent are required to follow (subject to the scope exception summarized in Table 12.2 for non-SEC registrants)</td>
<td>Subsidiary and parent are required to follow (subject to the scope exception summarized in Table 12.2 for non-SEC registrants)</td>
<td>Subsidiary and parent are required to follow (subject to the scope exception summarized in Table 12.2 for non-SEC registrants)</td>
</tr>
</tbody>
</table>
Table 12.2: Mandatorily Redeemable Financial Instruments of Non-SEC Registrants

<table>
<thead>
<tr>
<th>Description of Instrument</th>
<th>ASC Topic 480 Classification Requirements</th>
<th>ASC Topic 480 Measurement Requirements</th>
<th>ASC Topic 480 Disclosure Requirements</th>
</tr>
</thead>
<tbody>
<tr>
<td>Instruments that are not redeemable on fixed dates for amounts that are fixed or determined by reference to specified indices.</td>
<td>Scope exception</td>
<td>Scope exception</td>
<td>Scope exception</td>
</tr>
</tbody>
</table>

Mandatorily Redeemable Noncontrolling Interests (All Entities)

12.018 When one entity (a parent) consolidates another entity (a subsidiary) that is not wholly owned, the other owners of the consolidated entity (e.g., third party holders of a subsidiary’s preferred shares or common shares) are referred to as noncontrolling interests (e.g., minority interest holders) in the consolidated financial statements. As a result of various implementation issues related to the application of ASC Topic 480 to all noncontrolling interests, the Board provided a scope exception for applying certain of its provisions.

NONCONTROLLING INTERESTS THAT ARE MANDATORILY REDEEMABLE UPON TERMINATION OF A LIMITED-LIFE ENTITY

12.019 The governing agreements of partnerships, limited-liability companies, trusts, and entities domiciled in certain foreign jurisdictions frequently specify a fixed term for the entity’s existence whereby the entity will be terminated on a specified date (i.e., a limited-life entity). ASC Topic 480 states that mandatorily redeemable instruments are outside its scope if redemption is required to occur only upon the liquidation or termination of the reporting entity. Accordingly, the separate financial statements of a limited-life entity would not report the ownership interests in those entities as liabilities if redemption is required to occur only in the event of its liquidation or termination.

12.020 As a result of ASC paragraph 480-10-15-7E, the classification and measurement provisions of ASC Topic 480 do not apply to mandatorily redeemable noncontrolling interests that are outside its scope at the subsidiary level (because redemption will occur upon liquidation or termination of the subsidiary), but that would have been classified as liabilities by the consolidating entity in the consolidated financial statements under the provisions of ASC Topic 480. See Example 3.6 for an illustration of the application of these provisions.

12.021 All SEC registrants are required to provide the disclosures required by ASC Topic 480, in addition to disclosures required by other Topics (e.g., ASC paragraphs 505-10-15-1; 505-10-50-3 through 50-5 and 50-11). For example, a real estate company with a consolidated non-wholly owned investment in a limited-life partnership is required to
disclose the amount of consideration that would be paid to the holders of the noncontrolling interests as if termination of that partnership occurred on the reporting date. Likewise, entities with consolidated non-wholly owned subsidiaries in certain foreign jurisdictions, such as France and Brazil, which are required to specify a termination date in their articles of incorporation or other applicable governing documents as a matter of law, are similarly affected.

12.022 The disclosure requirements in ASC Topic 480 do not apply to these instruments for non-SEC registrants. However, the disclosure requirements in ASC paragraphs 505-10-15-1; 505-10-50-3 through 50-5; and 50-11, including disclosure of information about redemption requirements, will continue to apply to all entities.

MANDATORILY REDEEMABLE NONCONTROLLING INTERESTS ISSUED BEFORE NOVEMBER 5, 2003

12.023 Entities with mandatorily redeemable noncontrolling interests not discussed in Paragraphs 12.019–12.022, (e.g., instruments within the scope of ASC Topic 480 at both the subsidiary and parent level) that were issued before November 5, 2003, are required to apply the classification guidance in ASC Topic 480 for those instruments (i.e., they must be classified as liabilities.) However, the measurement provisions of ASC Topic 480 do not apply to all entities with mandatorily redeemable noncontrolling interests issued before November 5, 2003. Entities should continue to measure those instruments under other applicable Topics. For example, the measurement provisions of ASC paragraphs 480-10-S99-2 and 480-10-S99-3 may apply at the subsidiary level for SEC registrants.

12.024 The scope exception for ASC Topic 480’s measurement provisions for entities with mandatorily redeemable noncontrolling interests issued before November 5, 2003 applies at both the subsidiary and parent level. In reaching this conclusion, the Board affirmed its intent to have consistent application of ASC Topic 480 at both the parent and subsidiary levels.

12.025 ASC paragraph 480-10-15-7E requires that a company reclassify the mandatorily redeemable noncontrolling interests as liabilities in both the stand-alone subsidiary financial statements and the consolidated parent company financial statements. This is required provided the subsidiary is not required to be liquidated or terminated upon the payment of the preferred stock. However, since the measurement provisions in ASC Topic 480 do not apply to these types of instruments, both the parent and subsidiary should measure the carrying value of those instruments according to other applicable accounting literature.

12.026 We believe the requirement in ASC paragraph 480-10-15-7E to apply the classification requirements of ASC Topic 480 includes both income statement and balance sheet classifications. Accordingly, the subsidiary discussed in the previous paragraph would be required to classify the dividends on its mandatorily redeemable preferred stock as interest costs. Upon extinguishment of mandatorily redeemable preferred stock that is classified as a liability, any difference between the carrying amount
and the redemption amount is recognized as a gain or loss in accordance with ASC paragraphs 470-50-05-1; 470-50-15-3 and 15-4; 470-50-40-2 and 40-4, and ASC Topic 860, regardless of when the instrument was issued. The following example illustrates the application of these provisions:

**Example 12.3: Mandatorily Redeemable Preferred Stock Issued by a Subsidiary of an SEC Registrant Before November 5, 2003 (Redemption Required Before Termination of the Subsidiary)**

**Background**

On January 1, 2003, Subsidiary issues preferred stock to a third party that requires redemption on a fixed date (prior to liquidation or termination of the subsidiary) for a fixed amount. Subsidiary is consolidated by Parent Company, an SEC registrant.

**Analysis**

The mandatorily redeemable preferred stock should be classified as a liability in both the separate financial statements of Subsidiary and consolidated financial statements of Parent Company. However, measurement of the instrument should be determined according to other applicable accounting literature at both the Subsidiary and Parent Company levels. When recognized, dividends on the mandatorily redeemable preferred stock should be classified as interest costs in both the separate financial statements of Subsidiary and consolidated financial statements of Parent Company.

12.027 All SEC registrants are required to provide the disclosures required by ASC Topic 480, in addition to disclosures required by other Topics (e.g., ASC paragraphs 505-10-15-1; 505-10-50-3 through 50-5, and 50-11). The disclosure requirements in ASC Topic 480 do not apply to these instruments for non-SEC registrants. However, the disclosure requirements in ASC paragraphs 505-10-15-1; 505-10-50-3 through 50-5, and 50-11, including disclosure of information about redemption requirements, apply to all entities.

**MANDATORILY REDEEMABLE NONCONTROLLING INTERESTS ISSUED ON OR AFTER NOVEMBER 5, 2003**

12.028 Entities that issue mandatorily redeemable noncontrolling interests on November 5, 2003 or thereafter that are not discussed in Paragraphs 12.019–12.022 above are required to apply all the classification, measurement, and disclosure provisions of ASC Topic 480 to those instruments. The disclosure requirements in ASC paragraphs 505-10-15-1; 505-10-50-3 through 50-5, and 50-11, including disclosure of information about redemption requirements, continue to apply to all entities. The following example illustrates the application of those provisions:
Example 12.4: Mandatorily Redeemable Preferred Stock Issued by a Subsidiary of an SEC Registrant On or After November 5, 2003 (Redemption Required Before Termination of the Subsidiary)

Background

On December 1, 2003, Subsidiary issues preferred stock to a third party that requires redemption on a fixed date (prior to liquidation or termination of Subsidiary) for a fixed amount. Parent Company consolidates Subsidiary and is an SEC registrant.

Analysis

The instrument is within the scope of ASC Topic 480 and the classification, measurement, and disclosure provisions of ASC Topic 480 are required to be applied in the financial statements of both Subsidiary and Parent. ASC subparagraph 480-10-15-7E(b) does not defer the application of ASC Topic 480 to the instrument in this example because the noncontrolling interest was issued on or after November 5, 2003.

Mandatorily Redeemable Financial Instruments of Non-SEC Registrants

12.029 ASC Topic 480 specifies that a financial instrument issued in the form of shares is mandatorily redeemable if it embodies an unconditional obligation that requires the issuer to redeem the instrument by transferring its assets at a specified or determinable date (or dates) or upon an event certain to occur. Some entities restrict ownership of common stock to active employees by requiring their stock to be redeemed on the employee’s death or termination. ASC Topic 480 would have required those shares to be classified as liabilities because death or termination of employment is certain to occur. As a result, many employee-owned companies with those provisions would not have had outstanding “equity” instruments, because mandatorily redeemable shares of stock are classified as liabilities under ASC Topic 480.

12.030 As originally issued, ASC Topic 480 would have been effective for financial instruments entered into or modified after May 31, 2003, and otherwise would have been effective at the beginning of the first interim period beginning after June 15, 2003, except for mandatorily redeemable financial instruments of a nonpublic entity. For mandatorily redeemable financial instruments of a nonpublic entity, ASC Topic 480 would have become effective for existing or new instruments for fiscal periods beginning after December 15, 2003.
ASC paragraphs 480-10-15-7A through 15-7F state that certain provisions of ASC Topic 480 do not apply to mandatorily redeemable financial instruments issued by non-SEC registrants.

INSTRUMENTS ISSUED BY NON-SEC REGISTRANTS THAT ARE REQUIRED TO BE REDEEMED ON FIXED DATES FOR AMOUNTS THAT ARE EITHER FIXED OR DETERMINED BY REFERENCE TO CERTAIN INDICES

The classification, measurement, and disclosure provisions of ASC Topic 480 apply to non-SEC registrants that have issued instruments that are mandatorily redeemable on fixed dates or for amounts that either are fixed or are determined by reference to an interest rate index, currency index, or another external index. Instruments that meet these criteria include fixed- and floating-rate preferred stock that are required to be redeemed on a fixed date issued by an entity that is not required to be liquidated or terminated when the preferred stock is redeemed. The following example illustrates the application of these provisions:

Example 12.5: Preferred Stock–Redeemable on a Fixed Date for an Amount Determined by Reference to an Interest Rate Index

Background

On January 1, 20X2, a non-SEC registrant issues variable-rate preferred stock that requires redemption at the instrument’s stated value (e.g., $1,000 per share) plus cumulative, unpaid dividends on January 1, 20Y2.

Analysis

The redemption date is fixed and the redemption amount is determined based on an interest rate index, so ASC Topic 480 applies to the mandatorily redeemable preferred stock. The liability should be measured at the amount of cash that would be paid under the conditions specified in the contract if settlement occurred at the reporting date. Changes to the liability in subsequent periods should be recognized as interest cost.

The disclosure requirements in ASC Topic 480 do not apply to these instruments. However, the disclosure requirements in ASC paragraphs 505-10-15-1; 505-10-50-3 through 50-5, and 50-11, including disclosure of information about redemption requirements, do apply.

Mandatorily redeemable instruments issued by SEC registrants, including nonpublic entities that are SEC registrants, do not meet this scope exception.
OTHER MANDATORILY REDEEMABLE INSTRUMENTS ISSUED BY NON-SEC REGISTRANTS

12.035 The scope exception in ASC Topic 480, including all of its classification, measurement, and disclosure requirements, applies to all other mandatorily redeemable financial instruments issued by non-SEC registrants not discussed in Paragraphs 12.019–12.034. The scope exception applies to common or preferred stock issued by a non-SEC registrant that is required to be redeemed when an employee dies or otherwise terminates employment, because the redemption date is not fixed and the redemption amount under those arrangements generally is neither fixed nor determined by reference to an interest rate index, currency index, or another external index. This scope exception also applies to common or preferred stock issued by a non-SEC registrant that is required to be redeemed for fair value on a fixed date because the redemption amount is neither fixed nor determined by reference to an interest rate index, currency index, or another external index.

12.036 The disclosure requirements in ASC Topic 480 do not apply to these instruments. However, the disclosure requirements in ASC paragraphs 505-10-15-1; 505-10-50-3 through 50-5, and 50-11, including disclosure of information about redemption requirements, will continue to apply.

12.037 We believe that as a result of the scope exception, it will be unusual for a nonpublic, non-SEC registrant company with only mandatorily redeemable shares not to have any “equity” instruments outstanding. Thus, the guidance issued in ASC paragraphs 480-10-45-2A and 45-2B (see Paragraphs 8.009–8.014 and 9.020–9.022 for additional information) about the accounting for mandatorily redeemable shares when the redemption amount is different than the book value of the shares will have limited applicability. Notwithstanding this, an employee-owned company that is an SEC registrant (e.g., due to the number of its shareholders) that requires all stock to be redeemed on the employee’s death or termination of employment is one of the limited situations in which ASC paragraphs 480-10-45-2A and 45-2B are required to be applied.

12.038 The SEC staff indicated that broker-dealers are considered SEC registrants since they are required to file financial statements with the SEC and, thus, are not eligible for the scope exception under ASC paragraphs 480-10-15-7A through 65-7F for non-SEC registrants. Similarly, mandatorily redeemable instruments issued by SEC registrants, including nonpublic entities, are not eligible for the scope exception in ASC paragraph 480-10-15-7A. The following illustrates the application of these provisions:

Example 12.6: Non-SEC Registrant–Shares Redeemable on Death or Termination of Employment

Background

An employee-owned, non-SEC registrant issues common stock that is required to be redeemed at fair value when the holder dies or terminates employment.
Analysis

ASC paragraph 480-10-15-7A specifies that ASC Topic 480 does not apply to the common stock in this example.

Example 12.7: SEC Registrant–Shares Redeemable on Death or Termination of Employment

Background

An employee-owned company is an SEC registrant due to the number of its shareholders. All outstanding shares of common stock are required to be redeemed at fair value when the holder dies or terminates employment.

Analysis

The scope exception in ASC paragraph 480-10-15-7A does not apply to the mandatorily redeemable common stock in this example because the company is an SEC registrant. Therefore, the provisions of ASC Topic 480 should be applied.

If the company meets the definition of a nonpublic entity in ASC Subtopic 480-10-20, ASC Topic 480 is required to be applied to mandatorily redeemable financial instruments. The company should apply the provisions of ASC paragraphs 480-10-45-2A and 45-2B if the book value of those shares is different than the redemption amount (fair value). See Paragraphs 9.020–9.022 for additional information.

12.039 Not Used.

INITIAL PUBLIC OFFERINGS

12.040 An implementation issue arises when a nonpublic entity or a non-SEC registrant becomes an SEC registrant. The SEC staff indicated that if an entity was previously subject to the scope exception in ASC Topic 480 for a nonpublic entity or ASC paragraph 480-10-15-7A for a non-SEC registrant related to its mandatorily redeemable instruments and that entity files an initial public offering registration statement, the entity should reflect the adoption of ASC Topic 480 in its financial statements as if it were an SEC registrant for all periods presented.
13. Analysis of Complex Financial Instruments and Transactions under ASC Topic 480

Introduction

Financial Instruments Embodying Obligations That Can be Settled Either by Transferring Assets or Issuing the Entity’s Equity Shares

Outstanding Equity Shares

Financial Instruments Other Than Outstanding Equity Shares

Issuer’s Choice at Settlement

Holder’s Choice at Settlement

Certain Types of Compound Financial Statements

Mandatorily Redeemable Preferred Stock Denominated in Either a Precious Metal or a Foreign Currency

Prepaid Forward Contracts

Physically-Settled Prepaid Forward Purchase Contact for a Fixed Number of Shares

Physically-Settled Prepaid Forward Purchase Contact for a Variable Number of Shares

Physically-Settled Prepaid Forward Sale Contract for a Fixed Number of Shares

Physically-Settled Prepaid Forward Sale Contract for a Variable Number of Shares

Certain Structured Transactions Previously Addressed by the Emerging Issues Task Force

Debt Repayable with Proceeds from the Sale of Equity

Forward Purchase Contract Executed Simultaneously with Issuance of Equity Shares

Share Repurchase Program

Hedging Stock Appreciation Rights

Derivatives Indexed to the Minority Interest in a Business Combination

Derivatives Indexed to the Stock of a Consolidated Subsidiary

Forward Purchase Contract Executed Simultaneously with Issuance of a Written Put Option

Questions and Answers
13. Analysis of Complex Financial Instruments and Transactions under ASC Topic 480

INTRODUCTION

13.000 As discussed in Section 1, the scope of ASC Topic 480 is limited because the FASB has not resolved several significant issues identified in the liabilities and equity Exposure Draft, issued in October 2000, including the separation of instruments with characteristics of both liabilities and equity into components. Many issues impacting compound financial instruments, including dual-indexed share-settled instruments whose value is tied to an issuer’s equity shares and another underlying, are currently beyond the scope of ASC Topic 480.¹ This section provides interpretive guidance regarding the application of ASC Topic 480 to:

- Financial instruments embodying obligations that can be settled either by transferring assets or issuing the entity’s equity shares (i.e., they contain settlement alternatives);
- Certain types of compound financial instruments;
- Prepaid forward contracts; and
- Certain structured transactions previously addressed by the Emerging Issues Task Force.

FINANCIAL INSTRUMENTS EMBODYING OBLIGATIONS THAT CAN BE SETTLED EITHER BY TRANSFERRING ASSETS OR ISSUING THE ENTITY’S EQUITY SHARES

13.001 As discussed in Sections 4 and 5, all written put options and all forward purchase contracts on an entity’s equity shares with a single, required, settlement method (i.e., physical, net cash, or net share settlement) are within the scope of either ASC paragraphs 480-10-25-8 through 25-10 and 25-12 or 480-10-25-14. Because ASC paragraphs 480-10-25-8 through 25-10, 25-12, and 25-14 use the terms “requires or may require the issuer to settle the obligation by transferring assets” and “the issuer must or may settle by issuing a variable number of its equity shares,” respectively, to describe affected instruments, an instrument that has a single required settlement method may be within the scope of ASC Topic 480 even though the instrument could expire unexercised or may not result in an obligation for the issuer at the settlement date.

¹ Regardless of whether a dual-indexed share-settled instrument is determined to be within the scope of ASC Topic 480, an issuer must first evaluate whether the instrument is a derivative in its entirety or whether it contains embedded features that require separation under ASC Topic 815. When ASC Topic 480 was issued, the guidance in EITF Issue No. 88-9, “Put Warrants,” was completely nullified.
13.002 Some financial instruments embody settlement alternatives that enable either the issuer or the holder to determine whether the instrument will be settled by the issuer transferring assets or by issuing its equity shares. That is, a financial instrument may embody an obligation that permits either the issuer or the holder to determine whether, at the settlement date, the issuer will transfer its assets to satisfy its obligation or issue its equity shares to satisfy its obligation. Regardless of which party has the choice of settlement, if a financial instrument is an outstanding equity share, the issuer would determine whether the instrument is within the scope of ASC Topic 480 using the same analysis. However, if a financial instrument is not an outstanding equity share, the issuer would analyze the instrument using different analyses—depending on which party determines how the instrument would be settled.

Outstanding Equity Shares

13.003 If the financial instrument is an outstanding equity share (e.g., a preferred share) that may be settled in either cash or shares, the issuer would conclude that the financial instrument is outside the scope of ASC paragraphs 480-10-25-8 through 25-10 and 25-12 because it is an outstanding share. However, the issuer must determine whether that outstanding share is within the scope of ASC paragraphs 480-10-25-4 and 25-6 or 480-10-25-14. Generally, the issuer would conclude that the financial instrument is outside the scope of ASC paragraphs 480-10-25-4 and 25-6 because the obligation could be settled in the issuer’s equity shares, thus, it is not considered a mandatorily redeemable financial instrument. That is, the financial instrument does not embody an unconditional obligation requiring the issuer to redeem the instrument by transferring its assets.

13.004 Because an obligation, as defined in ASC Section 480-10-20, is a conditional or unconditional duty or responsibility to transfer assets or to issue equity shares, an issuer’s unconditional obligation related to a financial instrument that is an outstanding share and may be settled in either cash or shares may meet the requirements of ASC paragraph 480-10-25-14. As a result, the issuer must evaluate that instrument under the provisions of ASC paragraph 480-10-25-14 to determine whether it represents an unconditional obligation that the issuer may settle by issuing a variable number of its equity shares.

13.005 The following examples illustrate these provisions:

Example 13.1: Preferred Shares Subject to Redemption That May Be Settled in Cash or a Variable Number of the Issuer’s Equity Shares at the Option of the Issuer

Background

Company A issues preferred shares that are required to be redeemed 10 years from the date of issuance. Upon redemption, the issuer has the option to settle the redemption for an amount equal to the $100,000 liquidation preference of the shares (plus cumulative, unpaid dividends) in cash, or a variable number of its common equity shares with a fair value equal to that redemption amount.
Analysis

The instrument is an outstanding equity share and is outside the scope of ASC paragraphs 480-10-25-8 through 25-10 and 25-12. Since the instrument could be settled in Company A’s equity shares, it is not considered a mandatorily redeemable financial instrument within the scope of ASC paragraphs 480-10-25-4 and 25-6 (i.e., it does not embody an unconditional obligation requiring the issuer to redeem the instrument by transferring its assets). As a result, Company A should determine whether the instrument is within the scope of ASC paragraph 480-10-25-14.

The instrument is within the scope of ASC paragraph 480-10-25-14 because (1) it embodies an unconditional obligation, (2) Company A may settle the unconditional obligation by issuing a variable number of its common shares, and (3) at inception, the monetary value of the obligation is based solely on a fixed monetary amount known at inception (i.e., the holder will receive $100,000, plus cumulative, unpaid dividends, in a variable number of Company A’s common shares in 10 years).

As a result, the instrument is accounted for in accordance with the provisions of ASC paragraph 480-10-25-14.

Example 13.2: Preferred Shares Subject to Redemption That May Be Settled in Cash or a Fixed Number of the Issuer’s Equity Shares at the Option of the Issuer

Background

Company A issues preferred shares that are required to be redeemed 10 years from the date of issuance. Upon redemption, the issuer has the option to settle for an amount equal to the $100,000 liquidation preference of the shares (plus cumulative, unpaid dividends) or 1,000 Company A common equity shares.

Analysis

The instrument is an outstanding equity share and is outside the scope of ASC paragraphs 480-10-25-8 through 25-10 and 25-12. Since the instrument could be settled in Company A’s equity shares, it is not considered a mandatorily redeemable financial instrument within the scope of ASC paragraphs 480-10-25-4 and 25-6 (i.e., it does not embody an unconditional obligation requiring the issuer to redeem the instrument by transferring its assets). As a result, Company A should determine whether the instrument is within the scope of ASC paragraph 480-10-25-14.

The instrument is outside the scope of ASC paragraph 480-10-25-14 because the stock settlement alternative does not specify a variable number of shares.
Example 13.3: Preferred Shares Subject to Redemption That May Be Settled in Cash or a Variable Number of the Issuer’s Equity Shares at the Option of the Holder

Background

Company A issues preferred shares that are required to be redeemed 10 years from the date of issuance. Upon redemption, the holder has the option to require Company A to settle for an amount equal to the $100,000 liquidation preference of the shares (plus cumulative, unpaid dividends) in cash, or a variable number of Company A common equity shares with a fair value equal to that redemption amount.

Analysis

The instrument is an outstanding equity share and is outside the scope of ASC paragraphs 480-10-25-8 through 25-10 and 25-12. Since the instrument could be settled in Company A’s equity shares, it is not considered a mandatorily redeemable financial instrument within the scope of ASC paragraphs 480-10-25-4 and 25-6 (i.e., it does not embody an unconditional obligation requiring the issuer to redeem the instrument by transferring its assets). As a result, Company A should determine whether the instrument is within the scope of ASC paragraph 480-10-25-14.

The instrument is within the scope of ASC paragraph 480-10-25-14 because it (1) embodies an unconditional obligation, (2) the holder may require Company A to settle the unconditional obligation by issuing a variable number of its common shares, and (3) at inception, the monetary value of the obligation is based solely on a fixed monetary amount known at inception (i.e., the holder will receive $100,000, plus cumulative, unpaid dividends, in a variable number of Company A’s common shares in 10 years).

As a result, the instrument is accounted for in accordance with the provisions of ASC Topic 480.

Example 13.4: Preferred Shares Subject to Redemption That May Be Settled in Cash or a Fixed Number of the Issuer’s Equity Shares at the Option of the Holder

Background

Company A issues preferred shares that are required to be redeemed 10 years from the date of issuance. Upon redemption, the holder has the option to require Company A to settle for an amount equal to the $100,000 liquidation preference of
the shares (plus cumulative, unpaid dividends) or 1,000 Company A common equity shares.

**Analysis**

The instrument is an outstanding equity share and is outside the scope of ASC paragraphs 480-10-25-8 through 25-10 and 25-12. Since the instrument could be settled in Company A’s equity shares, it is not considered a mandatorily redeemable financial instrument within the scope of ASC paragraphs 480-10-25-4 and 25-6 (i.e., it does not embody an unconditional obligation requiring the issuer to redeem the instrument by transferring its assets). As a result, Company A should determine whether the instrument is within the scope of ASC paragraph 480-10-25-14.

The instrument is outside the scope of ASC paragraph 480-10-25-14 because the stock settlement alternative does not specify a variable number of shares.

**Financial Instruments Other Than Outstanding Equity Shares**

13.006 If a financial instrument is not an outstanding equity share, the issuer should analyze the instrument under the provisions of ASC Topic 480 based on which party has the choice of settlement methods.

**ISSUER’S CHOICE AT SETTLEMENT**

13.007 Certain financial instruments embody obligations that permit the issuer to determine whether it will settle the instrument either by transferring assets or by issuing equity shares at the settlement date. If the financial instrument is not an outstanding equity share (e.g., a forward contract to purchase an issuer’s shares), the issuer should conclude that the financial instrument is outside the scope of ASC paragraphs 480-10-25-4 and 25-6 because it is not an outstanding equity share. However, because those financial instruments embody obligations that permit the issuer to determine whether it will settle the instrument either by transferring assets or by issuing equity shares at the settlement date, the issuer has discretion to avoid a transfer of assets at the settlement date. The Board concluded that such instruments (i.e., financial instruments that are not outstanding equity shares) should be treated like financial instruments that require issuance of equity shares at the settlement date. Accordingly, those financial instruments only should be classified as a liability under ASC Topic 480 if, under the share settlement alternative, the instrument is within the scope of ASC paragraph 480-10-25-14.

13.008 The evaluation and classification of a financial instrument that is not an outstanding equity share that provides the issuer with the choice of settling its obligations either by transferring assets or by issuing equity shares at the settlement date under the provisions of ASC Topic 480 are initially performed at inception. Because share settlement is assumed to be the alternative the issuer will ultimately choose at the settlement date, it is not relevant whether the instrument is within the scope of ASC paragraphs 480-10-25-8 through 25-10 and 25-12 under the other settlement...
alternative(s). That is, for purposes of analyzing such instruments under ASC paragraphs 480-10-25-8 through 25-10 and 25-12, or 480-10-25-14, it is assumed that there is only one required settlement method—share settlement.

HOLDER’S CHOICE AT SETTLEMENT

13.009 Certain financial instruments embody obligations that permit the holder to determine whether the issuer will settle the instrument either by transferring assets or by issuing equity shares at the settlement date. If the financial instrument is not an outstanding equity share (e.g., a forward contract to purchase an issuer’s shares), the issuer would conclude that the financial instrument is outside the scope of ASC paragraphs 480-10-25-4 and 25-6 because it is not an outstanding equity share. However, because those financial instruments embody obligations that do not provide the issuer with discretion to avoid a transfer of assets at the settlement date, the Board concluded that such instruments (i.e., financial instruments that are not outstanding equity shares) should be treated like financial instruments that require a transfer of assets at settlement. Accordingly, those financial instruments only should be classified as a liability under ASC Topic 480 if, under the transfer of assets settlement alternative, the instrument is within the scope of ASC paragraphs 480-10-25-8 through 25-10 and 25-12.

13.010 The evaluation and classification of a financial instrument that is not an outstanding equity share that provides the holder with the choice of whether the issuer’s obligation will be settled either by transferring assets or by issuing equity shares at the settlement date under the provisions of ASC Topic 480 are initially performed at inception. Because a transfer of assets settlement is assumed to be the alternative the holder will ultimately choose at the settlement date, it is not relevant whether the instrument is within the scope of ASC paragraph 480-10-25-14 under the other settlement alternative(s). That is, for purposes of analyzing such instruments under ASC paragraphs 480-10-25-8 through 25-10 and 25-12, or 480-10-25-14, it is assumed that there is only one required settlement method—a transfer of assets settlement.

13.011 The following examples illustrate these provisions:

Example 13.5: Forward Purchase Contract That May Be Settled in Cash or a Variable Number of the Issuer’s Equity Shares at the Option of the Issuer

Background

On March 1, 20X3, Company A enters into a forward contract to purchase its own shares on March 1, 20X4. The terms of the contract indicate that if the common share price of Company A on March 1, 20X4 is greater than $20, Company A will, at its option, receive from the counterparty 50 times the amount above $20 either in cash or a variable number of Company A shares with a fair value equal to 50 times the amount above $20; however, if the common share price of Company A on
March 1, 20X4 is less than $20, Company A will, at its option, pay the counterparty 50 times the amount below $20 either in cash or a variable number of Company A shares with a fair value equal to 50 times the amount below $20.

**Analysis**

The instrument is not issued in the form of shares, thus, it is not considered a mandatorily redeemable financial instrument within the scope of ASC paragraphs 480-10-25-4 and 25-6. Because the instrument is not an outstanding equity share and provides Company A with discretion to avoid a transfer of assets at its settlement, it is assumed that Company A will settle the instrument with a transfer of its shares; that is, there is only one settlement method—share settlement. As a result, Company A should determine whether the instrument is within the scope of ASC paragraph 480-10-25-14 (i.e., it is not relevant whether the instrument is within the scope of ASC paragraphs 480-10-25-8 through 25-10 and 25-12 since share settlement is assumed for purposes of analyzing the instrument under the provisions of ASC Topic 480).

The instrument is within the scope of ASC paragraph 480-10-25-14 because the instrument (1) embodies a conditional obligation and is not an outstanding share of stock, (2) permits Company A to settle the conditional obligation by delivering a variable number of its common shares, and (3) has a monetary value, at inception, that is based solely on variations inversely related to changes in the fair value of its common shares (i.e., if Company A’s common share price is less than $20, Company A is required to transfer a variable number of its shares).

As a result, the instrument is accounted for in accordance with the provisions of ASC Topic 480.

**Example 13.6: Forward Purchase Contract That May Be Settled in Cash or a Variable Number of the Issuer’s Equity Shares at the Option of the Holder**

**Background**

On March 1, 20X3, Company A enters into a forward contract to purchase its own shares on March 1, 20X4. The terms of the contract indicate that if the common share price of Company A on March 1, 20X4 is greater than $20, Company A will, at the holder’s option, receive from the holder 50 times the amount above $20 either in cash or a variable number of Company A shares with a fair value equal to 50 times the amount above $20; however, if the common share price of Company
A on March 1, 20X4 is less than $20, Company A will, at the holder’s option, pay the holder 50 times the amount below $20 either in cash or a variable number of Company A shares with a fair value equal to 50 times the amount below $20.

Analysis

The instrument is not issued in the form of shares, thus, it is not considered a mandatorily redeemable financial instrument within the scope of ASC paragraphs 480-10-25-4 and 25-6. Because the instrument is not an outstanding equity share and provides the holder with a choice of settlement methods, it is assumed that the holder will require settlement of the obligation with a transfer of Company A’s assets; that is, there is only one settlement method—transfer of assets settlement. As a result, Company A should determine whether the instrument is within the scope of ASC paragraphs 480-10-25-8 through 25-10 and 25-12 (i.e., it is not relevant whether the instrument is within the scope of ASC paragraph 480-10-25-14 since the transfer of assets settlement is assumed for purposes of analyzing the instrument under the provisions of ASC Topic 480).

The instrument is within the scope of ASC paragraphs 480-10-25-8 through 25-10 and 25-12 because the instrument (1) is not an outstanding share of stock (i.e., it is a forward contract), (2) embodies an obligation, at inception, that is indexed to an obligation such that Company A must repurchase its own shares (in this case it represents a conditional obligation), and (3) may require Company A to settle the obligation by transferring its assets (i.e., if Company A’s common share price is less than $20, Company A is required to transfer cash).

As a result, the instrument is accounted for in accordance with the provisions of ASC Topic 480.

CERTAIN TYPES OF COMPOUND FINANCIAL INSTRUMENTS

13.012 ASC paragraphs 480-10-55-29 through 55-32 and 55-42 through 55-52 provide interpretive guidance regarding the application of ASC paragraphs 480-10-25-8 through 25-10, 25-12, and 25-14 to freestanding financial instruments comprised of more than one option or forward contract embodying obligations under ASC Topic 480. ASC paragraphs 480-10-55-29 through 55-32 and 55-42 through 55-52 are reproduced below:

Q—How do ASC paragraphs 480-10-25-8 through 25-10 and 25-12 apply to freestanding financial instruments composed of more than one option or forward contract embodying obligations that require or that may require settlement by transfer of assets? For example, a puttable warrant that allows the holder to purchase a fixed number of the issuer’s shares at a fixed price
that also is puttable by the holder at a specified date for a fixed monetary amount that the holder could require the issuer to pay in cash.

A—ASC paragraphs 480-10-15-3 and 15-4; 480-10-25-1 state that the provisions of ASC Topic 480 apply to freestanding financial instruments, including those that comprise more than one option or forward contract,2 and ASC paragraphs 480-10-25-4 through 25-6, 25-8 through 25-10, 25-12, and 25-14 shall be applied to a freestanding financial instrument in its entirety.3

Under ASC paragraphs 480-10-25-8 through 25-10 and 25-12, if a freestanding instrument is composed of a written call option and a written put option, the existence of the written call option does not affect the classification. As a result, the puttable warrant in question is a liability under ASC paragraphs 480-10-25-8 through 25-10 and 25-12, because it embodies an obligation indexed to an obligation to repurchase the issuer’s shares and may require a transfer of assets. It is a liability even if the repurchase feature is conditional on a defined contingency in addition to the level of the issuer’s share price. The warrant is not an outstanding share and therefore does not meet the exception for outstanding shares in ASC paragraphs 480-10-25-8 through 25-10 and 25-12. Unlike the application of ASC paragraph 480-10-25-14, applying 480-10-25-8 through 25-10 and 25-12 do not involve making any judgments about predominance among obligations or contingencies.

Example 1—Puttable Warrant That May Require Cash Settlement

Company A issues a puttable warrant to Holder. The warrant feature allows Holder to purchase 1 equity share at a strike price of $10 on a specified date. The put feature allows Holder instead to put the warrant back to Company A on that date for $2, and to require settlement in cash. If the share price on the settlement date is greater than $12, Holder would be expected to exercise the warrant, obligating Company A to issue a fixed number of shares in exchange for a fixed amount of cash. That feature does not result in a liability under ASC paragraphs 480-10-25-8 through 25-10 and 25-12. However, if the share price is equal to or less than $12, Holder would be expected to put the warrant back to Company A and could choose to obligate Company A to pay $2 in cash. That feature does result in a liability, because the financial instrument embodies an obligation that is indexed to an obligation to repurchase the

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2 Those instruments may be reexamined in Phase 2 of the liabilities and equity project, along with other compound instruments that are outside the scope of ASC Topic 480.

3 Included in ASC paragraphs 480-10-15-3 and 15-4; 480-10-25-1; 480-10-55-18 through 55-20 are examples to illustrate how that requirement should be applied to an instrument that consists solely of a written put option for an issuer’s equity shares and a purchased call option. ASC paragraphs 480-10-15-3 and 15-4; 480-10-25-1; 480-10-55-18 through 55-20 indicate that ASC Topic 480 requires liability (or asset in some circumstances) treatment, regardless of how that instrument would be settled. The instruments in those examples embody both an obligation and a right, and, in analyzing those instruments, the existence of the right does not affect the classification of the obligation under ASC paragraphs 480-10-25-4 through 25-6, 25-8 through 25-10, 25-12, and 25-14. The question at issue is how the requirements of ASC Topic 480 should be applied to a freestanding financial instrument composed of more than one option or forward contract that embodies more than one obligation to transfer assets or issue shares.
issuer’s shares (as the share price decreases toward $12, the fair value of the issuer’s obligation to stand ready to pay $2 begins to increase) and may require a transfer of assets. Therefore, ASC paragraphs 480-10-25-8 through 25-10 and 25-12 require Company A to classify the instrument as a liability.

Example 2–Warrant for Shares That Are Puttable That May Require Cash Settlement

Company B issues a warrant for shares that can be put back by Holder immediately after exercise of the warrant. The warrant feature allows Holder to purchase 1 equity share at a strike price of $10 on a specified date. The put feature allows holder to put the shares obtained by exercising the warrant back to Company B on that date for $12, and to require physical settlement in cash. If the share price on the settlement date is greater than $12, Holder would be expected to exercise the warrant obligating Company B to issue a fixed number of shares in exchange for a fixed amount of cash, and retain the shares. That feature alone does not result in a liability under ASC paragraphs 480-10-25-8 through 25-10 and 25-12. However, if the share price is equal to or less than $12, Holder would be expected to put the shares back to Company B and could choose to obligate Company B to pay $12 in cash. That feature does result in a liability, because the financial instrument embodies an obligation to repurchase the issuer’s shares and may require a transfer of assets. Therefore, ASC paragraphs 480-10-25-8 through 25-10 and 25-12 require Company B to classify the warrant as a liability. A warrant to issue shares that will be mandatorily redeemable is also classified as a liability, and should be analyzed under ASC Topic 815, Derivatives and Hedging.

2. Q–How does ASC paragraph 480-10-25-14 apply to freestanding financial instruments composed of more than one option or forward contract embodying obligations? For example, a puttable warrant that allows the holder to purchase a fixed number of the issuer’s shares at a fixed price that also is puttable by the holder at a specified date for a fixed monetary amount to be paid, at the issuer’s discretion, in cash or in a variable number of shares. Does such a financial instrument embody an obligation for the issuer that is a liability under ASC Topic 480?

A–It depends on the circumstances. A financial instrument composed of more than one option or forward contract embodying obligations to issue shares must be analyzed to determine whether the obligations under any of its components have one of the characteristics in ASC paragraph 480-10-25-14, and if so, whether those ASC paragraph 480-10-25-14 obligations are predominant relative to other obligations. The analysis can be summarized in two steps:

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4 Some freestanding instruments composed of more than one option or forward contract that embody obligations to issue both a fixed and variable number of shares are not in the scope of ASC Topic 480. Phase 2 of the liabilities and equity project will address such instruments.
Step 1: Identify any component obligations that, if freestanding, would be liabilities under ASC paragraph 480-10-25-14. Also identify the other component obligation(s) of the financial instrument.

Step 2: Assess whether the monetary value of any obligations embodied in components that, if freestanding, would be liabilities under ASC paragraph 480-10-25-14 is (collectively) predominant over the (collective) monetary value of other component obligation(s). If so, account for the entire instrument under ASC paragraph 480-10-25-14. If not, the financial instrument is not in the scope of ASC Topic 480 and other guidance applies.

In an instrument that allows the holder either to purchase a fixed number of the issuer’s shares at a fixed price or to compel the issuer to reacquire the instrument at a fixed date for shares equal to a fixed monetary amount known at inception, the holder’s choice will depend on the issuer’s share price at the settlement date. The issuer must analyze the instrument at inception and consider all possible outcomes to judge which obligation is predominant. To do so, the issuer considers all pertinent information as applicable, which may include its current stock price and volatility, the strike price of the instrument, and any other factors. If the issuer judges the obligation to issue a variable number of shares based on a fixed monetary amount known at inception to be predominant, the instrument is a liability under ASC paragraph 480-10-25-14(a). Otherwise, the instrument is not a liability under ASC Topic 480 but is subject to other applicable guidance such as ASC Subtopic 815-40, Derivatives and Hedging – Contracts in Entity’s Own Equity; ASC paragraph 480-10-55-63.5

Example 3–Warrant with Share-Settleable Put

Company C issues a puttable warrant to Holder. The warrant feature allows Holder to purchase 1 equity share at a strike price of $10 on a specified date. The put feature allows Holder instead to put the warrant back to Company C on that date for $2, settleable in fractional shares. If the share price on the settlement date is greater than $12, Holder would be expected to exercise the warrant, obligating Company C to issue a fixed number of shares in exchange for a fixed amount of cash; the monetary value of the shares varies directly with changes in the share price above $12. If the share price is equal to or less than $12, Holder would be expected to put the warrant back to Company C obligating the company to issue a variable number of shares with a fixed monetary value, known at inception, of $2. Thus, at inception, the number of shares that the puttable warrant obligates Company C to issue can vary, and the financial instrument must be examined under ASC paragraph 480-10-25-14. The facts and circumstances should be considered in judging whether the

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5 ASC Subtopic 815-40 and ASC paragraph 480-10-55-63 no longer apply to cash-settled put warrants. Those put warrants are subject to ASC Topic 480 and Question 1 above. Consequently, EITF Issue No. 88-9, “Put Warrants,” is completely nullified, and cash settled put warrants of nonpublic companies are classified as liabilities and measured at fair value. ASC Subtopic 815-40 and ASC paragraph 480-10-55-63 continue to apply for share-settleable put warrants that are not liabilities under ASC Topic 480.
monetary value of the obligation to issue a number of shares that varies is predominately based on a fixed monetary amount known at inception; if so, it is a liability under ASC paragraph 480-10-25-14(a). For example, if (a) Company C’s share price is well below the $10 exercise price of the warrant at inception of the instrument, (b) the warrant has a short life, and (c) Company C’s stock is determined to have very low volatility, those circumstances suggest that the monetary value of the obligation to issue shares would be judged to be based predominantly on a fixed monetary amount known at inception ($2 worth of shares), and the instrument would be classified as a liability.

Freestanding instruments with obligations settleable in shares have many variations. Each should be analyzed to determine whether it is within the scope of ASC Topic 480 and, therefore, should be classified as a liability. Otherwise, the instrument is subject to other accounting guidance. For example, a puttable warrant outside the scope of ASC Topic 480 is accounted for under ASC Subtopic 815-40 and ASC paragraph 480-10-55-63.

Example 4—Variable Share Forward Sales Contract

Company D enters into a contract to issue shares of Company D’s stock to Counterparty in exchange for $50 on a specified date. If Company D’s share price is equal to or less than $50 on the settlement date, Company D will issue 1 share to Counterparty. If the share price is greater than $50 but equal to or less than $60, Company D will issue $50 worth of fractional shares to Counterparty. Finally, if the share price is greater than $60, Company D will issue .833 shares. At inception, the share price is $49. Company D has an obligation to issue a number of shares that can vary; therefore, ASC paragraph 480-10-25-14 may apply. However, unless it is determined that the monetary value of the obligation to issue a variable number of shares is predominantly based on a fixed monetary amount known at inception (as it is in the $50 to $60 share price range), the financial instrument is not in the scope of ASC Topic 480.

Some financial instruments that are composed of more than one option or forward contract embody an obligation to issue a fixed number of shares and, once those shares are issued, potentially to issue a variable number of additional shares. The issuer must analyze that kind of financial instrument, at inception, to assess whether the possibility of issuing a variable number of shares in which the monetary value of that obligation meets one of the conditions in ASC paragraph 480-10-25-14 is predominant.

Example 5—Warrant with Share-Settleable Put

Company E issues a warrant to Holder allowing Holder to purchase 1 equity share at a strike price of $10. The warrant has an embedded “liquidity make-whole” put that entitles Holder to receive from Company E the net amount of any difference between the share price on the date the warrants are exercised and the sales price the holder receives when the shares are later sold. The make-whole provision is not legally detachable. Company E can settle by
issuing a variable number of shares. For example, if on the date Holder exercises the warrant, the share price is $15 and the share price subsequently decreases to $12 at the date Holder sells the shares, Holder would receive $3 worth of equity shares from Company E.

The financial instrument embodies an obligation to deliver a number of shares that varies—either a fixed number of shares under exercise of the warrant or additional shares if the share price declines after the warrant is exercised. However, unless it is judged that the possibility of having to issue a variable number of shares with a monetary value that is inversely related to the share price is predominant, the financial instrument is not in the scope of ASC paragraph 480-10-25-14(c) and would be evaluated under ASC Subtopic 815-40 and ASC paragraph 480-10-55-63.

If exercisability of a feature into a fixed or variable number of shares is contingent on both the occurrence or non-occurrence of a specified event and the issuer’s share price, a financial instrument settleable in a number of shares that can vary should be analyzed following the same method as in Examples 3–5 to consider all possibilities. In some cases, it may be determined that the instrument may not be within the scope of ASC paragraph 480-10-25-14 and thus not a liability under ASC Topic 480. That determination depends on whether the obligation to deliver a variable number of shares, with a monetary value based on either a fixed monetary amount known at inception or an inverse relationship with the share price, is predominant at inception.

**Example 6—Contingently Puttable Warrant**

Company F’s share-settleable puttable warrant, described in Example 3, might provide that the put feature is exercisable only if Company F fails to accomplish an operational plan (e.g., failure to complete a building within two years). If at inception the possibility that both the building will not be completed in two years and the put will be exercised is judged to be predominant, the put warrant would be recognized as a liability under ASC paragraphs 480-10-25-14(a).

**Transition**

The guidance in ASC paragraphs 480-10-55-29 through 55-32 and 55-42 through 55-52 is effective immediately for freestanding financial instruments issued by entities to which the requirements of ASC Topic 480 have already been applied. The guidance should be applied for other entities as part of the adoption of ASC Topic 480. If this guidance results in changes to previously reported information, the cumulative effect shall be reported according to the provisions of ASC Topic 480 in the first period beginning after the final updated Topic (FSP) is posted to the FASB website.

**13.013** As discussed in Section 6, ASC Topic 480 applies to freestanding financial instruments, including those that comprise more than one option or forward contract such
as put warrants. ASC paragraphs 480-10-55-29 and 55-30 address the application of ASC paragraphs 480-10-25-8 through 25-10 and 25-12 to freestanding financial instruments that consist of more than one option or forward contract embodying obligations that may require settlement by transfer of assets (e.g., put warrants that require physical or net cash settlement). The classification provisions in ASC paragraphs 480-10-25-4 through 25-6, 25-8 through 25-10, 25-12, and 25-14 should be applied to such an instrument in its entirety. For example, if a freestanding financial instrument other than an outstanding share consists of a written call option and a written put option, both the written call option’s potential settlement and the written put option’s potential settlement embody obligations that should be evaluated under ASC Topic 480. If either of these potential settlements would result in the instrument being within the scope of ASC paragraphs 480-10-25-8 through 25-10 and 25-12, the entire instrument is within the scope of ASC Topic 480. That is, because ASC paragraphs 480-10-25-8 through 25-10 and 25-12 use the term “may require” to describe affected instruments, an instrument (other than an outstanding share) that has a possible settlement outcome that is within the scope of ASC paragraphs 480-10-25-8 through 25-10 and 25-12 is within the scope of ASC Topic 480 regardless of the other potential settlement outcomes.

13.014 The example in ASC paragraph 480-10-55-31 illustrates the application of ASC Topic 480 to an instrument comprised of a written call option and a written put option. The example in ASC paragraph 480-10-55-32 illustrates the application of ASC Topic 480 to an instrument comprised of a written call option to issue puttable shares. In both cases, the FASB staff determined that the instruments are within the scope of ASC Topic 480. The example in ASC paragraph 480-10-55-32 involves a warrant to acquire shares that can be put back to the holder immediately after exercise. However, a warrant to acquire common or preferred shares that (1) will become puttable at a future date or (2) would become puttable if a contingent event occurs (e.g., shares that become puttable upon a change in control), would also be within the scope of ASC Topic 480. It is not necessary for the exercise period of the warrant to overlap with the put date(s) on the underlying common or preferred shares in order for the warrant to be within the scope of ASC Topic 480. Also, a warrant to acquire contingently puttable common or preferred shares would be within the scope of ASC Topic 480 regardless of the probability that the contingent event will occur (provided that the contingent feature is substantive). While not specifically addressed in ASC paragraph 480-10-55-32, it is important to note that, upon exercise of a warrant to acquire shares with an embedded put option, the shares are outside the scope of ASC Topic 480 (see Paragraph 4.004 and Question and Answer 4.1 for additional information). The example in ASC paragraph 480-10-55-32 also clarifies that a warrant to issue shares that will be mandatorily redeemable should be classified as a liability and analyzed under ASC Topic 815.

13.015 The following examples illustrate the application of the guidance in ASC Topic 480 and ASC paragraph 480-10-55-29 and 55-30:

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6 When ASC Topic 480 was issued, the guidance in EITF Issue No. 88-9, “Put Warrants,” was completely nullified.
**Example 13.7: Puttable Warrant**

**Background**

Company A issued a puttable warrant whereby (1) the counterparty can elect to purchase shares of Company A’s stock for $50 on a specified date (a written call option) or (2) the counterparty can require Company A to repurchase the warrant for $10 (a written put option). Physical settlement is required.

If Company A’s share price exceeds $60 on the settlement date, the counterparty would be expected to exercise the call option, requiring Company A to issue a fixed number of shares in exchange for a fixed amount of cash ($50). If Company A’s share price is less than $60 on the settlement date, the counterparty would be expected to exercise the put option and require Company A to repurchase the warrant for a fixed amount of cash ($10).

**Analysis**

Because ASC Topic 480 applies to instruments comprised of more than one option or forward contract, the contract should be analyzed as a single freestanding instrument consisting of a written call option and a written put option.

The instrument is not issued in the form of shares, so it is not considered a mandatorily redeemable financial instrument within the scope of ASC paragraphs 480-10-25-4 and 25-6.

The written call option feature does not cause the instrument in its entirety to be within the scope of ASC paragraphs 480-10-25-8 through 25-10 and 25-12 because it could not require Company A to transfer assets at settlement (Company A would issue a fixed number of shares in exchange for a fixed amount of cash if the written call option is exercised). Also, the written call option feature would not be within the scope of ASC paragraph 480-10-25-14 because it does not embody an obligation that Company A may settle by issuing a variable number of shares (it embodies an obligation that Company A may be required to settle by issuing a fixed number of shares).

However, the written put option feature causes the instrument in its entirety to be within the scope of ASC paragraphs 480-10-25-8 through 25-10 and 25-12 because the instrument (1) is not an outstanding share of stock (i.e., it is a puttable warrant), (2) contains a written put option that embodies an obligation, at inception, that is indexed to an obligation to repurchase its own shares (in this case the put feature represents a conditional obligation), and (3) may require Company A to settle the obligation by transferring its assets (i.e., if Company A’s common share price is less than $60 and the put option is exercised, Company A is required to pay cash).
As a result, the instrument in its entirety is accounted for in accordance with the provisions of ASC Topic 480.

**Example 13.8: Warrant to Acquire Puttable Shares**

**Background**

On January 1, 20X1, Company A issued a warrant whereby the counterparty can elect to purchase a fixed number of Company A’s preferred shares for $50 per share (a written call option) at any time for a period of five years. Physical settlement is required. Company A’s preferred shares can be put back to Company A by the counterparty for $60 per share at any time after December 31, 20X8. Assume the put option embedded in the preferred shares is not nonsubstantive or minimal.

**Analysis**

The contract should be analyzed as a single freestanding instrument consisting of a written call option and a written put option.

The instrument is not issued in the form of shares, so it is not considered a mandatorily redeemable financial instrument within the scope of ASC paragraphs 480-10-25-4 and 25-6.

The written call option feature does not cause the instrument in its entirety to be within the scope of ASC paragraphs 480-10-25-8 through 25-10 and 25-12 because it could not require Company A to transfer assets at settlement (Company A would issue a fixed number of preferred shares if the written call option is exercised). Also, the written call option feature would not be within the scope of ASC paragraph 480-10-25-14 because it does not embody an obligation that Company A may settle by issuing a variable number of shares (it embodies an obligation that Company A may be required to settle by issuing a fixed number of preferred shares).

However, the written put option feature (embedded in the preferred shares underlying the warrant) causes the warrant in its entirety to be within the scope of ASC paragraphs 480-10-25-8 through 25-10 and 25-12 because the instrument (1) is not an outstanding share of stock (i.e., it is a warrant to acquire puttable shares), (2) requires issuance of a financial instrument (preferred shares) with an embedded written put option that embodies an obligation, at inception, that is indexed to an obligation to repurchase its own shares (in this case the put feature represents a conditional obligation), and (c) may require Company A to settle the obligation by transferring its assets (i.e., if the written call option is exercised, Company A would issue preferred shares that the counterparty may ultimately put back to the Company for cash after December 31, 20X8). It is not necessary for the exercise
period of the warrant (January 1, 20X1 through December 31, 20X5) to overlap with the put dates on the underlying preferred shares (any time after December 31, 20X8) in order for the warrant to be within the scope of ASC Topic 480.

Upon exercise of the warrant, Company A’s preferred shares (which contain an embedded put option) would not be within the scope of ASC Topic 480 (see Paragraph 4.004 and Question and Answer 4.1 for additional information).

Example 13.9: Warrant to Acquire Contingently Puttable Shares

Background

On January 1, 20X1, Company A issued a warrant whereby the counterparty can elect to purchase a fixed number of Company A’s common shares for $50 per share (a written call option) at any time for a period of five years. Physical settlement is required. Company A’s common shares can be put back to Company A by the counterparty for $60 per share upon a change in control. Although the occurrence of a change in control is not considered likely at the present time, the contingent put option embedded in the common shares is not deemed nonsubstantive or minimal.

Analysis

The contract should be analyzed as a single freestanding instrument consisting of a written call option and a written put option.

The instrument is not issued in the form of shares, so it is not considered a mandatorily redeemable financial instrument within the scope ofASC paragraphs 480-10-25-4 and 25-6.

The written call option feature does not cause the instrument in its entirety to be within the scope ofASC paragraphs 480-10-25-8 through 25-10 and 25-12 because it could not require Company A to transfer assets at settlement (Company A would issue a fixed number of common shares if the written call option is exercised). Also, the written call option feature would not be within the scope ofASC paragraph 480-10-25-14 because it does not embody an obligation that Company A may settle by issuing a variable number of shares (it embodies an obligation that Company A may be required to settle by issuing a fixed number of common shares).

However, the contingent written put option feature (embedded in the common shares underlying the warrant) causes the warrant in its entirety to be within the scope ofASC paragraphs 480-10-25-8 through 25-10 and 25-12 because the instrument (1) is not an outstanding share of stock (i.e., it is a warrant to acquire contingently puttable shares), (2) requires issuance of a financial instrument (common shares) with an embedded contingent written put option that embodies an...
obligation, at inception, that is indexed to an obligation to repurchase its own shares (in this case the contingent put feature represents a conditional obligation), and (3) may require Company A to settle the obligation by transferring its assets (i.e., if the written call option is exercised, Company A would issue common shares that the counterparty may ultimately put back to the Company for cash if a change in control occurs). The warrant in its entirety is within the scope of ASC Topic 480, regardless of the probability that the contingent event enabling the counterparty to put the underlying shares back to Company A will occur.

Upon exercise of the warrant, Company A’s common shares (which contain an embedded contingent put option) would not be within the scope of ASC Topic 480 (see Paragraph 4.004 and Q&A 4.2 for additional information).

13.016 The following example illustrates application of the guidance in ASC Topic 480 to a compound financial instrument consisting of a purchased call option and a written put option in a single contract (i.e., a collar). If the fair values of the two options (the purchased call and the written put) are equal and opposite at issuance, the financial instrument has a fair value of zero at inception (and is generally called a zero-cost collar). This analysis is not affected by the guidance in ASC paragraphs 480-10-55-29 through 55-32 and 55-42 through 55-52 because the instrument embodies an obligation (the written put option) and a right (the purchased call option), rather than a financial instrument with more than one obligation to transfer assets or issue equity shares.

Example 13.10: Combination of a Written Put Option and a Purchased Call Option Issued as a Single Freestanding Financial Instrument that Permits Physical or Net Cash Settlement

Background

Company A entered into a single, non-separable contract whereby (1) it can elect to purchase shares of its own stock from the counterparty for $51 on a specified date if the stock price exceeds $51 (a purchased call option) and (2) the counterparty can require Company A to purchase shares of Company A’s stock on a specified date for $50 if the stock price falls below $50 (a written put option). Physical or net cash settlement is required.

Analysis

Because ASC Topic 480 applies to instruments comprised of more than one option or forward contract, the contract should be analyzed as a single freestanding instrument consisting of a purchased call option and a written put option. That is, the contract should not be analyzed as a forward purchase contract. Company A’s ability to repurchase its own stock from the counterparty if the price exceeds $51 does not embody an obligation and is outside the scope of ASC Topic 480. However, the counterparty has the ability to require Company A to repurchase shares of its stock if the stock price falls below $50. The contract requires physical
or net cash settlement, so it is a liability under ASC paragraphs 480-10-25-8 through 25-10 and 25-12 because the instrument (1) is not an outstanding share (i.e., it is a collar), (2) embodies an obligation, at inception, such that Company A is required to repurchase its own shares (i.e., in this case it is a conditional obligation), and (3) requires Company A to settle the obligation by transferring its assets (i.e., cash).

Because the instrument has a potential settlement alternative that is within the scope of ASC paragraphs 480-10-25-8 through 25-10 and 25-12, the entire instrument is within the scope of ASC Topic 480.

13.017 ASC paragraph 480-10-55-42 addresses the application of ASC paragraph 480-10-25-14 to freestanding financial instruments that consist of more than one option or forward contract embodying obligations that may require settlement by transfer of assets or issuance of the issuer’s equity shares (e.g., put warrants that can be net share settled at the option of the issuer). Because the instrument is not an outstanding share and the issuer has the option to settle a component obligation (the put feature) in cash or shares, that component obligation must be evaluated to determine whether it would be within the scope of ASC paragraph 480-10-25-14 if freestanding. If so, that component obligation would be evaluated to determine whether it is predominant relative to other component obligations. See Paragraphs 5.022–5.025 of Section 5 for additional information.

13.018 If an instrument allows the holder either to purchase a fixed number of the issuer’s shares at a fixed price or to compel the issuer to reacquire the instrument at a fixed date for a variable number of shares equal to a fixed monetary amount known at inception, the instrument contains two potential outcomes in which the issuer will be obligated to perform. The holder’s choice and the outcome will depend on the issuer’s share price at the settlement date. In order to determine whether the instrument is within the scope of ASC paragraph 480-10-25-14, the issuer must analyze the instrument at inception and consider all possible outcomes to judge which obligation is predominant (i.e., the issuance of a fixed number of the issuer’s shares at a fixed price or the reacquisition of the instrument and delivery of a variable number of its shares with a fixed monetary amount). If the issuer judges the obligation to issue a variable number of shares based on a fixed monetary amount known at inception to be predominant, the instrument is a liability under ASC paragraph 480-10-25-14(a). Otherwise, the instrument is not a liability under ASC Topic 480. ASC paragraphs 480-10-55-29 through 55-32 and 55-42 through 55-52 clarify that this evaluation requires the following two-step analysis:

**Step 1:** Identify any (1) component obligations that would be within the scope of ASC paragraph 480-10-25-14 if freestanding and (2) identify any other component obligations.

**Step 2:** Evaluate whether the monetary value of the component obligations that would be within the scope of ASC paragraph 480-10-25-14 if freestanding is (collectively) predominant over the (collective) monetary value of other component obligations. If so, the entire instrument is within the scope of ASC
paragraph 480-10-25-14. If not, the instrument is outside the scope of ASC Topic 480 and other relevant authoritative guidance should be applied.

13.019 The example in ASC paragraphs 480-10-55-45 and 55-46 emphasizes that all the relevant facts and circumstances should be considered in determining whether the monetary value of an obligation to issue a variable number of shares is predominantly based on a fixed monetary amount known at inception. If a warrant with a share-settleable put is outside the scope of ASC Topic 480, the guidance in ASC Subtopic 815-40 and ASC paragraph 480-10-55-63 should be applied to the instrument.

13.020 The example in ASC paragraphs 480-10-55-50 and 55-51 illustrates the steps to evaluate a forward equity sales contract that may be settled in a variable number of shares. Each component obligation in such an instrument should be evaluated to determine if it would be within the scope of ASC paragraph 480-10-25-14 if freestanding. If so, the component obligation(s) within the scope of ASC paragraph 480-10-25-14 should be evaluated to determine if its monetary value is predominant over the monetary value of all other component obligations. The evaluation of a variable share forward sale contract is also presented in Example 5.8 of Section 5 of this book.

13.021 The example in ASC paragraphs 480-10-55-47 through 55-49 illustrates the application of ASC Topic 480 to a financial instrument comprised of more than one option or forward contract that embodies a conditional obligation to issue a fixed number of shares and, once those shares are issued, a conditional obligation to issue a variable number of additional shares. Unless the monetary value of the component obligation to issue a variable number of shares that would be within the scope of ASC paragraph 480-10-25-14 if freestanding is deemed predominant, the instrument is outside the scope of ASC Topic 480.

13.022 The example in ASC paragraph 480-10-55-52 illustrates the evaluation of an instrument when exercisability is contingent on both (1) the occurrence (or non-occurrence) of a specified event, and (2) the issuer’s stock price. Similar to the previous examples in ASC paragraphs 480-10-55-29 through 55-32 and 55-42 through 55-52, such instruments would only be in the scope of ASC Topic 480 if the monetary value of the obligation that would be within the scope of ASC paragraph 480-10-25-14, if it were freestanding, were deemed to be predominant at inception of the instrument. This evaluation at inception would encompass consideration of the likelihood that the specified contingent event would occur.

13.023 The following example illustrates the application of the guidance in ASC Topic 480 and ASC paragraph 480-10-55-42.

Example 13.11: Puttable Warrant That May Be Net Share Settled

Background

Company A issued a puttable warrant whereby (1) the counterparty can elect to purchase shares of Company A’s stock for $50 on a specified date (a written call
option) or (2) the counterparty can require Company A to repurchase the warrant on that date for $10, settleable in fractional shares (a written put option). Physical settlement is required for the written call option and net share settlement is required for the written put option.

If Company A’s share price exceeds $60 on the settlement date, the counterparty would be expected to exercise the call option, requiring Company A to issue a fixed number of shares in exchange for a fixed amount of cash ($50). If Company A’s share price is less than $60 on the settlement date, the counterparty would be expected to exercise the put option and require Company A to repurchase the warrant for a variable number of shares with a fixed monetary value ($10).

**Analysis**

Because ASC Topic 480 applies to instruments comprised of more than one option or forward contract, the contract should be analyzed as a single freestanding instrument consisting of a written call option and a written put option.

The instrument is not issued in the form of shares so it is not considered a mandatorily redeemable financial instrument within the scope of ASC paragraphs 480-10-25-4 and 25-6.

The written call option feature does not cause the instrument in its entirety to be within the scope of ASC paragraphs 480-10-25-8 through 25-10 and 25-12 because it could not require Company A to transfer assets at settlement (Company A would issue a fixed number of shares in exchange for a fixed amount of cash if the written call option is exercised). Also, the written call option feature would not be within the scope of ASC paragraph 480-10-25-14 because it does not embody an obligation that Company A may settle by issuing a variable number of shares (it embodies an obligation that Company A may be required to settle by issuing a fixed number of shares).

The written put option feature does not cause the instrument in its entirety to be within the scope of ASC paragraphs 480-10-25-8 through 25-10 and 25-12 because it could not require Company A to transfer assets at settlement (Company A would issue a variable number of shares with a fixed monetary value if the written put option is exercised). However, the written put option feature would be within the scope of ASC paragraph 480-10-25-14 because the instrument (1) embodies a conditional obligation and is not an outstanding share of the issuer (i.e., it is a puttable warrant), (2) permits Company A to settle the obligation by delivering a variable number of its shares, and (3) has a monetary value, at inception, that is based solely on a fixed monetary amount known at inception ($10).

Because a component obligation in this financial instrument would be a liability under ASC paragraph 480-10-25-14 if freestanding, Company A must further analyze the instrument and consider all possible outcomes to determine whether that component obligation (the net share settled written put option) is predominant.
over the remaining component obligation (the written call option). To do so, Company A must consider all pertinent information, including its current stock price, volatility, exercise price, option term, and other relevant factors. If the monetary value of the net share settled written put option (that would be within the scope of ASC paragraph 480-10-25-14 if freestanding) is considered predominant over the remaining component obligation (the written call option), the instrument in its entirety would be accounted for in accordance with the provisions of ASC Topic 480. If the monetary value of the written call option is considered predominant, the instrument is outside the scope of ASC Topic 480 and other guidance applies (e.g., ASC Subtopic 815-40; ASC paragraph 480-10-55-63).

13.024 The following example illustrates the application of the guidance in ASC Topic 480. This analysis is not affected by the guidance in ASC paragraphs 480-10-55-29 through 55-32 and 55-42 through 55-52 because the instrument embodies an obligation (the written put option) and a right (the purchased call option), rather than a financial instrument with more than one obligation to transfer assets or issue equity shares.

Example 13.12: Combination of a Written Put Option and a Purchased Call Option Issued as a Single Freestanding Financial Instrument That Requires Net Share Settlement

Background

Company A entered into a single contract, which, in its entirety, is a freestanding financial instrument. Company A can elect to purchase shares of its own stock from the counterparty for $51 on a specified date if the stock price exceeds $51 (a purchased call option) and the counterparty can require Company A to purchase shares of Company A’s stock on a specified date for $50 if the stock price falls below $50 (a written put option). Net share settlement is required.

Analysis

Because ASC Topic 480 applies to an instrument comprised of more than one option or forward contract, the contract should be analyzed as a single freestanding instrument consisting of a purchased call option and a written put option. That is, the contract should not be analyzed as a forward purchase contract. Company A’s ability to repurchase its own stock from the counterparty if the price exceeds $51 does not embody an obligation and is outside the scope of ASC Topic 480. However, the counterparty has the ability to require Company A to repurchase shares of Company A’s stock if the stock price falls below $50. The contract requires net share settlement, so it is a liability under ASC paragraph 480-10-25-14 because the instrument (a) embodies a conditional obligation and is not an outstanding share of the issuer (i.e., it is a collar), (b) may require Company A to settle the obligation by delivering a variable number of its shares, and (c) has a monetary value, at inception, that is based solely on variations inversely related to changes in the fair value of the shares (i.e., if the put option is exercised and
Company A’s share price is less than $50 per share, Company A is required to transfer a variable number of its shares.

Mandatorily Redeemable Preferred Stock Denominated in Either a Precious Metal or a Foreign Currency

13.025 ASC Topic 480 requires that mandatorily redeemable financial instruments within the scope of ASC paragraphs 480-10-25-4 and 25-6 be classified as liabilities and not as temporary equity. As a result, the exception noted in ASC paragraph 815-10-15-74(a) of ASC Topic 815 is not applicable to an instrument within the scope of ASC Topic 480 because such an instrument is not classified in equity. The Board revised ASC paragraphs 815-15-55-110 through 55-113 such that it addresses only whether mandatorily redeemable preferred stock with payments that are denominated in either a precious metal or a foreign currency contain an embedded derivative under ASC Topic 815 that is required to be identified and separately accounted for by the issuer.

13.026 ASC paragraphs 815-15-55-110 through 55-113 conclude that mandatorily redeemable preferred stock, as described in the issue, that is payable in gold contains an embedded derivative whose underlying is the price of gold. The embedded derivative should be separated from the host contract and accounted for as a derivative because the embedded derivative is not clearly and closely related to the host contract. ASC paragraphs 815-15-55-110 through 55-113 also conclude that mandatorily redeemable preferred stock, as described in the issue, whose periodic preferred payments, redemption payment, or both, are payable only in a stipulated amount of a specific foreign currency, contain no embedded foreign currency derivative that warrants separate accounting under ASC Topic 815; however, the reporting entity is required to apply the provisions of ASC Topic 830 to the foreign-currency-denominated mandatorily redeemable preferred stock.

PREPAID FORWARD CONTRACTS

13.027 Prepaid financial instruments should be evaluated to determine whether they are in the scope of ASC Topic 480. In some cases, prepaid forward contracts are executed concurrently with the issuance of one or more additional financial instruments. We believe a detailed evaluation of such multiple financial instruments and any related agreements should be performed to determine whether such instruments should be accounted for on a separate or a combined basis. When making that determination, the prohibition on combining instruments within the scope of ASC Topic 480 (as specified in ASC paragraph 480-10-25-15) does not apply to an individual instrument if that instrument is considered a freestanding financial instrument and is outside the scope of ASC Topic 480. Instead, to determine whether that individual instrument should be combined for accounting purposes, other applicable guidance should be considered (e.g., the guidance in ASC paragraphs 815-10-15-8 and 15-9; 815-10-55-176 through 55-180).

13.028 As discussed in Section 4, ASC paragraphs 480-10-25-8 through 25-10 and 25-12 indicate that a financial instrument is required to be classified as a liability (or an asset in some circumstances) if (a) it is not an outstanding share of the issuer, (b) it embodies an
obligation, at inception, to repurchase the issuer’s equity shares, or is indexed to such an obligation, and (c) requires or may require, at inception, the issuer to settle the obligation by transferring its assets. This requirement should be analyzed when reviewing prepaid forward contracts to purchase or sell a fixed or variable number of an issuer’s equity shares.

13.029 As discussed in Section 5, ASC paragraph 480-10-25-14 indicates that a financial instrument is required to be classified as a liability (or an asset in some circumstances) if (a) it embodies an unconditional obligation, or if it is not an outstanding share, a conditional obligation, (b) it requires or may require the issuer to settle the obligation by issuing a variable number of its equity shares, and (c) the monetary value, at inception, is based solely or predominantly on (i) a fixed monetary amount known at inception, (ii) variations in something other than the fair value of the issuer’s equity shares, or (iii) variations inversely related to changes in the fair value of the issuer’s equity shares. This requirement should be analyzed when reviewing prepaid forward contracts to purchase or sell a fixed or variable number of an issuer’s equity shares.

13.030 Prepaid forward contracts may contain settlement alternatives that allow physical, net share, or net cash settlement. Regardless of which party has the option to determine the settlement method, the provisions of ASC paragraphs 480-10-25-8 through 25-10, 25-12, and 25-14 are required to be reviewed. The remainder of this section discusses the application of ASC Topic 480 to the following prepaid forward contracts:

1. **Physically-Settled Prepaid Forward Purchase Contract for a Fixed Number of Shares**: An enterprise transfers assets at inception of a forward contract to repurchase a fixed number of its equity shares at a future date;

2. **Physically-Settled Prepaid Forward Purchase Contract for a Variable Number of Shares**: An enterprise transfers assets at inception of a forward contract to repurchase a variable number of its equity shares at a future date;

3. **Physically-Settled Prepaid Forward Sale Contract for a Fixed Number of Shares**: An enterprise receives assets at inception of a forward contract to issue a fixed number of its equity shares at a future date; and

4. **Physically-Settled Prepaid Forward Sale Contract for a Variable Number of Shares**: An enterprise receives assets at inception of a forward contract to issue a variable number of its equity shares at a future date.

**Physically-Settled Prepaid Forward Purchase Contract for a Fixed Number of Shares**

13.031 In the case of a physically-settled prepaid forward contract to repurchase a fixed number of an issuer’s equity shares, the issuer does not have a conditional or unconditional duty or responsibility to transfer assets or to issue its equity shares because the assets have already been transferred at inception. At maturity, the issuer will receive a fixed number of its equity shares. As a result, a physically-settled prepaid forward contract to repurchase a fixed number of an issuer’s equity shares does not embody an
obligation and is outside the scope of ASC paragraphs 480-10-25-8 through 25-10 and 25-12, or 480-10-25-14 (or any other paragraph in ASC Topic 480).

13.032 Instead, prepaid forward contracts to repurchase a fixed number of the issuer’s equity shares that require physical settlement should be accounted for in conformity with the guidance in ASC Topic 815 and ASC Subtopic 815-40; ASC paragraph 480-10-55-63. If such a contract is classified as an equity instrument, the total amount paid at inception of the contract should reduce equity. Under ASC Subtopic 815-40; ASC paragraph 480-10-55-63, subsequent adjustments to the value of the contract recorded in equity at inception would not be recognized as long as the instrument is classified in permanent equity. At maturity of the contract, the entity would eliminate the related equity amount with an offset to treasury stock. If such a contract is classified as an asset at inception under the provisions of ASC Subtopic 815-40; ASC paragraph 480-10-55-63, the entity should record all changes in the fair value of the instrument through earnings. If such a contract is within the scope of ASC Topic 815, the provisions of ASC Topic 815, including its embedded derivative provisions, apply. At maturity of the contract, the entity would eliminate the related asset or liability amounts with an offset to treasury stock.

13.033 Although a physically-settled prepaid forward contract to repurchase a fixed number of an issuer’s equity shares is accounted for as a single instrument, it can be viewed as two separate components. The first component would be a forward contract to repurchase a fixed number of an entity’s own shares with physical delivery as the only settlement alternative. If that component were viewed separately, it would be classified as if it were within the scope of ASC Topic 480. That is, a liability would be recorded at inception equal to the fair value of the underlying shares (adjusted for any consideration or unstated rights or privileges), with an offset to equity (see discussion of initial measurement of such contracts in Paragraph 9.009 of Section 9 for additional information). The liability would be remeasured each period at the present value of the amount that would have been paid at settlement (by accruing interest cost at the rate implicit at inception as if the contract was not prepaid), resulting in a liability at maturity equal to the forward contract amount that would have been paid if the contract was not prepaid at inception. The second component would be a loan receivable. If that component were viewed separately, it would be classified as an asset. That is, an asset would be recorded upon payment of cash at inception in an amount equal to the actual fixed amount prepaid. The entity would impute interest income on the asset using the rate implicit at inception, such that the loan receivable is equal to the liability under the forward purchase contract at the end of each period. In such contracts, the requirements for net presentation in ASC Sections 210-20-15, 210-20-45, 815-10-45, and 815-10-50, for the separate asset and liability components typically are met and the liability under the forward purchase contract would be offset against the loan receivable. In essence, this results in a net reduction of cash and equity upon payment of the prepaid purchase price at inception of the contract. As a result, regardless of whether a physically-settled prepaid forward contract to repurchase a fixed number of an issuer’s equity shares is accounted for as a single equity instrument or as a combination of its separate components, the impact is the same.
Accordingly, if such a contract is classified within permanent equity at inception, we believe that the common shares underlying such contracts should be excluded from the denominator in the calculation of basic and diluted earnings per share during the life of the contract by analogy to the earnings per share treatment for shares of common stock under a forward contract that requires physical settlement by repurchase of a fixed number of the issuer’s common shares in exchange for cash because one of the two components of the contract can be viewed as if it met that criteria (see Paragraph 10.004 of Section 10 for additional information).

However, in some cases, a physically-settled prepaid forward purchase contract for a fixed number of shares is executed concurrently with the issuance of one or more additional financial instruments. As indicated above, a physically-settled prepaid forward contract to repurchase a fixed number of an entity’s equity shares is outside the scope of ASC Topic 480. Accordingly, the prohibition on combining instruments within the scope of ASC Topic 480 (as specified in ASC paragraph 480-10-25-15) does not apply. Therefore, we believe a detailed evaluation of such multiple financial instruments and any related agreements should be performed to determine whether the instruments should be accounted for on a separate or a combined basis (e.g., the guidance in ASC paragraphs 815-10-15-8 and 15-9; 815-10-55-176 through 55-180). If, based on that evaluation, a physically-settled prepaid forward purchase contract is required to be accounted for on a combined basis with another financial instrument, it generally would not be appropriate to exclude the shares underlying the prepaid forward purchase contract from the denominator in the calculation of basic and diluted earnings per share if the combined unit of financial instruments requires the issuer to receive or pay assets at the maturity of the contract or forfeit or receive common shares (other than the fixed number to be received as specified in the prepaid forward purchase contract).

The following illustrates the accounting for a physically-settled prepaid forward contract to repurchase a fixed number of an issuer’s common shares:

**Example 13.13: Physically-Settled Prepaid Forward Contract to Repurchase a Fixed Number of Shares**

**Background**

On March 1, 20X3, Company A enters into a forward contract to purchase its own common shares on March 1, 20X4. The terms of the contract require Company A to pay $1,000 cash to the counterparty on March 1, 20X3 (inception) in exchange for 50 common shares to be delivered on March 1, 20X4 (maturity). At inception, Company A determines that the prepaid amount ($1,000) should be recorded as a reduction to permanent equity in accordance with ASC Subtopic 815-40; ASC paragraph 480-10-55-63.

**Analysis**

Company A does not have a conditional or unconditional duty or responsibility to transfer assets or issue equity shares (i.e., the assets have already been transferred at
inception and at maturity the entity will receive its common shares). Therefore, the physically-settled prepaid forward contract to purchase a fixed number of the issuer’s equity shares does not embody an obligation and is outside the scope of ASC paragraphs 480-10-25-8 through 25-10 and 25-12, or 480-10-25-14 (or any other paragraph in ASC Topic 480).

Since the contract meets the criteria for permanent equity classification in ASC Subtopic 815-40; ASC paragraph 480-10-55-63, the total amount paid at inception of the contract ($1,000) should reduce equity and subsequent adjustments to the value of the contract recorded in equity would not be recognized since the instrument is classified in permanent equity. Upon receipt of the 50 shares at maturity, Company A should eliminate the previously recorded equity amount and record treasury stock for $1,000 (i.e., net equity would not be affected).

For purposes of the basic and diluted earnings per share calculation, the 50 shares of common stock to be received on March 1, 20X4, should be deducted from the denominator on a weighted average basis from March 1, 20X3.

Physically-Settled Prepaid Forward Purchase Contract for a Variable Number of Shares

13.037 In the case of a physically-settled prepaid forward contract to repurchase a variable number of an issuer’s equity shares, the issuer does not have a conditional or unconditional duty or responsibility to transfer assets or issue equity shares because the assets have already been transferred at inception and, at maturity the issuer will receive a variable number of its equity shares. As a result, a physically-settled prepaid forward contract to repurchase a variable number of the issuer’s equity shares does not embody an obligation and is outside the scope of ASC paragraphs 480-10-25-8 through 25-10, and 25-12 or ASC paragraph 480-10-25-14 (or any other paragraph in ASC Topic 480).

13.038 Instead, prepaid forward contracts to repurchase a variable number of the issuer’s equity shares that require physical settlement should be accounted for in conformity with the guidance in ASC Topic 815 and ASC Subtopic 815-40; ASC paragraph 480-10-55-63. If such a contract is classified as an equity instrument, the total amount paid at inception of the contract should reduce equity. Under ASC Subtopic 815-40; ASC paragraph 480-10-55-63, subsequent adjustments to the value of the contract recorded in equity at inception would not be recognized as long as the instrument is classified in permanent equity. At maturity of the contract, the entity would eliminate the related equity amount with an offset to treasury stock. If such a contract is classified as an asset at inception under the provisions of ASC Subtopic 815-40; ASC paragraph 480-10-55-63, the entity should record all changes in the fair value of the instrument through earnings. If such a contract is within the scope of ASC Topic 815, the provisions of ASC Topic 815, including its embedded derivative provisions, apply. At maturity of the contract, the entity would eliminate the related asset or liability amounts with an offset to treasury stock.
13.039 Because such prepaid forward purchase contracts do not require settlement in a fixed number of the issuer’s equity shares, an entity should not analogize to the earnings per share guidance in ASC Topic 480 related to forward contracts that require physical settlement by repurchase of a fixed number of the issuer’s common shares in exchange for cash. That is, the aggregate common shares underlying prepaid forward purchase contracts for a variable number of shares should not be deducted from the denominator in the calculation of basic and diluted earnings per share during the life of the contract. The relevant guidance in ASC Topic 260 and ASC paragraphs 260-10-55-32 through 55-34, 55-36, and 55-77; 260-10-45-22 must be applied in determining the appropriate earnings per share treatment.

13.040 The following illustrates the accounting for a physically-settled prepaid forward contract to repurchase a variable number of an issuer’s common shares:

**Example 13.14: Physically-Settled Prepaid Forward Purchase Contract for a Variable Number of Shares**

**Background**

On March 1, 20X3, Company A enters into a forward contract to purchase its own common shares on March 1, 20X4. The terms of the contract require Company A to pay $1,000 cash to the counterparty on March 1, 20X3 (inception) in exchange for a variable number of its common shares with a fair value of $1,100 to be delivered on March 1, 20X4 (maturity). At inception, Company A determines that the prepaid amount ($1,000) should be recorded as a reduction to permanent equity in accordance with ASC Subtopic 815-40; ASC paragraph 480-10-55-63.

**Analysis**

Company A does not have a conditional or unconditional duty or responsibility to transfer assets or issue equity shares (i.e., the assets have already been transferred at inception and at maturity the entity will receive its common shares). Therefore, the physically-settled prepaid forward contract to purchase a variable number of the issuer’s equity shares does not embody an obligation and is outside the scope of ASC paragraphs 480-10-25-8 through 25-10 and 25-12, or 480-10-25-14 (or any other paragraph in ASC Topic 480).

Since the contract meets the criteria for permanent equity classification in ASC Subtopic 815-40; ASC paragraph 480-10-55-63, the total amount paid at inception of the contract ($1,000) should reduce equity and subsequent adjustments to the value of the contract recorded in equity would not be recognized since the instrument is classified in permanent equity. Upon receipt of the shares at maturity, Company A should eliminate the previously recorded equity amount and record treasury stock for $1,000 (i.e., net equity would not be affected). Note that, at
maturity, Company A received $1,100 worth of its common shares and records $1,000 as treasury stock (since Company A locked in that price at inception of the equity classified instrument).

Because the prepaid forward purchase contract does not require settlement in a fixed number of the issuer’s equity shares, Company A should not analogize to the earnings per share guidance in ASC Topic 480 related to forward contracts that require physical settlement by repurchase of a fixed number of the issuer’s common shares in exchange for cash. That is, the aggregate common shares underlying this prepaid forward purchase contract should not be deducted from the denominator in the calculation of basic and diluted earnings per share during the life of the contract. The relevant guidance in ASC Topic 260 and ASC paragraphs 260-10-55-32 through 55-34, 55-36, and 55-77; 260-10-45-22 should be applied in determining the appropriate earnings per share treatment.

Physically-Settled Prepaid Forward Sale Contract for a Fixed Number of Shares

13.041 In the case of a physically-settled prepaid forward contract to sell a fixed number of an issuer’s equity shares, the issuer does not have a conditional or unconditional duty or responsibility to transfer assets or issue a variable number of its equity shares. The issuer will receive assets at inception of the contract (e.g., cash) and deliver a fixed number of its equity shares at maturity of the contract. As a result, a physically-settled prepaid forward contract to sell a fixed number of an issuer’s equity shares is outside the scope of ASC paragraphs 480-10-25-8 through 25-10 and 25-12, or 480-10-25-14 (or any other paragraph in ASC Topic 480).

13.042 Instead, prepaid forward contracts to sell a fixed number of the issuer’s equity shares that require physical settlement should be accounted for in conformity with the guidance in ASC Topic 815 and ASC Subtopic 815-40; ASC paragraph 480-10-55-63. If such a contract is classified as an equity instrument, the total amount received at inception of the contract should increase equity. Under ASC Subtopic 815-40; ASC paragraph 480-10-55-63, subsequent adjustments to the value of the contract recorded in equity at inception would not be recognized as long as the instrument is classified in permanent equity. At maturity of the contract, the entity would eliminate the related equity amount with an offset to common stock and additional paid-in capital. If such a contract is classified as a liability at inception under the provisions of ASC Subtopic 815-40; ASC paragraph 480-10-55-63, the entity should record all changes in the fair value of the instrument through earnings. If such a contract is within the scope of ASC Topic 815, the provisions of ASC Topic 815, including its embedded derivative provisions, apply. At maturity of the contract, the entity would eliminate the related asset or liability amounts with an offset to common stock and additional paid-in capital.

13.043 Because this is a prepaid forward sales contract and not a prepaid forward purchase contract, we believe an entity should not analogize to the earnings per share
guidance in ASC Topic 480 related to forward contracts that require physical settlement by repurchase of a fixed number of the issuer’s common shares in exchange for cash. That is, the aggregate common shares underlying prepaid forward sale contracts for a fixed number of shares should not be added to the denominator in the calculation of basic and diluted earnings per share during the life of the contract. The relevant guidance in ASC Topic 260 and ASC paragraphs 260-10-55-32 through 55-34, 55-36, and 55-77; 260-10-45-22 must be applied in determining the appropriate earnings per share treatment.

13.044 The following illustrates the accounting for a physically-settled prepaid forward contract to sell a fixed number of an issuer’s common shares:

Example 13.15: Physically-Settled Prepaid Forward Sale Contract for a Fixed Number of Shares

Background

On March 1, 20X3, Company A enters into a forward contract to sell its own shares on March 1, 20X4. The terms of the contract require the counterparty to pay $1,000 cash to Company A on March 1, 20X3 (inception) in exchange for 50 shares of its common stock to be delivered on March 1, 20X4 (maturity). At inception, Company A determines that the prepaid amount ($1,000) should be recorded as an increase to permanent equity in accordance with ASC Subtopic 815-40; ASC paragraph 480-10-55-63.

Analysis

Company A does not have a duty or responsibility to transfer assets (i.e., Company A received assets at inception). While Company A has an obligation to transfer its equity shares, it is required to transfer a fixed number of its equity shares (i.e., Company A is required to transfer 50 common shares at maturity). Therefore, the physically-settled prepaid forward contract to sell a fixed number of the issuer’s equity shares is outside the scope of ASC paragraphs 480-10-25-8 through 25-10 and 25-12, or 480-10-25-14 (or any other paragraph in ASC Topic 480).

Since the contract meets the criteria for permanent equity classification in ASC Subtopic 815-40; ASC paragraph 480-10-55-63, the total amount received at inception of the contract ($1,000) should increase equity and subsequent adjustments to the value of the contract would not be recognized since the instrument is classified in permanent equity. Upon delivery of the shares at maturity, Company A should eliminate the previously recorded equity amount and record common stock and additional paid-in capital for $1,000 (i.e., net equity would not be affected).

Because this is a prepaid forward sales contract and not a prepaid forward purchase contract, an entity should not analogize to the earnings per share guidance in ASC Topic 480 related to forward contracts that require physical settlement by
repurchase of a fixed number of the issuer’s common shares in exchange for cash. That is, the aggregate common shares underlying prepaid forward sale contracts for a fixed number of shares should not be added to the denominator in the calculation of basic and diluted earnings per share during the life of the contract. The relevant guidance in ASC Topic 260 and ASC paragraphs 260-10-55-32 through 55-34, 55-36, and 55-77; 260-10-45-22 should be applied in determining the appropriate earnings per share treatment.

**Physically-Settled Prepaid Forward Sale Contract for a Variable Number of Shares**

**13.045** In the case of a physically-settled prepaid forward contract to sell a variable number of an issuer’s equity shares, the issuer does not have a conditional or unconditional duty or responsibility to transfer assets. As a result, the instrument is outside the scope of ASC paragraphs 480-10-25-8 through 25-10 and 25-12. However, since the contract embodies an unconditional obligation that requires the issuer to deliver a variable number of its equity shares, the contract is required to be reviewed to determine whether the monetary value, at inception, is based solely or predominantly on (1) a fixed monetary amount known at inception, (2) variations in something other than the fair value of the issuer’s equity shares, or (3) variations inversely related to changes in the fair value of the issuer’s equity shares, to determine whether it is within the scope of ASC paragraph 480-10-25-14. For such prepaid forward contracts, the monetary value of the obligation is often solely or predominantly based on one of those characteristics (typically, a fixed monetary amount known at inception). Therefore, if the contract is outside the scope of ASC Topic 815, it should be accounted for under the provisions of ASC Topic 480.

**13.046** Because this is a prepaid forward sales contract rather than a prepaid forward purchase contract and the shares underlying the contract are variable, rather than fixed, we believe an entity should not analogize to the earnings per share guidance in ASC Topic 480 related to forward contracts that require physical settlement by repurchase of a fixed number of the issuer’s common shares in exchange for cash. That is, the aggregate common shares underlying prepaid forward sale contracts for a variable number of shares should not be added to the denominator in the calculation of basic and diluted earnings per share during the life of the contract. The relevant guidance in ASC Topic 260 and ASC paragraphs 260-10-55-32 through 55-34, 55-36, and 55-77; 260-10-45-22 must be applied in determining the appropriate earnings per share treatment.

**13.047** The following illustrates the accounting for a physically-settled prepaid forward contract to sell a variable number of an issuer’s common shares:
Example 13.16: Physically-Settled Prepaid Forward Sale Contract for a Variable Number of Shares

Background

On March 1, 20X3, Company A enters into a forward contract to sell its own shares on March 1, 20X4. The terms of the contract require Company A to receive $1,000 cash from the counterparty on March 1, 20X3 (inception) in exchange for a variable number of shares of its common stock with a fair value of $1,100 to be delivered on March 1, 20X4 (maturity).

Analysis

The instrument is within the scope of ASC paragraph 480-10-25-14(a) because the instrument (1) embodies an unconditional obligation, (2) requires Company A to settle the unconditional obligation by delivering a variable number of its common shares, and (3) has a monetary value that is based on a fixed monetary amount known at inception (i.e., Company A is required to transfer a variable number of its shares with a fair value of $1,100 at maturity). The contract should be accounted for under the provisions of ASC Topic 480 if the contract is outside the scope of ASC Topic 815.

Because this is a prepaid forward sales contract, rather than a prepaid forward purchase contract, and the shares underlying the contract are variable, rather than fixed, we believe an entity should not analogize to the earnings per share guidance in ASC Topic 480 related to forward contracts that require physical settlement by repurchase of a fixed number of the issuer’s common shares in exchange for cash. That is, the aggregate common shares underlying prepaid forward sale contracts for a variable number of shares should not be added to the denominator in the calculation of basic and diluted earnings per share during the life of the contract. The relevant guidance in ASC Topic 260 and ASC paragraphs 260-10-55-32 through 55-34, 55-36 and 55-77; 260-10-45-22 should be applied in determining the appropriate earnings per share treatment.

CERTAIN STRUCTURED TRANSACTIONS PREVIOUSLY ADDRESSED BY THE EMERGING ISSUES TASK FORCE

13.048 This section describes the effect ASC Topic 480 had on certain existing EITF Issues. Except as specifically noted herein, this section does not reflect the original consensuses previously reached by the EITF prior to the issuance of ASC Topic 480.
Debt Repayable with Proceeds from the Sale of Equity

13.049 EITF Issue No. 84-40, “Long-Term Debt Repayable by a Capital Stock Transaction” addressed the following transaction:

- Parent forms a subsidiary that in turn forms an owner trust of which the subsidiary is the sole beneficiary.
- The trust issues debt and uses the proceeds, together with cash paid in by the subsidiary, to purchase preferred stock issued by Parent.
- The preferred stock is cumulative, is callable (after a period of time but not while the stock is held by the trust) at Parent’s option, and carries an adjustable dividend rate determined in a manner similar to the rate on the debt.
- The preferred stock is also convertible into common stock of Parent at a fluctuating conversion rate.
- An agreement between Parent and the trust provides that Parent can issue only common stock if the preferred stock is converted.
- The trust agreement requires that the trustee either (1) sell the preferred stock or (2) convert and sell the related common stock to make required principal payments on its debt. In summary, the debt issued by the Trust is repayable solely by the issuance and subsequent sale of Parent’s capital stock (whether preferred or common).

13.050 Regardless of the source of the trust’s capacity to repay the debt (i.e., through the sale of Parent’s equity), the debt represents an obligation of the trust to transfer cash to the debt holder and, accordingly, the debt is classified as a liability in the separate financial statements of the trust. If the trust is consolidated pursuant to FASB Interpretation No. 46, (revised December 2003) Consolidation of Variable Interest Entities, or the original consensus in EITF 84-40 (e.g., prior to adoption of ASC Topic 810) the debt is also classified as a liability in the separate financial statements of Parent. If the trust is not consolidated under ASC Topic 810, the shares (whether preferred or converted into common) could be mandatorily redeemable for Parent if the trust is required to sell the shares back to the issuer and the issuer is required to redeem the shares. If the trust is not consolidated under ASC Topic 810 and the shares are not mandatorily redeemable under ASC Topic 480, other relevant guidance should be followed to account for the preferred stock issued by Parent. Additionally, the conversion terms of the preferred stock are required to be evaluated to determine whether a beneficial conversion feature exists under ASC Subtopic 470-20, Debt – Debt with Conversion and Other Options.

Forward Purchase Contract Executed Simultaneously with Issuance of Equity Shares

13.051 EITF Issue No. 98-12, “Application of Issue No. 00-19 to Forward Equity Sales Transactions,” addressed the following transaction structure:
Company A sells 1,000 shares of its common stock to an unrelated party (the Banker) for its current market value of $50 per share less a transaction fee. Simultaneous with the issuance of the common stock, Company A enters into a forward purchase contract with the Banker to be settled at a price of $55 per share in one year. In this example, the forward price is equal to the initial sales price of the common stock ($50) plus a fixed return of 10% for the length of time the forward is outstanding. Company A can settle the forward at its discretion in a number of ways as follows (all settlement options are economically equivalent to the issuer):

- **Physical Settlement**—The forward is settled by exchange whereby the 1,000 shares are returned to Company A in exchange for $55,000.

- **Net Share Settlement**—Depending on the market value of the stock on the settlement date, the forward is settled by delivery of additional shares to the Banker or return of shares to Company A so that the net return to the Banker is equal to $5,000.

- **Net Cash Settlement**—Depending on the market value of the stock on the settlement date, the forward is settled by the payment to or receipt of cash from the Banker so that the net return to the Banker is equal to $5,000.

The Banker assumes the risks and rewards of ownership of the common stock and is free to sell or pledge the shares. In addition, because the issuer is not required to physically settle, the shares could remain outstanding after the forward contract matures.

**13.052** As discussed in Section 6, a freestanding financial instrument within the scope of ASC Topic 480 may not be combined with another freestanding financial instrument in applying the classification provisions in ASC paragraphs 480-10-25-4 through 25-6, 25-8 through 25-10, 25-12, and 25-14 of ASC Topic 480, unless combination is required under the provisions of ASC Topic 815 and its related guidance. ASC Topic 480 requires that a freestanding forward purchase contract for the issuer’s equity shares, such as the forward purchase contract described above, be classified as a liability, regardless of the form of settlement (see Sections 4 and 5 for additional information).

**Share Repurchase Program**

**13.053** An accelerated share repurchase program may contain a combination of transactions that permits an entity to purchase a targeted number of shares immediately with the final purchase price of those shares determined by an average market price over a fixed period of time. Typically, an accelerated share repurchase program is intended to combine the immediate share retirement benefits of a tender offer with the market impact and pricing benefits of a disciplined daily open market stock repurchase program. ASC paragraphs 505-30-25-5 and 25-6; 505-30-55-1, 55-3, 55-5, and 55-6; 505-30-60-2; 260-10-55-89:
Treasury Stock Purchase

Investment Banker, an unrelated third party, borrows 1,000,000 shares of Company A common stock from investors, becomes the owner of record of those shares, and sells the shares short to Company A on January 1, 20X9, at the current market value of $50 per share. Company A pays $50,000,000 in cash to Investment Banker on January 1, 20X9, to settle the purchase transaction. The shares are held in treasury. Company A has legal title to the shares, and no other party has the right to vote those shares.

Forward Contract

Company A simultaneously enters into a net settled forward sale contract with Investment Banker on 1,000,000 shares of Company A common stock. On the April 1, 20X9 settlement date, if the volume-weighted average daily market price of Company A’s common stock during the contract period (January 1, 20X9 to April 1, 20X9) exceeds the $50 initial purchase price (net of a commission fee to Investment Banker), Company A will deliver to Investment Banker cash or shares of common stock (at Company A’s option) equal to the price difference multiplied by 1,000,000. If the volume-weighted average daily market price of Company A’s common stock during the contract period is less than the $50 initial purchase price (net of a commission fee to Investment Banker), Investment Banker will deliver to Company A cash equal to the price difference multiplied by 1,000,000.

13.054 The EITF reached a consensus on the accounting for the transaction and concluded that an entity should account for such a structure as two separate transactions:

   (1) As common shares acquired in a treasury stock transaction recorded on the acquisition date (January 1, 20X9 in the above example); and
   
   (2) As a forward sales contract indexed to its own common stock.

13.055 The equity shares acquired in a treasury stock transaction are outside the scope of ASC Topic 480. Additionally, the net settled forward sale contract is outside the scope of ASC Topic 480 based on the following analysis. Company A (the issuer) is entitled to determine the settlement method, so the obligation under the forward sale contract must be evaluated under ASC paragraph 480-10-25-14 as an obligation that may require issuance of a variable number of the issuer’s equity shares. The forward sale contract is outside the scope of ASC paragraph 480-10-25-14 because while the instrument (1) embodies a conditional obligation and is not an outstanding share of stock, and (2) may require Company A to settle the obligation by transferring a variable number of its common shares (i.e., if the volume-weighted average daily market price of Company A’s common shares during the contract period is above $50 and Company A decides to settle the obligation in shares), the monetary value, at inception, is based solely on variations directly related to changes in the fair value of its common shares. Since neither instrument is within the scope of ASC Topic 480, other authoritative guidance should be
used to determine the appropriate classification, measurement, and disclosure for each separate transaction.

13.056 In addition to the accelerated share repurchase transaction structure described above, there are other types of share repurchase programs that differ from the specific fact pattern set forth in ASC paragraphs 505-30-25-5 and 25-6; 505-30-55-1, 55-3, 55-5, and 55-6; 505-30-60-2; 260-10-55-89. All such transaction structures should be analyzed to determine whether the transaction or its separate components are within the scope of ASC Topic 480. The following examples illustrate that analysis for similar transactions:

**Example 13.17: Share Repurchase Program--Example I**

**Background**

On January 1, 20X9, Company A enters into a forward contract to purchase its own equity shares on April 1, 20X9. The terms of the contract require Company A to pay $50,000,000 cash to the counterparty in exchange for 1,000,000 equity shares (i.e., $50 per share).

Company A simultaneously enters into a net settled forward sale contract with the same counterparty on 1,000,000 shares of Company A equity shares. On the April 1, 20X9 settlement date, if the volume-weighted average daily market price of Company A’s equity shares during the contract period (January 1, 20X9 to April 1, 20X9) exceeds $50, Company A will deliver to the counterparty cash or equity shares (at Company A’s option) equal to the price difference multiplied by 1,000,000. If the volume-weighted average daily market price of Company A’s equity shares during the contract period is less than the $50 initial purchase price, the counterparty will deliver to Company A cash equal to the price difference multiplied by 1,000,000.

**Analysis**

Since the forward purchase contract requires physical settlement by repurchase of a fixed number of Company A’s common shares in exchange for cash, it is within the scope of ASC paragraphs 480-10-25-8 through 25-10 and 25-12 because the instrument (a) is not an outstanding share of the issuer (i.e., it is a forward purchase contract), (b) embodies an obligation, at inception, such that Company A is required to repurchase its own shares (i.e., in this case it represents an unconditional obligation), and (e) requires Company A to settle the obligation by transferring its assets (i.e., $50,000,000 cash). Based on the terms of the forward purchase contract, it is within the scope of ASC paragraphs 480-10-25-8 through 25-10 and 25-12, 480-10-30-3 through 30-5, 480-10-35-3 and 480-10-45-3, and the
shares of common stock under the contract (i.e., 1,000,000 shares) are excluded from the denominator in the calculation of basic and diluted earnings per share on a weighted-average basis during the life of the contract.

The forward sale contract requires Company A to transfer its assets or a variable number of its equity shares or receive cash from the counterparty in settlement of the contract, depending on the volume-weighted average daily market price of Company A’s equity shares during the contract period. In essence, the contract is a conditional obligation for Company A. Because the instrument is not an outstanding share and Company A is entitled to determine the settlement method, the obligation must be evaluated under ASC paragraph 480-10-25-14 as an obligation that may require issuance of a variable number of the issuer’s equity shares. The contract is outside the scope of ASC paragraph 480-10-25-14 because, while the instrument (1) embodies a conditional obligation and is not an outstanding share of stock, and (2) may require Company A to settle the obligation by transferring a variable number of its common shares (i.e., if the volume-weighted average daily market price of Company A’s common shares during the contract period is above $50 and Company A decides to settle the obligation in shares), the monetary value, at inception, is based solely on variations directly related to changes in the fair value of its common shares. Since the contract is outside the scope of ASC paragraph 480-10-25-14 (or any other paragraph), it is not accounted for under its provisions.

As discussed in Section 6, a freestanding financial instrument within the scope of ASC Topic 480 may not be combined with another freestanding financial instrument in applying the classification provisions in ASC paragraphs 480-10-25-4 through 25-6, 25-8 through 25-10, 25-12, and 25-14, unless combination is required under the provisions of ASC Topic 815 and its related guidance. Assuming the provisions of ASC Topic 815 and its related guidance do not require Company A to combine the instruments, Company A would account for the forward purchase contract (which is within the scope of ASC Topic 480) and the forward sale contract (which is outside the scope of ASC Topic 480) as two separate financial instruments.
Example 13.18: Share Repurchase Program--Example II

Background

On January 1, 20X9, Company A enters into a forward contract to purchase its own equity shares on April 1, 20X9. The terms of the contract require Company A to pay $50,000,000 cash to the counterparty on January 1, 20X9 (inception) in exchange for 1,000,000 shares of its equity shares to be delivered on April 1, 20X9 (maturity).

Company A simultaneously enters into a net settled forward sale contract with the counterparty on 1,000,000 of its own equity shares. On the April 1, 20X9 settlement date, if the volume-weighted average daily market price of Company A’s common stock during the contract period (January 1, 20X9 to April 1, 20X9) exceeds the $50 initial purchase price, Company A will deliver to the counterparty cash or equity shares (at Company A’s option) equal to the price difference multiplied by 1,000,000. If the volume-weighted average daily market price of Company A’s equity shares during the contract period is less than the $50 initial purchase price, the counterparty will deliver to Company A cash equal to the price difference multiplied by 1,000,000.

Analysis

With regard to the prepaid forward purchase contract, Company A does not have a conditional or unconditional duty or responsibility to transfer assets or issue equity shares (i.e., the assets have already been transferred at inception and at maturity the entity will receive its common shares). Therefore, the physically-settled prepaid forward contract to purchase a fixed number of the issuer’s equity shares does not embody an obligation and is outside the scope of ASC paragraphs 480-10-25-8 through 25-10, and 25-12 or 480-10-25-14 (or any other paragraph in ASC Topic 480).

The forward sale contract requires Company A to transfer its assets or a variable number of its equity shares or receive cash from the counterparty in settlement of the contract, depending on the volume-weighted average daily market price of Company A’s equity shares during the contract period. As such, the contract is a conditional obligation for Company A. Because the instrument is not an outstanding share and Company A is entitled to determine the settlement method, the obligation must be evaluated under ASC paragraph 480-10-25-14 as an obligation that may require issuance of a variable number of the issuer’s equity shares. The contract is outside the scope of ASC paragraph 480-10-25-14 because, while the instrument (1) embodies a conditional obligation and is not an outstanding share of stock, and (2) may require Company A to settle the obligation by transferring a variable number of its common shares (i.e., if the volume-
weighted average daily market price of Company A’s common shares during the contract period is above $50 and Company A decides to settle the obligation in shares, the monetary value, at inception, is based solely on variations directly related to changes in the fair value of its common shares.

Since the contract is outside the scope of either ASC paragraphs 480-10-25-8 through 25-10, and 25-12 or 480-10-25-14 (or any other paragraph), it is not accounted for under its provisions.

Based on the analysis above, neither the (1) physically-settled prepaid forward contract to purchase a fixed number of Company A’s equity shares nor the (2) net settled forward sale contract indexed to Company A’s equity shares are within the scope of ASC Topic 480. Accordingly, the prohibition on combining instruments within the scope of ASC Topic 480 (as specified in ASC paragraph 480-10-25-15 and discussed in Section 6 does not apply. As such, a detailed evaluation of the contracts and any related agreements must be performed to determine whether the two contracts should be accounted for on a separate or a combined basis. If, based on this evaluation, the contracts should be accounted for on a combined basis, the guidance in Paragraphs 13.037 through 13.040 of this book regarding physically-settled prepaid forward purchase contracts for a variable number of shares should be applied. If, based on this evaluation, the contracts should not be combined, Company A should account for this share repurchase program as two separate financial instruments: (1) as a physically-settled prepaid forward contract to purchase a fixed number of Company A’s equity shares and (2) as a net settled forward sale contract indexed to Company A’s equity shares. Neither of these instruments is within the scope of ASC Topic 480, so other accounting guidance (e.g., ASC Subtopic 815-40; ASC paragraph 480-10-55-63) should be applied.

If (1) the physically-settled prepaid forward contract to purchase a fixed number of Company A’s equity shares and (2) the net settled forward sale contract indexed to Company A’s equity shares are accounted for as two separate financial instruments, we believe the shares of common stock underlying the prepaid forward purchase contract (i.e., 1,000,000 shares) should be deducted from the denominator in the calculation of basic and diluted earnings per share on a weighted-average basis during the life of the contract. (See further discussion in Paragraph 13.034 regarding the earnings per share treatment of physically-settled prepaid forward purchase contracts for a fixed number of shares.) However, if the two financial instruments are required to be accounted for on a combined basis, the combined unit would be equivalent to a forward contract to purchase a variable number of shares and it would not be appropriate to deduct the shares of common stock under the forward purchase contract from the calculation of basic and diluted earnings per share. The relevant guidance in ASC Topic 260 and ASC paragraphs 260-10-55-32 through 55-34, 55-36, and 55-77; 260-10-45-22 would be applied in determining the appropriate earnings per share treatment.
Example 13.19: Share Repurchase Program--Example III

Background

Company A entered into an accelerated share repurchase agreement on March 14, 20X3 (the Trade Date) that requires it to pay $100 million in cash to Bank Z for the purchase of its own equity shares. On April 3, 20X3 (the Settlement Date), Bank Z will deliver 7 million shares (the Initial Shares) and Company A will record the purchase of treasury shares and a corresponding credit to cash for the acquisition cost of the Initial Shares (referred to as the Prepayment Amount). On June 3, 20X3 (the Valuation Date), Company A will either receive or be required to deliver additional cash or shares to Bank Z depending on the average share price that Bank Z paid for the shares during the calculation period (i.e., between April 3, 20X3 and June 3, 20X3).

This accelerated share repurchase agreement represents a combination of two transactions: a treasury stock acquisition and a forward contract between Company A and Bank Z. The forward contract represents an agreement with Bank Z to pay an agreed-upon price for the shares that Bank Z repurchases to cover its short position during the term of the forward contract. The contract price equals the volume-weighted average share price over the acquisition period, less the initial price paid to Bank Z. At the end of the contract, if the average share price that Bank Z paid for the shares is less than the initial purchase price that Company A paid, Bank Z must deliver cash or shares to Company A. If the average price is greater than the initial purchase price, Company A must deliver cash or shares to Bank Z, equal to the difference in price multiplied by the number of shares purchased.

Analysis

ASC paragraph 480-10-25-8 requires liability classification for financial instruments, other than outstanding shares, that embody an obligation to repurchase an issuer's equity shares and requires or may require the issuer to settle the obligation by transferring assets. On March 14, 20X3, Company A signed the accelerated share repurchase agreement and, in doing so, incurred an obligation to pay $100 million in cash to Bank Z for the purchase of its own equity shares. On March 14, 20X3, Company A should record a liability of $100 million with an offset to additional paid in capital (APIC) (assuming all the requirements of ASC Subtopic 815-40 are met). The obligation arises on the Trade Date (March 14, 20X3) and extends to the Settlement Date (April 3, 20X3). Therefore, Company A should record a liability (i.e., the obligation to pay $100 million) on March 14, 20X3.

Upon payment of cash on April 3, 20X3, Company A will transfer assets to settle its obligation and there is no remaining obligation to purchase its own equity shares. Therefore, the accelerated share repurchase agreement will no longer be within the scope of ASC paragraph 480-10-25-8. As such on April 3, 20X3,
Company A should debit the forward contract liability to remove it from the books and record a corresponding credit to cash. In addition, on April 3, 20X3, Company A will also debit Treasury Shares and credit APIC for the cost basis of the shares it received on April 3, 20X3.

Hedging Stock Appreciation Rights

13.057 ASC paragraph 815-20-55-33 discusses whether a company can designate an instrument as a cash flow hedge of the exposure to variability in expected future cash flows attributable to changes in the company’s stock price that arises in nonvested stock appreciation rights (SARs). Even though ASC Topic 480 did not impact the response in ASC paragraph 815-20-55-33, the issue was revised to indicate that ASC Topic 480 and ASC Subtopic 815-40; ASC paragraph 480-10-55-63 should be reviewed to determine whether the proposed hedging instrument is classified as an asset or liability since only a derivative instrument classified as an asset or a liability can qualify as a hedging instrument.

Derivatives Indexed to the Minority Interest in a Business Combination

13.058 ASC paragraphs 480-10-55-53 through 55-62 address a situation in which an enterprise acquires a controlling equity interest in a business and enters into one of three types of derivative contracts with the minority interest holder at the same time the enterprise acquires its interest. Specifically, ASC paragraphs 480-10-55-53 through 55-62 are applicable to transactions with the following structures:

A controlling majority owner (parent) acquires 80% of a subsidiary’s equity shares. The remaining 20% (the minority interest) is owned by an unrelated entity (the minority interest holder). Simultaneous with the acquisition of the minority interest, the minority interest holder and the parent enter into a derivative contract that is indexed to the subsidiary’s equity shares. The terms of the derivative contract may be any of the following:

**Derivative 1**: The parent has a fixed-price forward contract to purchase the 20% minority interest at a stated future date.

**Derivative 2**: The parent has a call option to purchase the 20% minority interest at a fixed price at a stated future date, and the minority interest holder has a put option to sell the other 20% to the parent under those same terms, that is, the fixed price of the call is equal to the fixed price of the put option.

**Derivative 3**: The parent and the minority interest holder enter into a total return swap. The parent will pay interest to the minority interest holder based on a formula (e.g., LIBOR plus an agreed spread) plus, at the termination date, any net depreciation of the fair value of the 20% interest since inception of the swap. The minority interest holder will remit to the parent any dividends paid on the minority interest plus, at the termination date, any net appreciation of the fair value of the 20% minority interest since inception of the swap.
Prior to the issuance of ASC Topic 480, the EITF reached a consensus in ASC paragraphs 480-10-55-53 through 55-62 that, in each of the three situations described in Paragraph 13.058, the derivatives should be viewed on a combined basis with the minority interest and accounted for as a financing of the parent’s purchase of the minority interest. Under that original consensus, the parent would recognize as part of the business combination accounting the fair value of 100% of the net assets of the subsidiary and attribute the stated yield under the combined derivative and minority interest position to interest expense. As discussed in Section 6, a freestanding financial instrument within the scope of ASC Topic 480 may not be combined with another freestanding financial instrument in applying the classification provisions in ASC paragraphs 480-10-25-4 through 25-6, 25-8 through 25-10, 25-12, and 25-14 of ASC Topic 480, unless combination is required under the provisions of ASC Topic 815 and its related guidance. As a result, ASC Topic 480 nullified the original consensuses in ASC paragraphs 480-10-55-53 through 55-62 related to Derivatives 1 and 3 in all cases. ASC Topic 480 also nullified the original consensuses related to Derivative 2, unless Derivative 2 is not freestanding (e.g., it is considered embedded within the minority interest holders’ shares). The determination of whether a financial instrument is freestanding of a minority interest requires a detailed analysis of the relevant facts and circumstances. See discussion in Paragraph 6.010 of Section 6.

Under ASC Topic 480, Derivatives 1, 2, and 3 (as described in Paragraph 13.058) are accounted for as follows:

**Derivative 1:** The physically-settled forward contract to purchase a fixed number of the subsidiary’s equity shares (the minority interest) is within the scope of ASC paragraphs 480-10-25-8 through 25-10 and 25-12 because the instrument (1) is not an outstanding share of the issuer (i.e., it is a forward purchase contract), (2) embodies an obligation, at inception, such that the parent is required to repurchase the shares of its consolidated subsidiary (i.e., in this case it represents an unconditional obligation), and (3) requires the parent to settle the obligation by transferring its assets. The forward purchase contract is recognized as a liability, initially measured at the present value of the contract amount; the minority interest is correspondingly reduced. Subsequently, increases in the liability to the contract amount and any amounts paid or to be paid to holders of those contracts are recognized as interest cost. The accounting required for this forward purchase contract under ASC Topic 480 is similar to the accounting required under the original consensus in ASC paragraphs 480-10-55-53 through 55-62 (prior to issuance of ASC Topic 480). That is, the parent accounts for the transaction as a financing of the minority interest and, consequently, consolidates 100% of the subsidiary.

**Derivative 2:** Depending on how the derivative was issued, one of three different accounting methods applies. If Derivative 2 were issued as a single freestanding instrument, under ASC Topic 480 it is accounted for in its entirety as a liability (or an asset in some circumstances), initially and subsequently measured at fair value. If the written put option and the purchased call option in Derivative 2 were issued as two freestanding instruments, the written put option is accounted for

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under ASC Topic 480 as a liability measured at fair value, and the purchased call option would be accounted for under ASC paragraphs 810-10-05-7; 810-10-25-17 and 25-18; 810-10-35-2; 810-10-40-3; 815-10-55-64; 815-10-15-77. Under both of those situations, the subsidiary’s equity shares (the minority interest) are accounted for separately from the derivatives under the relevant authoritative guidance. However, if the written put option and purchased call option are embedded in the subsidiary’s equity shares (the minority interest) and those shares are not mandatorily redeemable, the freestanding instrument is not in the scope of ASC Topic 480 and continues to be accounted for under the original consensus in ASC paragraphs 480-10-55-53 through 55-62 with the parent consolidating 100% of the subsidiary.

**Derivative 3:** The total return swap contract is within the scope of ASC paragraphs 480-10-25-8 through 25-10 and 25-12 because the instrument (1) is not an outstanding share of the issuer (i.e., it is a total return swap contract), (2) is indexed to an obligation, at inception, to repurchase the shares of its consolidated subsidiary (i.e., in this case it represents a conditional obligation), and (3) may require the parent to settle the obligation by transferring its assets. The total return swap is required to be accounted for as a liability (or asset in some circumstances) initially, and subsequently measured at fair value. The subsidiary’s equity shares (the minority interest) are accounted for separately from the total return swap under the relevant authoritative guidance for noncontrolling interests.

**Derivatives Indexed to the Stock of a Consolidated Subsidiary**

**13.061** ASC paragraphs 810-10-05-7; 810-10-25-17 and 25-18; 810-10-35-2; 810-10-40-3; 815-10-55-64; 815-10-15-77 address situations in which an enterprise enters into a freestanding derivative instrument that is indexed to, and potentially settled in, the stock of a consolidated subsidiary and that are not addressed in ASC paragraphs 480-10-55-53 through 55-62. For example, a parent company may enter into freestanding contracts that are indexed to, and sometimes settled in, the stock of a consolidated subsidiary. The subsidiary may or may not be wholly owned by the parent company. The counterparty may or may not also hold shares of the subsidiary at the inception of the contract. Examples of these contracts include written put options, written call options, purchased put options, purchased call options, forward sales contracts, and forward purchase contracts. These contracts may be settled using physical settlement, net share settlement, or net cash settlement or one of the parties may have a choice of those settlement methods.

**13.062** The EITF originally reached a general consensus that the stock of a subsidiary is not considered equity of the parent (reporting entity). As a result of that decision, derivatives indexed to, and potentially settled in, the stock of a consolidated subsidiary do not meet the scope exception in ASC paragraph 815-10-15-74(a) of ASC Topic 815 and, accordingly, if those derivatives meet the definition of a derivative instrument in ASC paragraph 815-10-15-83 (and did not meet any other exceptions in ASC Topic 815), they should be accounted for under ASC Topic 815. For derivatives accounted for under ASC Topic 815, if the parent company ultimately receives shares of the consolidated
subsidiary, the cost of acquiring those shares would include the amount paid at settlement plus (minus) the parent’s gain (loss) on the derivative. That cost should be accounted for by the parent company as a step acquisition in accordance with ASC Topic 805. If the parent company ultimately delivers shares of the consolidated subsidiary, a gain or loss should be recognized. In determining the gain or loss, the asset or liability balance of the derivative contract at the settlement date should be reflected as a decrease or increase, respectively, in the settlement price of the shares delivered.

13.063 As a result of the general consensus that the stock of a subsidiary is not considered equity of the parent (reporting entity), with respect to instruments within the scope of ASC paragraphs 810-10-05-7; 810-10-25-17 and 25-18; 810-10-35-2; 810-10-40-3; 815-10-55-64; 815-10-15-77 that are not accounted for under ASC Topic 815, the EITF originally reached the following consensuses:

- If a parent company enters into a forward contract to purchase outstanding common shares of its subsidiary at a future date, the parent should not record the acquisition of the shares until the forward contract is settled and the shares are received.
- If a parent company enters into a forward contract to sell common shares of its subsidiary at a future date, the parent should not record the disposition of shares until the forward contract is settled and the shares are transferred.
- If the parent purchases an option contract that permits the parent to buy or sell shares of a subsidiary at a future date, the parent should not record the acquisition or disposition of shares until it exercises its option and purchases or sells the shares.

13.064 While the EITF discussed written options that are within the scope of ASC paragraphs 810-10-05-7; 810-10-25-17 and 25-18; 810-10-35-2; 810-10-40-3; 815-10-55-64; 815-10-15-77 that are not accounted for under Statement 133ASC Topic 480, it did not reach a consensus. Instead, the SEC staff indicated that its longstanding position is that written options initially should be reported at fair value and subsequently marked to fair value through earnings.

13.065 ASC paragraph 480-10-05-6 and ASC Section 480-10-20 indicate that for financial instruments issued by members of a consolidated group of entities, the issuer’s equity shares includes the equity shares of any entity whose financial statements are included in the consolidated financial statements. As a result, since the original consensuses in ASC paragraphs 810-10-05-7; 810-10-25-17 and 25-18; 810-10-35-2; 810-10-40-3; 815-10-55-64; 815-10-15-77 were based on the opposite premise, the original consensuses in ASC paragraphs 810-10-05-7; 810-10-25-17 and 25-18; 810-10-35-2; 810-10-40-3; 815-10-55-64; 815-10-15-77 are nullified for any instrument within the scope of ASC paragraphs 810-10-05-7; 810-10-25-17 and 25-18; 810-10-35-2; 810-10-40-3; 815-10-55-64; 815-10-15-77 that is also within the scope of ASC Topic 480. Examples of those instruments include freestanding forward purchase contracts, written put options, and certain other instruments potentially settled with equity shares of an entity or any of its subsidiaries.
Forward Purchase Contract Executed Simultaneously with Issuance of a Written Put Option

13.066 The following transaction structure was discussed in EITF Issue No. 01-11, “Application of Issue No. 00-19 to a Contemporaneous Forward Purchase Contract and Written Put Option”:

Forward Equity Purchase Contract
Company A enters into a forward equity purchase contract indexed to its own common shares with Investment Bank. Under the terms of the forward equity purchase contract, Company A agrees to purchase a fixed number of its common shares at specified dates in the future at a fixed price (the forward price for those shares). The terms of the forward equity purchase contract:

• Allow Company A to settle the contract by physical delivery, net share settlement, or net cash settlement,
• Allow Company A to settle the contract by delivering unregistered shares,
• Contain an explicit share cap, and
• Are adjusted in the event of a change of control so that upon settlement, Investment Bank receives the same change of control consideration as other common shareholders.

Written Put Option
Contemporaneously with the issuance of the forward equity purchase contract, Company A enters into a written put option on its own common shares with Investment Bank on a multiple of the number of shares subject to the forward equity purchase contract. The terms of the written put option are as follows:

• Investment Bank is allowed to exercise the put option at any time. However, if the forward equity purchase contract is exercised early, there is no requirement that Investment Bank settle the written put; it could be held to its maturity and settled separately. Alternatively, the parties can settle the written put (at its fair value) at any time with the forward purchase contract remaining outstanding.
• The maturity date of the written put exceeds the maturity date of the forward purchase contract by one week.
• The written put option’s notional amount is a multiple of the forward contract’s notional amount. It is determined, in conjunction with the put option’s strike price, in a manner that ensures Investment Bank will be made whole for potential losses below the share cap in the forward equity purchase contract.
• The written put option’s strike price is established at the “changeover price,” which is the price by which the shares in the share cap under the forward
equity purchase contract are no longer adequate to make Investment Bank whole.

- Net cash settlement upon exercise is required.

13.067 As discussed in Section 6, a freestanding financial instrument within the scope of ASC Topic 480 may not be combined with another freestanding financial instrument in applying the classification provisions in ASC paragraphs 480-10-25-4 through 25-6, 25-8 through 25-10, 25-12, and 25-14 of ASC Topic 480, unless combination is required under the provisions of ASC Topic 815 and its related guidance. Both financial instruments described in this transaction (forward equity purchase contract and written put option) are classified as liabilities and measured at fair value under ASC Topic 480. As a result, ASC Topic 480 resolved the lack of a consensus in EITF 01-11.

QUESTIONS AND ANSWERS

Q&A 13.1: Company A enters into a forward contract to purchase 1,000,000 of its equity shares on December 31, 20X8 for $10,000,000. At maturity, the forward purchase contract enables the issuer to elect physical settlement, net share settlement, or net cash settlement.

Q. Is the financial instrument within the scope of ASC Topic 480?

A. Yes. The instrument provides the issuer with the choice of settlement methods—either physical, net cash, or net shares. As such, settlement in shares is assumed and the instrument is in the scope of ASC Topic 480 if the conditions in ASC paragraph 480-10-25-14 are met. The instrument is within the scope of ASC paragraph 480-10-25-14(c) because it (1) embodies a conditional obligation and is not an outstanding share of stock, (2) permits Company A to settle the conditional obligation by delivering a variable number of its common shares, and (3) has a monetary value, at inception, that is based solely on variations inversely related to changes in the fair value of Company A’s equity shares.

Q&A 13.2: Company A enters into a forward contract to purchase 1,000,000 of its equity shares on December 31, 20X8 for $10,000,000. At maturity, the forward purchase contract enables the holder (the counterparty) to elect physical settlement, net share settlement, or net cash settlement.

Q. Is the financial instrument within the scope of ASC Topic 480?

A. Yes. The instrument provides the holder with a choice of settlement methods—either physical, net cash, or net shares. As such, settlement in cash is assumed and the instrument is in the scope of ASC Topic 480 if the conditions in ASC
paragraphs 480-10-25-8 through 25-10 and 25-12 are met. The instrument is within the scope of ASC paragraphs 480-10-25-8 through 25-10 and 25-12 because the instrument (1) is not an outstanding share of stock, (2) embodies an obligation, at inception, that is indexed to an obligation to repurchase Company A’s own shares, and (3) may require Company A to settle the obligation by transferring its assets.

Q&A 13.3: Company A issues puttable warrants that allow the holder to (a) purchase one equity share at a strike price of $50 on August 1, 20X5, or (b) put each warrant back to the issuer for $5, settleable in fractional shares. If the share price on August 1, 20X5 is greater than $55, the holder would be expected to exercise the warrants to purchase one equity share per warrant. If the share price on August 1, 20X5 is less than $55, the holder would be expected to put the warrant back to the issuer, obligating the issuer to issue a variable number of shares with a fixed monetary value of $5 per warrant.

Q. Are the warrants with a share-settleable put in the scope of ASC Topic 480?

A. It depends. The puttable warrants should be analyzed as single freestanding instruments with components consisting of a written call option and a written put option. The written call option component embodies a conditional obligation to issue a fixed number of shares and would not be in the scope of ASC Topic 480 if freestanding. However, the share-settleable written put option component would be within the scope of ASC Topic 480 if freestanding because it (a) embodies a conditional obligation and is not an outstanding share, (b) requires or permits the issuer to settle the conditional obligation by issuing a variable number of its equity shares, and (c) has a monetary value that is based on a fixed monetary amount known at inception (i.e., $5). If, at inception, the monetary value of the written put option component (that would be within the scope of ASC Topic 480 if freestanding) is predominant over the monetary value of the written call option component (that would not be within the scope of ASC Topic 480 if freestanding), then the puttable warrants in their entirety would be within the scope of ASC Topic 480. If, at inception, the monetary value of the written call option component is predominant over the monetary value of the written put option component, the puttable warrants are outside the scope of ASC Topic 480 and other relevant authoritative guidance (e.g., ASC Topic 815 or ASC Subtopic 815-40; ASC paragraph 480-10-55-63) should be applied.
Technical References

FASB Codification Topics

ASC Topic 260, *Earnings per Share*

ASC Topic 450, *Contingencies*

ASC Topic 470, *Debt*

ASC Topic 480, *Distinguishing Liabilities from Equity*

ASC Topic 505, *Equity*

ASC Topic 718, *Compensation--Stock Compensation*

ASC Topic 805, *Business Combinations*

ASC Topic 815, *Derivatives and Hedging*

ASC Topic 830, *Foreign Currency Matters*

ASC Topic 860, *Transfers and Servicing*

ASC Subtopic 210-10, *Balance Sheet - Overall*

ASC Subtopic 260-10, *Earnings per Share - Overall*

ASC Subtopic 310-10, *Receivables - Overall*

ASC Subtopic 310-40, *Receivables - Troubled Debt Restructurings by Creditors*

ASC Subtopic 460-10, *Guarantees - Overall*

ASC Subtopic 470-10, *Debt - Overall*

ASC Subtopic 470-20, *Debt - Debt with Conversion and Other Options*

ASC Subtopic 470-50, *Debt - Modifications and Extinguishments*

ASC Subtopic 470-60, *Debt - Troubled Debt Restructurings by Debtors*

ASC Subtopic 480-10, *Distinguishing Liability from Equity - Overall*

ASC Subtopic 505-10, *Equity - Overall*

ASC Subtopic 505-30, *Equity - Treasury Stock*

ASC Subtopic 505-50, *Equity - Equity-Based Payments to Non-Employees*
Technical References

ASC Subtopic 718-40, Compensation -- Stock Compensation - Employee Stock Ownership Plans

ASC Subtopic 718-50, Compensation -- Stock Compensation - Employee Share Purchase Plans

ASC Subtopic 718-740, Compensation -- Stock Compensation - Income Taxes

ASC Subtopic 810-10, Consolidation - Overall

ASC Subtopic 815-10, Derivatives and Hedging - Overall;

ASC Subtopic 815-15, Derivatives and Hedging - Embedded Derivatives

ASC Subtopic 815-20, Derivatives and Hedging - General

ASC Subtopic 815-40, Derivatives and Hedging - Contracts in Entity’s Own Equity

ASC Subtopic 835-20, Interest - Capitalization of Interest

ASC Subtopic 835-30, Interest - Imputation of Interest

SEC Guidance in Codification

SEC Staff Accounting Bulletin Topic 3C, Redeemable Preferred Stock (ASC paragraph 480-10-S99-2)

SEC Staff Accounting Bulletin Topic 5Q, Increasing Rate Preferred Stock (ASC paragraph 505-10-S99-7)

Other Sources

APB Opinion No. 25, Accounting for Stock Issued to Employees

AU 560, Subsequent Events

EITF Issue No. 84-40, “Long-Term Debt Repayable by a Capital Stock Transaction”

EITF Issue No. 87-23, “Book Value Stock Purchase Plans”

EITF Issue No. 87-31, “Sale of Put Options on Issuer’s Stock”

EITF Issue No. 88-6, “Book Value Stock Plans in an Initial Public Offering”

EITF Issue No. 94-7, “Accounting for Financial Instruments Indexed to, and Potentially Settled in, a Company’s Own Stock”
EITF Issue No. 96-1, “Sale of Put Options on Issuer’s Stock That Require or Permit Cash Settlement”

EITF Issue No. 96-13, “Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company’s Own Stock”

EITF Issue No. 97-8, “Accounting for Contingent Consideration Issued in a Purchase Business Combination”

EITF Issue No. 97-15, “Accounting for Contingency Arrangements Based on Security Prices in a Purchase Business Combination”

EITF Issue No. 99-3, “Application of Issue No. 96-13 to Derivative Instruments with Multiple Settlement Alternatives”

EITF Issue No. 00-7, “Application of Issue No. 96-13 to Equity Derivative Instruments That Contain Certain Provisions That Require Net Cash Settlement If Certain Events outside the Control of the Issuer Occur”

EITF Issue No. 00-23, “Issues Related to the Accounting for Stock Compensation under APB Opinion No. 25 and FASB Interpretation No. 44”

EITF Issue No. 02-2, “When Certain Contracts That Meet the Definition of Financial Instruments Should Be Combined for Accounting Purposes”


FASB Concepts Statement No. 6, *Elements of Financial Statements*

*FASB Discussion Memorandum, Distinguishing between Liability and Equity Instruments and Accounting for Instruments with Characteristics of Both*

*FASB Exposure Draft, Proposed Amendment to FASB Concepts Statement No. 6 to Revise the Definition of Liabilities*

*FASB Exposure Draft, Proposed Statement of Financial Accounting Standards: Accounting for Financial Instruments with Characteristics of Liabilities, Equity or Both*

FASB Interpretation No. 44, *Accounting for Certain Transactions involving Stock Compensation*

FASB Statement No. 123, *Accounting for Stock-Based Compensation*

FASB Statement No. 141, *Business Combinations*

*International Accounting Standard 32 (revised March 2004), Financial Instruments: Disclosure and Presentation*
Technical References

Acronyms

AICPA  American Institute of Certified Public Accountants
APB    Accounting Principles Board
ARB    Accounting Research Bulletin
ASC    FASB Accounting Standards Codification
ASR    SEC Accounting Series Release
DIG    Derivatives Implementation Group
EITF   Emerging Issues Task Force
EPS    Earnings Per Share
ERISA  Employee Retirement Income Security Act of 1974
ESOP   Employee Stock Ownership Plan
FASB   Financial Accounting Standards Board
FIN    FASB Interpretation
FSP    FASB Staff Position
FTB    FASB Technical Bulletin
IAS    International Accounting Standard
IRC    Internal Revenue Code
### Acronyms

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<th>Acronym</th>
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<tr>
<td>LIBOR</td>
<td>London Interbank Offered Rate</td>
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<tr>
<td>LLC</td>
<td>Limited Liability Company</td>
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<td>SAB</td>
<td>SEC Staff Accounting Bulletin</td>
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<td>S&amp;P 500 Index</td>
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<tr>
<td>SAR</td>
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<td>SEC</td>
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Glossary

This glossary provides definitions of various terms as they are used in ASC Topic 480.

CALL OPTION

An option that gives the holder the right, but not the obligation, to purchase an underlying (for example, an issuer’s equity shares) from the option writer. A purchaser of a call option speculates that the price of the underlying will rise above a specified price within a specified time period, thus providing the option holder with the right to purchase the underlying at a price that is lower than the then-current price. A call option seller speculates that the price of the underlying will not exceed a specified price for a specified period, thus providing the seller with income related to the premium received for writing (selling) the option. If the right is not exercised after a specified period of time, the option expires.

EQUITY SHARES

Shares that are accounted for as equity in the balance sheet of the issuer.

FAIR VALUE

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

FINANCIAL INSTRUMENT

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

1. Imposes on one entity a contractual obligation to deliver cash or another financial instrument to a second entity or (2) to exchange other financial instruments on potentially unfavorable terms with the second entity

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1 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.

2 The use of the term financial instrument in this definition is recursive (because the term financial instrument is included in it), though it is not circular. The definition requires a chain of contractual obligations that ends with the delivery of cash or an ownership interest in an entity. Any number of obligations to deliver financial instruments can be links in a chain that qualifies a particular contract as a financial instrument.
b. Conveys to that second entity a contractual right\(^3\) (1) to receive cash or another financial instrument from the first entity or (2) to exchange other financial instruments on potentially favorable terms with the first entity.  
[ASC Section 815-10-20]

**FORWARD CONTRACT**

A contract to purchase or sell a specific quantity of an underlying (e.g., an issuer’s equity shares) at a specified price with delivery and settlement at a specified future date.

**FREESTANDING FINANCIAL INSTRUMENT**

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

**ISSUER**

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

**ISSUER’S EQUITY SHARES**

Equity shares of any entity whose financial statements are included in the consolidated financial statements.

**MANDATORILY REDEEMABLE FINANCIAL INSTRUMENT**

Any of various financial instruments issued in the form of shares that embody an unconditional obligation requiring the issuer to redeem the instrument by transferring its assets at a specified or determinable date (or dates) or upon an event that is certain to occur.

**MONETARY VALUE**

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

\(^3\) 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.
NET CASH SETTLEMENT

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

NET SHARE SETTLEMENT

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

NONPUBLIC ENTITY

Any entity other than one (1) whose equity securities trade in a public market either on a stock exchange (domestic or foreign) or in the over-the-counter market, including securities quoted only locally or regionally, (2) that makes a filing with a regulatory agency in preparation for the sale of any class of equity securities in a public market, or (3) that is controlled by an entity covered by (1) or (2). [ASC Section 718-10-20]

NON-SEC REGISTRANT

An entity that is not an SEC registrant as defined below.

OBLIGATION

A conditional or unconditional duty or responsibility to transfer assets or to issue equity shares.5

OPTION

A contract that gives the option holder the right, but not the obligation, to purchase (call) an underlying (for example, an issuer’s equity shares) from the option writer or to sell (put) an underlying to the option writer. An option specifies a price at which the option can be executed (called the strike, or exercise, price), and a time period during which the option is valid. If the right is not exercised after a specified period of time, the option expires.

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4 The term transfer is used in ASC Topic 480 in a broad sense consistent with its use in Concepts Statement 6, rather than the narrow sense in which it is used in ASC Topic 860.
5 Because ASC Topic 480 relates only to financial instruments and not to contracts to provide services and other types of contracts, but includes duties or responsibilities to issue equity shares, this definition of obligation differs from the definition of Concepts Statement 6 and is applicable only for items in the scope of ASC Topic 480.
OPTION HOLDER

Someone who has purchased a call or put option contract but has not yet exercised or sold it.

OPTION WRITER

Someone who has written, or sold, an option contract in order to earn the premium, which is the fee that the purchaser pays to the writer. A writer of a call option promises to sell the underlying investment to the call option holder, who has bought the right to purchase it at a specific price for a specified period of time. A writer of a put option has promised to buy the underlying investment from the put option holder, who has bought the right to sell the investment at a specific price for a specified period of time.

PHYSICAL SETTLEMENT

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.

PUT OPTION

An option that gives the holder the right, but not the obligation, to sell an underlying (e.g., an issuer’s equity shares) to the option writer. A purchaser of a put option speculates that the price of the underlying will fall below a specified price within a specified time period, thus providing the option holder with the right to sell the underlying at a price that is higher than the then-current price. A put option seller speculates that the price of the underlying will exceed a specified price for a specified period, thus providing the seller with income related to the premium received for writing (selling) the option. If the right is not exercised after a specified period of time, the option expires.

PUT WARRANT

A financial instrument with characteristics of both warrants and put options. The holder of a put warrant has the right, but not the obligation, to exercise (1) the warrant feature to purchase the issuer’s equity shares at a specified price within a specified time period, (2) the put option feature to sell (put) the instrument back to the issuer for a cash payment, or (3) in some cases, both the warrant feature to acquire the issuer’s equity shares and the put option feature to sell (put) those shares back to the issuer for a cash payment. If none of the rights conveyed by a put warrant are exercised after a specified period of time, the instrument expires. Sometimes put warrants are issued to purchasers of debt or preferred stock as an incentive to consummate the related financing transaction.
SEC REGISTRANT

An entity, or an entity that is controlled by an entity, (1) that has issued or will issue debt or equity securities that are traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local or regional markets), (2) that is required to file financial statements with the SEC, or (3) that provides financial statements for the purpose of issuing any class of securities in a public market. Therefore, a subsidiary of an SEC registrant also is an SEC registrant.

SHARES

The various forms of ownership that may not take the legal form of securities (for example, partnership or LLC interests), as well as other interests, including those that are liabilities in substance but not in form. Shares may be classified as liabilities or equity in the balance sheet of the issuer.

WARRANT

A financial instrument that gives the holder the right, but not the obligation, to purchase the issuer’s equity shares from the issuer at a specified price within a specified time period. If the right is not exercised after a specified period of time, the warrant expires. Sometimes warrants are issued to purchasers of debt or preferred stock as an incentive to consummate the related financing transaction.
Acknowledgments

This Handbook has been produced by the Department of Professional Practice of KPMG LLP in the United States.

We would like to acknowledge the efforts of the main contributors to this edition:

Kimber Bascom

Patrick Garguilo

Paul Munter

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