

**FASB STAFF POSITION**

**No. FAS 150-1**

**Title:** 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*

**Date Posted:** October 16, 2003

1. Q—How does paragraph 11 of Statement 150 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—Paragraph 13 of Statement 150 states that the provisions of the Statement apply to freestanding financial instruments, including those that comprise more than one option or forward contract,<sup>1</sup> and paragraphs 9–12 shall be applied to a freestanding financial instrument in its entirety.<sup>2</sup> Under paragraph 11, 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 paragraph 11, 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 paragraph 11. Unlike the application of paragraph 12, applying paragraph 11 does 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

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<sup>1</sup> 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 Statement 150.

<sup>2</sup> Included in paragraphs 13, A15, and A16 of Statement 150 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. Those paragraphs indicate that Statement 150 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 paragraphs 9–12 of Statement 150. The question at issue is how the requirements of Statement 150 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.

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 paragraph 11. 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 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, paragraph 11 requires 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 paragraph 11. 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, paragraph 11 requires 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 FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*.

2. Q—How does paragraph 12 of Statement 150 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 Statement 150?

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 paragraph 12, and if so, whether those paragraph 12 obligations are predominant relative to other obligations.<sup>3</sup> The analysis can be summarized in two steps:

Step 1: Identify any component obligations that, if freestanding, would be liabilities under paragraph 12 of Statement 150. 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 paragraph 12 of Statement 150 is (collectively) predominant over the (collective) monetary value of other component obligation(s). If so, account for the entire instrument under paragraph 12. If not, the financial instrument is not in the scope of Statement 150 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 paragraph 12(a) of Statement 150. Otherwise, the instrument is not a liability under Statement 150 but is subject to other applicable guidance such as EITF Issue No. 00-19, "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock."<sup>4</sup>

### **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

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<sup>3</sup> 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 Statement 150. Phase 2 of the liabilities and equity project will address such instruments.

<sup>4</sup> Issue 00-19 no longer applies to cash-settled put warrants. Those put warrants are subject to Statement 150 and Question 1 of this FSP. 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. Issue 00-19 continues to apply for share-settleable put warrants that are not liabilities under Statement 150.

that the puttable warrant obligates Company C to issue can vary, and the financial instrument must be examined under paragraph 12 of Statement 150. The facts and circumstances should be considered in judging whether the monetary value of the obligation to issue a number of shares that varies is predominantly based on a fixed monetary amount known at inception; if so, it is a liability under paragraph 12(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 Statement 150 and, therefore, should be classified as a liability. Otherwise, the instrument is subject to other accounting guidance. For example, a puttable warrant not within the scope of Statement 150 is accounted for under Issue 00-19.

#### **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, paragraph 12 of Statement 150 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 Statement 150.

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 paragraph 12 of Statement 150 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 paragraph 12(c) of Statement 150 and would be evaluated under Issue 00-19.

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 paragraph 12 and thus not a liability under Statement 150. 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 (for example, 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 paragraph 12(a) of Statement 150.

#### **Transition**

The guidance in this FSP is effective immediately for freestanding financial instruments issued by entities to which the requirements of Statement 150 have already been applied. The guidance should be applied for other entities as part of the adoption of Statement 150. If this guidance results in changes to previously reported information, the cumulative effect shall be reported according to the provisions of Statement 150 in the first period beginning after the final FSP is posted to the FASB website.