FASB Emerging Issues Task Force

Issue No. 07-5

Title: Determining Whether an Instrument (or an Embedded Feature) Is Indexed to an Entity's Own Stock

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References:

FASB Statement No. 123 (revised 2004), *Share-Based Payment* (FAS 123(R))

FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities* (FAS 133)

FASB Statement No. 154, *Accounting Changes and Error Corrections* (FAS 154)

International Accounting Standard 32, *Financial Instruments: Disclosure and Presentation* (IAS 32)

EITF Issue No. 00-19, "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock" (Issue 00-19)

EITF Issue No. 01-6, "The Meaning of 'Indexed to a Company's Own Stock'" (Issue 01-6)

EITF Issue No. 05-2, "The Meaning of 'Conventional Convertible Debt Instrument' in Issue No. 00-19" (Issue 05-2)

Proposed Statement 133 Implementation Issue No. C21, "Whether Options (Including Embedded Conversion Options) Are Indexed to both an Entity's Own Stock and Currency Exchange Rates" (proposed DIG Issue C21)

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* **The alternative views presented in this Issue Summary Supplement are for purposes of discussion by the EITF. No individual views are to be presumed to be acceptable or unacceptable applications of Generally Accepted Accounting Principles until the Task Force makes such a determination, exposes it for public comment, and it is ratified by the Board.**

Background

1. Paragraph 11(a) of FAS 133 specifies that a contract that would otherwise meet the definition of a derivative under that Statement issued or held by the reporting entity that is **both** (a) indexed to the entity's own stock and (b) classified in stockholders' equity in the entity's statement of financial position shall not be considered a derivative financial instrument for purposes of applying FAS 133. If a freestanding financial instrument (for example, a stock purchase warrant) meets the scope exception in paragraph 11(a) of FAS 133, it is classified as an equity instrument and is not accounted for as a derivative instrument.

2. Paragraph 12 of FAS 133 requires that an embedded derivative instrument be separated from the host contract and accounted for as a derivative instrument pursuant to FAS 133 if certain criteria are met. One of those criteria, set forth in paragraph 12(c), is that a separate instrument with the same terms as the embedded derivative instrument would, pursuant to paragraphs 6–11 of FAS 133, be a derivative instrument subject to the requirements of FAS 133. Consequently, if an embedded feature (for example, the conversion option embedded in a convertible debt instrument) meets the scope exception in paragraph 11(a) of FAS 133, it would not be separated from the host contract and accounted for as a derivative by the issuer.

3. This Issue addresses the determination of whether an instrument (or an embedded feature) is indexed to an entity's own stock, which is the first part of the scope exception in paragraph 11(a) of FAS 133. If an instrument (or an embedded feature) that has the characteristics of a derivative instrument under paragraphs 6–9 of FAS 133 is indexed to an entity's own stock, it is still necessary to evaluate whether it is classified in stockholders' equity (or would be classified in stockholders' equity if it were a freestanding instrument). For example, a net-cash-settled stock purchase warrant may be indexed to an entity's own stock, but it is not classified in stockholders' equity. Other applicable authoritative accounting literature, including Issues 00-19 and 05-2, provides guidance for determining whether an instrument (or an embedded feature) is classified in stockholders' equity (or would be classified in stockholders' equity if it were a freestanding instrument). This Issue does not address that second part of the scope exception in paragraph 11(a) of FAS 133.

4. In addition, some instruments that are potentially subject to the guidance in Issue 00-19 do not have all the characteristics of a derivative instrument under paragraphs 6–9 of FAS 133. For example, a physically settled forward contract to issue an entity's own equity shares in exchange for cash would not meet the net-settlement characteristic of a derivative instrument, as described in paragraphs 6(c) and 9 of FAS 133, if the underlying equity shares are not readily convertible to cash. If the forward contract is considered to be indexed to the entity's own stock, it would be evaluated under Issue 00-19 to determine whether it should be classified in equity or as an asset or a liability. However, if the terms of that forward contract are such that it is not considered to be indexed to the entity's own stock, equity classification would be precluded and the instrument would not be within the scope of Issue 00-19 (that Issue provides accounting guidance for instruments that are **indexed to**, and potentially settled in, the issuer's own stock). Consequently, for certain freestanding instruments that do not have all the characteristics of a derivative instrument under paragraphs 6–9 of FAS 133 but are potentially settled in an entity's own equity shares, this Issue would apply when evaluating whether they are within the scope of Issue 00-19.

5. Issue 01-6 provides guidance for evaluating whether certain instruments and embedded features are indexed to an entity's own stock. Specifically, Issue 01-6 applies to instruments and embedded features for which exercisability is based on one or more defined contingencies provided that once a contingency has occurred, the instrument's settlement amount is based solely on the issuing company's own stock. The consensus in Issue 01-6 specifies that instruments within the scope of that Issue are considered indexed to a company's own stock provided that (a) the contingency provisions are not based on (i) an observable market, other than the market for the issuer's stock (if applicable), or (ii) an observable index, other than those measured solely by reference to the issuer's own operations, and (b) once the contingent events have occurred, the instrument's settlement amount is based solely on the issuer's own stock.

Prior EITF Discussion

6. At the September 11, 2007 EITF meeting, the Task Force discussed how an entity should determine whether the following types of instruments or embedded features are indexed to its own stock.

Issue 1— Instruments and embedded features for which exercisability is based on one or more defined contingencies provided that once a contingency has occurred, the instrument's settlement amount is based solely on the difference between the fair value of a fixed number of the entity's equity shares and a fixed strike price.

Issue 2— Instruments and embedded features for which (a) the settlement amount is always based on the entity's stock price and one or more other variables or (b) the party receiving shares at settlement has a noncontingent option to deliver noncash consideration whose fair value is affected by one or more variables other than the entity's stock price.

Issue 3— Instruments and embedded features for which the settlement amount is based solely on the difference between the fair value of a fixed number of the entity's equity shares and a fixed strike price unless a defined contingency occurs or specified condition is met (including a condition relating to the issuer's share price at settlement). Upon occurrence of the contingent event or other condition, there is an adjustment to the number of shares used to calculate the settlement amount, the strike price, or both.

7. The Task Force reached a tentative conclusion on Issue 1 that contingent exercise provisions do not preclude an instrument or embedded feature from being indexed to an entity's own stock, provided that those provisions are not based on (a) an observable market, other than the market for the entity's stock (if applicable), or (b) an observable index, other than those calculated solely by reference to the entity's own operations (for example, sales revenue of the entity, EBITDA [earnings before interest, taxes, depreciation, and amortization] of the entity, net income of the entity, or total equity of the entity). That tentative conclusion would reaffirm the existing consensus in Issue 01-6.

8. The Task Force discussed Issue 2 but was not asked to reach a tentative conclusion.

9. The Task Force reached a tentative conclusion on Issue 3 that an entity must presume the occurrence of a contingent event or other condition that would adjust the settlement terms of that

instrument or embedded feature when evaluating whether an instrument or embedded feature is indexed to its own stock.

10. The Task Force requested that the FASB staff form a working group to assist in developing a framework for evaluating whether the instruments and embedded features addressed in Issues 2 and 3 are indexed to an entity's own stock. The Task Force recommended that the working group focus on developing a framework under which an instrument or embedded feature would be considered indexed to an entity's own stock if its ultimate settlement amount will equal the difference between the fair value of a fixed number of the entity's equity shares and a fixed strike price. An instrument or embedded feature for which the number of shares used to calculate the settlement amount, the strike price, or both, may vary would not be indexed to an entity's own stock unless the only variables that could affect the settlement amount would be inputs to a fair value measurement of any option or forward contract on equity shares (for example, interest rates). However, under that approach, standard antidilution provisions would not preclude an instrument or embedded feature from being indexed to an entity's own stock.

11. Task Force members observed that the tentative conclusions reached on Issues 1 and 3 may be reconsidered after the working group provides the Task Force with input on Issue 2.

Scope

12. This Issue applies to any freestanding financial instrument or embedded feature that has all the characteristics of a derivative in paragraphs 6–9 of FAS 133, for purposes of determining whether that instrument or embedded feature qualifies for the first part of the scope exception in paragraph 11(a) of FAS 133. This Issue also applies to any freestanding financial instrument that is potentially settled in an entity's own stock, regardless of whether the instrument has all the characteristics of a derivative in paragraphs 6–9 of FAS 133, for purposes of determining whether the instrument is within the scope of Issue 00-19.

13. This Issue does not apply to share-based payment awards within the scope of FAS 123(R) for purposes of determining whether instruments are classified as liability awards or equity awards under that Statement.

Working Group Discussion

14. Pursuant to the Task Force's request at the September 11, 2007 EITF meeting, a Working Group was formed to provide input on this Issue and a meeting was held on October 22, 2007. The Working Group was not asked to vote or make formal recommendations at that meeting. Consequently, this summary of the Working Group's discussion is based on the general feedback provided by Working Group members at that meeting.

<u>Approach to Addressing This Issue</u>

15. The Working Group discussed an overall approach for developing principles-based guidance on determining whether an instrument (or embedded feature) is indexed to an entity's own stock. That overall approach ("settlement approach") can be summarized as follows:

Step 1: Evaluate the instrument's contingent exercise provisions, if any.

Step 2: Evaluate the instrument's settlement provisions.

16. At the September 11, 2007 EITF meeting, the Task Force tentatively decided to reaffirm the existing guidance in Issue 01-6 for purposes of applying Step 1. If the evaluation of Step 1 would not preclude an instrument from being considered indexed to the entity's own stock, the analysis would proceed to Step 2 and an evaluation of the instrument's settlement provisions would be performed. An instrument or embedded feature would be considered indexed to an entity's own stock if its settlement amount will equal **the difference between the fair value of a fixed number of the entity's equity shares and a fixed strike price**. At the November 29, 2007 EITF meeting, the Task Force will be asked to discuss issues that are intended to clarify the extent that the settlement amount of an instrument can deviate from this "fixed for fixed" principle before it is precluded from being considered indexed to an entity's own stock.

17. In general, Working Group members expressed support for this approach to developing principles-based guidance on determining whether an instrument (or embedded feature) is

indexed to an entity's own stock. However, one Working Group member strongly supported an alternative approach ("fair value inputs approach") that can be summarized as follows:

> Step 1: Identify every input to a fair value measurement of the instrument, including exercise contingencies that would affect the instrument's fair value.
>
> Step 2: Evaluate each input identified in Step 1 and identify those inputs that are consistent with the notion of the instrument being indexed to the entity's own stock, as well as those inputs that are inconsistent with the notion of the instrument being indexed to the entity's own stock. (The determination of which inputs are consistent with the indexation to the entity's stock would have to be developed by the Task Force.)
>
> Step 3: Make a determination of whether the instrument is indexed to the entity's own stock, considering the nature and significance of the inputs identified in Step 2.

18. That Working Group member also commented that he believes a fair value inputs approach would be more consistent with the application of a standard that requires fair value accounting for items within its scope. A few Working Group members noted that a model that applies a consistent principle to all terms including exercise contingencies may be preferable to the settlement approach. However, Working Group members expressed concerns that the fair value inputs approach would not reduce diversity in practice unless rules-based guidance were developed on the types of fair value inputs that are inconsistent with the notion of being indexed to an entity's own stock. Potential alternatives to either a settlement approach or a fair value inputs approach were briefly discussed. Accordingly, most Working Group members did not object to the Task Force continuing with its development of the settlement approach for purposes of addressing this Issue. After considering the input of the Working Group, the focus of this Issue Supplement continues to be on the development of the settlement approach.

Tentative Conclusions Reached at the September 11, 2007 EITF Meeting

19. The Working Group discussed the Task Force's tentative conclusion at the September 11, 2007 EITF meeting to reaffirm the guidance in existing GAAP (Issue 01-6) for purposes of

evaluating exercise contingencies. One Working Group member who supported a fair value inputs approach to addressing this Issue did not support that tentative conclusion. That Working Group member believes that there is no basis for requiring separate evaluations for (a) exercise contingencies and (b) settlement provisions. Consequently, that Working Group member continued to express support for a fair value inputs approach to addressing this Issue, noting that exercise contingencies would be inputs to a fair value measurement of an instrument and would be subject to the same analysis as other inputs.

20. Some Working Group members observed that diversity in practice relating to the evaluation of **exercise contingencies** under the existing guidance in Issue 01-6, primarily relates to the following contingent exercise provisions:

a. Terms that permit exercise of a contingently exercisable embedded conversion option if the issuer's credit rating is downgraded
b. Terms that permit exercise of a contingently exercisable embedded conversion option when the trading price of the convertible debt instrument in its entirety is lower than a specified percentage (for example, 98 percent) of the instrument's if-converted value (referred to as "parity" provisions).

21. Some Working Group members observed that, in many cases, the financial reporting outcome from differences in views regarding those exercise contingencies will not be significant because of differing constituent views on the unit of account for contingently exercisable embedded derivatives.

22. There was also some discussion of what an "index" means in the context of Issue 01-6. Questions discussed included whether an index had to be observed or quoted in a market, or if the occurrence or non-occurrence of a single event was considered an index (and if not, whether a trend or average or other statistic based on periodic observations of the occurrence or non-occurrence of an event an index). Some Working Group members suggested discussion of this issue by the Task Force. Others noted that practice does not appear to have difficulty in interpreting the consensus in Issue 01-6 and do not believe that it is necessary for the Task Force

to expand on the existing guidance for evaluating exercise contingencies (Step 1 of the settlement approach). Consequently, the Task Force will not be asked to provide explicit guidance on how those contingent exercise provisions should be evaluated under the Task Force's tentative conclusion on Issue 1 reached at the September 11, 2007 EITF meeting (which is consistent with the existing requirements of Issue 01-6).

23. Some Working Group members expressed support for the Task Force's tentative conclusion at the September 11, 2007 EITF meeting that an entity must presume the occurrence of a contingent event or other condition that would adjust the settlement terms of an instrument or embedded feature when evaluating whether the instrument or embedded feature is indexed to its own stock. This tentative conclusion has been incorporated into the alternative views provided for Issue 1, which will be discussed by the Task Force at the November 29, 2007 EITF meeting.

<u>Evaluating Instruments for which the Settlement Amount Is Not Based on the Difference between a Fixed Number of Shares and a Fixed Strike Price</u>

24. At the September 11, 2007 EITF meeting, the Task Force requested that the Working Group provide input on a framework under which an instrument or embedded feature would be considered indexed to an entity's own stock if its ultimate settlement amount will equal the difference between the fair value of a fixed number of the entity's equity shares and a fixed strike price. An instrument or embedded feature for which the number of shares used to calculate the settlement amount, the strike price, or both, may vary would not be indexed to an entity's own stock unless the only variables that could affect the settlement amount would be inputs to a fair value measurement of any option or forward contract on equity shares (for example, interest rates). The Working Group discussed various aspects of this approach and provided input on issues that should be clarified for it to be applied consistently in practice.

25. Some Working Group members observed that the components of the fair value measurement for a "plain-vanilla" option or forward contract on equity shares would be (a) intrinsic value and (b) time value (including volatility-related value for options). The Working Group agreed that such an instrument (or embedded feature) should not be precluded from being classified in equity solely because of a provision that permits early settlement at fair value, even

though settlement at fair value would be affected by variables including interest rates, the issuer's credit standing, dividends and share price volatility (for option contracts and forward contracts with option features, such as caps and floors). Consequently, one Working Group member suggested that the description of the framework being developed in this Issue be revised as follows:

> An instrument or embedded feature for which the number of shares used to calculate the settlement amount, the strike price, or both, may vary would not be indexed to an entity's own stock unless the only variables that could affect the settlement amount would be <u>elements of the time value</u> ~~inputs to a fair value measurement~~ of an option or forward contract on equity shares (for example, interest rates).

26. One Working Group member commented that he believed the result would be the same because time value is the difference between the fair value and intrinsic value. Other Working Group members observed that an instrument's strike price might vary based on changes in an input that affects the instrument's time value. For example, an equity forward sale contract might provide for the issuance of a fixed number of shares in exchange for a strike price that varies based on changes in LIBOR (or the Federal Funds or Treasury rate) over the contract period. The Working Group agreed that, because interest rates are an element of time value, such provisions should not preclude an entity from concluding that the instrument (or embedded feature) is indexed to its own stock, provided that a leverage factor is not present.

27. Some Working Group members observed that, to facilitate settlement upon early termination events, some contracts contain explicit adjustment provisions upon certain early terminations. For example, the offering documents for convertible debt instruments frequently contain a "make-whole" provision that provides for adjustments to the conversion rate (that is, to provide additional shares at conversion) for the purpose of reimbursing the investor for lost time value upon the occurrence of certain events, such as (a) a change in control before a specified date or (b) the issuer's exercise of a call option before a specified date. Adjustments to the conversion rate from such events are typically predetermined through a table such that the amount of incremental shares decreases (a) based on the passage of time that the instrument was

outstanding prior to the occurrence of the specified event and (b) for increases in the price of the underlying equity shares (because the investor's loss of time value has been offset by increases to intrinsic value). Because potential adjustments to the conversion rate from such make-whole provisions are fixed at inception, they are not affected by changes in the variables that affect an instrument's time value (for example, changes in interest rates) that occur between issuance and settlement. However, several Working Group members agreed that such provisions that are designed to compensate the investor for lost time value upon an early settlement of the instrument should not preclude an entity from concluding that the instrument (or embedded feature) is indexed to its own stock.

28. Some Working Group members observed that an instrument's settlement amount at its contractual settlement date is often determined based on its intrinsic value computed using an average share price over a specified period of time (or a volume-weighted average price (VWAP)), rather than the spot price of the equity share on the settlement date. Some members of the Working Group expressed the view that a settlement provision based on the difference between the average fair value of a fixed number of the entity's equity shares over a specified time period and a fixed strike price should be considered to comply with the "fixed for fixed" concept. That is, such settlement provisions would not preclude an entity from concluding that the instrument (or embedded feature) is indexed to its own stock.

29. Some Working Group members stated their view that under the settlement approach as described in paragraph 15 above, an instrument (or embedded feature) that either (a) requires the exchange of a variable number of shares that is affected by changes in foreign currency rates or (b) provides for a strike price denominated in a currency other than the entity's functional currency, would not be indexed to the entity's own stock. For instruments and embedded features for which the strike price is denominated in a currency other than the entity's functional currency, the amount to be paid (for a purchased option on the entity's own shares) or received (for a written option or forward sale contract on the entity's own shares) varies based on changes in currency exchange rates and creates a foreign currency exposure for the entity. For such instruments, the strike price is not fixed and a variable affecting the settlement amount (foreign exchange rates) is not an element of time value, so equity classification would be precluded.

Such treatment would be consistent with the guidance in proposed DIG Issue C21, which has been put on hold pending the Task Force's deliberations of this Issue.

30. One Working Group member expressed strong disagreement with any model for which an entity's functional currency would be a consideration when determining whether an instrument or embedded feature is indexed to its own stock. That Working Group member expressed a view that, under a fair value inputs approach, the entity's functional currency would not affect the fair value of an instrument or embedded feature, so it would not impact the determination of whether that instrument or embedded feature is indexed to the entity's own stock. Additionally, that Working Group member expressed a view that the denomination of the currency in which the underlying shares trade, rather than the entity's functional currency, was perhaps a more appropriate factor to consider for purposes of evaluating whether an instrument or embedded feature is indexed to an entity's own stock, as that would influence the exercise behavior of the investor (who would find the issuer's functional currency an irrelevant factor). That Working Group member suggested that if the Task Force continues to pursue the settlement, the Task Force discuss whether an exception to the general principles of that approach should be provided for instruments or embedded features that are exercisable for a fixed amount of a currency other than the entity's functional currency. The Task Force will be asked to consider this suggestion at the November 29, 2007 EITF meeting.

31. The Working Group also discussed certain standard provisions in equity derivative contracts that provide for either (a) modification to the terms of a contract or (b) cancellation and settlement of a contract upon the occurrence of specified events (for example, merger, tender offer, nationalization, insolvency, or delisting). There was some discussion regarding why these terms are included in instruments and how they function in practice. Varying views were expressed regarding whether such terms are consistent with equity classification. The Working Group agreed that an education session led by external working group members representing the International Swaps and Derivatives Association (ISDA) may assist Task Force as it considers these features in its deliberations. **In connection with the deliberations on this Issue (subsequent to the education session), Task Force members will be asked to discuss how**

they would evaluate those standard provisions in equity derivative contracts under View B of Issue 1.

32. The Working Group discussed the application of the proposed model to market-based employee stock option valuation instruments. Some Working Group members expressed a view that such instruments would not be considered indexed to an entity's own stock under the settlement approach as currently drafted. However, other Working Group members expressed a view that instruments designed to provide a market-based measure of the grant-date fair value of equity-classified employee stock options should not be precluded from equity classification. Consequently, the Task Force will be asked to discuss whether it wants to create an exception to the proposed model for purposes of evaluating market-based employee stock option valuation instruments. The Working Group agreed that an education session led by an external working group member that specializes in such instruments, may assist the Task Force in its consideration of such an exception.

Accounting Issues and Alternatives

33. Based on the decisions of the Task Force at the September 11, 2007 EITF meeting and after consideration of the input received from the Working Group members, the Task Force will be asked to discuss the specific aspects of a model for evaluating whether an instrument (or embedded feature) is indexed to an entity's own stocks using the following two-step approach:

Step 1: Evaluate the instrument's contingent exercise provisions, if any.

Step 2: Evaluate the instrument's settlement provisions.

34. The Issues below address the evaluation of settlement provisions for purposes of determining whether an instrument or embedded feature is indexed to an entity's own stock (Step 2 above).

Issue 1: How an entity should evaluate settlement provisions for purposes of determining whether an instrument or embedded feature is indexed to its own stock.

View A: An instrument or embedded feature would be considered indexed to an entity's own stock if its ultimate settlement amount will equal the difference between the fair value (or average fair value over a specified time period) of a fixed number of the entity's equity shares and a fixed strike price. An instrument or embedded feature would not be considered indexed to an entity's own stock if its terms provide for any potential adjustment to either the number of shares or the strike price that is used to determine the settlement amount (regardless of the probability of such adjustment(s)). However, standard antidilution provisions would not preclude an instrument or embedded feature from being indexed to an entity's own stock. Standard antidilution provisions are those that result in adjustments to the strike price in the event of an equity restructuring (as defined in the glossary of FAS 123(R)) that are designed to maintain the value of the instrument or embedded feature.

35. Under View A, a written call option that gives the counterparty a right to buy a fixed number of the entity's shares for a fixed strike price is indexed to the entity's own stock, provided that the strike price is denominated in the entity's functional currency. However, contractual terms (other than standard anti-dilution provisions) that provide for adjustments to either the number of shares to be delivered or the amount of functional-currency-equivalent proceeds to be received at settlement would result in a conclusion that the instrument or embedded feature is not indexed to the entity's own stock. For example, a written call option that gives the counterparty a right to buy a fixed number of the entity's shares for a fixed price and provides for settlement at fair value upon the occurrence of a specified event (for example, merger, tender offer, nationalization, insolvency, or delisting) would **not** be indexed to the entity's own stock under View A. Additionally, an equity forward sale contract that will require the issuance of a fixed number of the entity's shares in exchange for a cash payment based on a strike price that varies with changes in LIBOR over the contract period would **not** be indexed to the entity's own stock under View A.

36. View A proponents are supporters of a narrow view of equity. They believe that provisions providing for an adjustment to the terms of an instrument are often included for protective purposes, to eliminate a counterparty's exposure to significant events that were not foreseeable at

inception of a contract. View A proponents observe that such provisions may benefit the issuer of equity-related financial instruments because the reduced counterparty risk from unforeseen events results in more advantageous pricing. However, notwithstanding the valid business purposes for such protective contract terms, View A proponents believe that those terms are not consistent with an owner relationship and should preclude equity classification. Additionally, View A proponents believe that View A is the least complex alternative because it should be readily apparent as to whether the terms of a contract provide for any potential adjustment to either the number of shares or the strike price that is used to determine the settlement amount.

37. Proponents of View A believe that such guidance would significantly reduce the proportion of equity-related financial instruments that are currently considered indexed to an entity's own stock because many of those instruments contain provisions that would adjust the settlement consideration under certain circumstances. Consequently, those proponents believe that the resulting accounting treatment (a narrow view of equity) under View A makes it the alternative that is most consistent with the FASB Board's position as set forth in the Basic Ownership Approach in the forthcoming liabilities and equity Preliminary Views document. Additionally, those proponents believe that such guidance represents an opportunity to reduce differences between U.S. GAAP and IFRS because View A is similar to the following guidance from paragraph 22 of IAS 32:

> A contract that will be settled by the entity (receiving or) delivering a fixed number of its own equity instruments in exchange for cash or another financial asset is an equity instrument. For example, an issued share option that gives the counterparty a right to buy a fixed number of the entity's shares for a fixed price or for a fixed stated principal amount of a bond is an equity instrument. Changes in the fair value of a contract arising from market interest rates that do not affect the amount of cash or other financial assets to be paid or received, or the number of equity instruments received or delivered, on settlement of the contract do not preclude the contract from being an equity instrument….

38. Opponents agree that View A will result in a very limited number of equity-related financial instruments that are considered indexed to an entity's own stock, based on the provisions of instruments that are currently outstanding in the marketplace. However, those opponents do not support that outcome and believe that such a dramatic change to current practice is best achieved

through the FASB's comprehensive project on liabilities and equity, rather than through this Issue. Those opponents acknowledge that, similar to the Basic Ownership Approach, View A would significantly increase the proportion of equity-related financial instruments that are accounted for at fair value as assets and liabilities (a narrow view of equity). However, those opponents observe that the model in View A is not comparable to the Basic Ownership Approach in the liabilities and equity project. Those opponents also observe that the Board could ultimately decide to pursue an approach other than the Basic Ownership Approach in that project. In addition, opponents of View A observe that while View A is similar to paragraph 22 of IAS 32, there would continue to be fundamental differences between U.S. GAAP and IFRS with respect to equity-related financial instruments. For example, unlike U.S. GAAP, net-share settled instruments would not qualify for equity classification under IAS 32 because they involve a variable number of shares.

View B: Same as View A, except that an instrument or embedded feature for which the number of shares used to calculate the settlement amount, the strike price, or both, may vary would not be indexed to an entity's own stock ***unless the only variables that could affect the settlement amount would be elements of the time value of an option or forward contract on equity shares (for example, interest rates).***

39. Under View B, elements of time value of an option or forward contract on equity shares include interest rates, the issuer's credit standing, dividends and share price volatility (for option contracts and forward contracts with option features, such as caps and floors). A written call option (for example, a warrant) that gives the counterparty a right to buy a fixed number of the entity's shares for a fixed price and provides for settlement at fair value upon the occurrence of a specified event (for example, merger, tender offer, nationalization, insolvency, or delisting) would be indexed to the entity's own stock. Additionally, a convertible bond that (a) gives the counterparty a right to buy a fixed number of the entity's shares in exchange for the reacquisition of the bond upon exercise of the embedded conversion option and (b) contains a "make-whole" provision that provides for adjustments to the conversion rate (that is, to provide additional shares at conversion) for the purpose of reimbursing the investor for lost time value upon the occurrence of certain events would be considered indexed to the entity's own stock. Under View

B, an equity forward sale contract that will require the issuance of a fixed number of the entity's shares in exchange for a cash payment based on a strike price that varies with changes in LIBOR over the contract period would be indexed to the entity's own stock. However, a written call option that gives the counterparty a right to buy a fixed number of the entity's equity shares for a specified price but provides for a reduction to that exercise price if certain operating targets are not met (sometimes referred to as a "penalty warrant") would **not** be indexed to the entity's own stock under View B.

40. View B proponents believe that contractual terms providing for an adjustment to an instrument's settlement amount based on the variables that would affect the time value of any option or forward contract on equity shares should not affect the evaluation of whether an instrument or embedded feature is indexed to an entity's own stock. They observe that such variables are consistent with the pricing of those instruments at inception and would affect the amount an entity would be expected to pay to acquire that instrument from an investor in the marketplace. View B proponents acknowledge that features designed to protect a counterparty in the event that certain events occur are not provided to the holder of an equity share. However, those proponents observe that there is no "time value" associated with an outstanding equity share, so holders of outstanding equity shares are not at risk of losing time value in the first place.

41. Proponents of View B acknowledge that such treatment requires a more in-depth evaluation than View A; however; they believe that such an evaluation will not be overly complex and could be applied in practice. Additionally, View B proponents observe that such treatment is likely to have less of a dramatic effect on practice than View A. They believe that such a dramatic increase in the number of equity-related financial instruments that would be accounted for as assets or liabilities at fair value each period (which would result under View A) should be undertaken in connection with the liabilities and equity project, not this Issue.

42. Opponents agree that while View B will likely result in some changes to current practice, those changes are not expected to be far reaching, fundamental changes to the existing accounting treatment for financial instruments with characteristics of liabilities and equity. View

B opponents have a narrower view of equity in general, so they believe this Issue should require a great deal more equity-related financial instruments to be accounted for as assets and liabilities at fair value.

Issue 2: How an entity should evaluate whether instruments (or embedded features) are indexed to its own stock if (a) the monetary consideration to be exchanged at settlement (that is, the strike price) is not denominated in the entity's functional currency or (b) the shares to be exchanged at settlement are traded only on exchanges (or other established marketplaces) on which trades are not executed in the currency in which the strike price is denominated. <u>This Issue was addressed in proposed DIG Issue C21, which has been put on hold pending the Task Force's deliberations of this Issue.</u>

View A: Apply the guidance in Issue 1. A different approach should not be applied solely for purposes of evaluating whether equity-related financial instruments with foreign currency elements are indexed to an entity's own stock. <u>The analysis of the foreign currency elements under this View is consistent with the analysis of those elements under the tentative guidance in proposed DIG Issue C21. If no consensus is reached on Issue 2, the effect will be the same as a consensus on View A because the overall framework developed in Issue 1 would be applied.</u>

43. Under View A, a written call option that gives the counterparty a right to buy a fixed number of the entity's shares for a fixed price (or for the reacquisition of a bond upon exercise of an embedded conversion option) is indexed to the entity's own stock, provided that the strike price is denominated in the entity's functional currency. The currency in which the underlying equity shares are traded is not relevant to the determination of whether the instrument or embedded feature is indexed to the entity's own stock. However, if the exercise price of a freestanding written call option or the principal amount of a convertible bond is denominated in a currency other than the entity's functional currency, the instrument or embedded feature would **not** be considered indexed to the entity's own stock under View A.

44. View A proponents observe that the issuer of an equity-related financial instrument incurs an economic exposure to changes in currency exchange rates if the instrument's strike price is

denominated in a currency other than its functional currency. Consequently, those proponents believe that when determining whether a strike price is "fixed" for purposes of evaluating an instrument's ultimate settlement amount (Step 2 of the settlement approach), the determination should be based on functional-currency-equivalent cash flows. View A proponents believe that because the scope exception in paragraph 11(a) is only relevant to the reporting entity, the evaluation of how changes in currency exchange rates affect an instrument's settlement amount should be assessed from the perspective of the reporting entity, not the counterparty. Additionally, View A proponents believe that an equity share is not inherently "denominated" in a particular currency, so the currency in which the underlying shares trade is not relevant to the determination of whether an option is indexed to its own stock.

45. View A proponents do not believe that a separate model is necessary for purposes of evaluating equity-related financial instruments with foreign currency elements. Those proponents observe that the objective of this Issue was to develop principles-based guidance for determining whether an instrument (or embedded feature) is indexed to an entity's own stock and believe it would be inconsistent with that objective to require a different model for certain instruments. Additionally, View A proponents believe that this is a less complex alternative than View B because (a) it should be readily apparent as to whether a contract's strike price is denominated in a currency other than the entity's functional currency and (b) it does not impose an incremental model for evaluating certain types of instruments.

View B: For purposes of evaluating whether equity-related financial instruments with foreign currency elements are indexed to an entity's own stock, an instrument or embedded feature that provides for the exchange of a fixed number of the entity's shares for a fixed amount of currency units would be indexed to the entity's own stock, provided that those currency units are denominated in either (a) the entity's functional currency or (b) a currency in which the underlying shares are traded.

46. Under View B, a written call option that gives the counterparty a right to buy a fixed number of the entity's shares for a fixed price is considered indexed to the entity's own stock, provided that the strike price is denominated in (a) the entity's functional currency or (b) a

currency in which the underlying equity shares are traded. Similarly, an embedded conversion option that provides for the issuance of a fixed number of shares upon conversion would be considered indexed to the entity's own stock, provided that the bond is denominated in (a) the entity's functional currency or (b) a currency in which the underlying equity shares are traded. However, if the exercise price of a freestanding written call option or the principal amount of a convertible bond is denominated in a currency other than (a) the entity's functional currency or (b) a currency in which the underlying equity shares are traded, the instrument or embedded feature would **not** be considered indexed to the entity's own stock under View B.

47. Conceptually, View B proponents believe that the currency in which the underlying equity shares are traded is the currency in which the strike price should be denominated for an equity-related financial instrument with foreign currency elements to be considered indexed to an entity's own stock. Those proponents believe that such an approach is more consistent with financial theory (for example, option pricing theory) than View A. For example, View B proponents assert that forward rates for foreign currencies do not affect the fair value of instruments and embedded features with a strike price that is denominated in a currency in which the underlying equity shares are traded. Those proponents also observe that foreign currencies do not affect option exercise behavior relating to instruments for which the strike price is denominated in a currency in which the underlying equity shares are traded. View B proponents focus on whether the counterparty to the instrument has an exposure to currency exchange rates because the counterparty will make the exercise decision for a significant proportion of the instruments affected by this Issue (for example, warrants and convertible debt).

48. Notwithstanding their support for an approach based on the currencies in which the underlying equity shares are traded, View B proponents generally acknowledge that such an approach, which is based on fair value inputs, may be inconsistent with the overall settlement approach that would be applied to other instruments within the scope of this Issue. Consequently, View B proponents would not object to a conclusion that an equity-related financial instrument with foreign currency elements would be considered indexed to an entity's own stock if the instrument provides for the exchange of a fixed number of the entity's shares for

a fixed amount of currency units that are denominated in **either** (a) the entity's functional currency or (b) a currency in which the underlying shares are traded.

Issue 3: Whether an exception to the settlement approach should be developed for purposes of evaluating market-based employee stock option valuation instruments.

49. Market-based employee stock option valuation instruments are generally expected to provide for variable quarterly payments to investors that are determined based on the stock option exercise behavior of multiple employees within the underlying reference pool. Accordingly, such instruments do not appear to provide for a settlement amount that will equal the difference between the fair value (or average fair value over a specified time period) of a fixed number of the entity's equity shares and a fixed strike price. Additionally, certain variables that would affect the settlement amount (for example, employee option exercises in a given period) are not elements of time value. Therefore, such instruments would not appear to be considered indexed to an entity's own stock under the settlement approach. However, a number of Working Group members expressed a view that instruments designed to provide a market-based measure of the grant-date fair value of equity-classified employee stock options should not be precluded from equity classification themselves. Consequently, the Task Force will be asked to discuss whether it wants to create an exception to the proposed model for purposes of evaluating market-based employee stock option valuation instruments.

International Convergence

50. None of the alternative views in this Issue Supplement would converge with IFRS because there is no requirement in IFRS to evaluate whether an instrument is "indexed to the entity's own stock." However, paragraph 22 of IAS 32 contains the following guidance:

> A contract that will be settled by the entity (receiving or) delivering a fixed number of its own equity instruments in exchange for cash or another financial asset is an equity instrument. For example, an issued share option that gives the counterparty a right to buy a fixed number of the entity's shares for a fixed price or for a fixed stated principal amount of a bond is an equity instrument. Changes in the fair value of a contract arising from market interest rates that do not affect the amount of cash or other financial assets to be paid or received, or the number

> of equity instruments received or delivered, on settlement of the contract do not preclude the contract from being an equity instrument…

51. The alternative views in this Issue Supplement that are the most consistent with IAS 32 would be View A on both Issue 1 and Issue 2. However, because of other differences between the requirements for equity classification in U.S. GAAP (Issue 00-19) and IFRS, those views would not necessarily achieve convergence for instruments within the scope of this Issue.

Interaction with Other Board Agenda Projects

52. The objective of the liabilities and equity project is to develop a comprehensive standard of accounting and reporting for financial instruments with characteristics of equity, liabilities, or both, and assets. Such a standard would likely replace existing accounting guidance for financial instruments with those characteristics, including instruments within the scope of this Issue.

53. The liabilities and equity project is being conducted under a modified joint approach with the IASB. Under that approach, the FASB's initial due process document will be in the form of a Preliminary Views, which is expected to be issued by the end of 2007. That document will be concurrently published by the IASB for comment by its constituents. The Boards plan to use the input received on those initial due process documents as the basis for a joint project to develop a common standard of accounting and reporting. In that joint project, the Boards will deliberate and develop a proposed Statement, to be followed by joint redeliberations and development of a common final Statement. A final statement resulting from the liabilities and equity project is not expected to have an effective date any earlier than January 1, 2012, for calendar year-end companies.

54. None of the alternative approaches being considered in that project include an explicit requirement to evaluate whether an instrument or an embedded feature is "indexed to an entity's own stock." However, it is expected that a final statement resulting from the liabilities and equity project would apply to (a) basic ownership instruments (whether or not ownership instruments in legal form), (b) other legal ownership instruments, and (c) any other contract that is either **settled with** basic ownership instruments or **whose settlement may be determined by** prices of basic ownership instruments. That is, the determination of whether certain contracts are

within the scope of a final statement resulting from the liabilities and equity project would require consideration of how the contract is settled. Additionally, under one of the three approaches being considered under that project (the ownership-settlement approach), equity classification would be precluded for an instrument that contains contingent exercise provisions based on (a) an observable market other than the market for the reporting entity's direct ownership instruments or (b) an observable index other than an index calculated or measured solely by reference to the reporting entity's own operations. That proposed treatment under the ownership-settlement approach is consistent with the Task Force's tentative conclusion on Issue 1 at the September 11, 2007 EITF meeting and with the existing guidance in Issue 01-6.

Transition and Effective Date

55. No transition is required with respect to the evaluation of contingent exercise provisions, because the Task Force affirmed the existing consensus in Issue 01-6. However, when evaluating a settlement amount to determine whether an instrument or embedded feature is indexed to an entity's own stock, the FASB staff recommends that a consensus be effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years. Early application would not be permitted.

56. The Task Force will be asked to consider the staff's recommended transition. The transition disclosures in paragraphs 17 and 18 of FAS 154 would be required regardless of the transition method chosen by the Task Force. This transition guidance would not apply to the evaluation of contingent exercise provisions, because the Task Force affirmed the existing consensus in Issue 01-6.

57. The FASB staff recommends that the guidance in this Issue be applied to outstanding instruments as of the beginning of the fiscal year in which this Issue is initially applied. The cumulative effect of the change in accounting principle would be recognized as an adjustment to the opening balance of retained earnings (or other appropriate components of equity or net assets in the statement of financial position) for that fiscal year, presented separately. The cumulative-effect adjustment is the difference between the amounts recognized in the statement of financial position before initial application of this Issue and the amounts recognized in the statement of

financial position at initial application of this Issue. The amounts recognized in the statement of financial position at initial application of this Issue should be determined based on the amounts that would have been recognized if the guidance in this Issue had been applied from the issuance date of the instrument(s).

58. The staff considered retrospective application for a number of reasons including comparability. The FASB's conceptual framework describes comparability (including consistency) as one of the qualitative characteristics of accounting information. The staff also considered the guidance in paragraph B7 of FAS 154, which specifies that "the Board concluded that retrospective application improves financial reporting because it enhances the consistency of financial information between periods. That improved consistency enhances the usefulness of the financial statements, especially by facilitating analysis and understanding of comparative accounting data." However, the staff did not recommend retrospective application because the staff believes that the information needed to retrospectively apply a consensus under this Issue (including inputs to potentially complex option pricing models to determine the quarterly fair values of freestanding financial instruments and embedded features) may not be readily available in all circumstances. Additionally, the staff believes that even if such information were available, it may be difficult to objectively determine the period-specific fair value changes of certain instruments within the scope of this Issue. Finally, the staff believes that retrospective application of a consensus under this Issue may not be cost effective based on the additional data that may be required to recreate the information needed to retrospectively apply a consensus to prior periods.