

**APPENDIX F: EITF ISSUE NO. 00-19, “ACCOUNTING FOR
DERIVATIVE FINANCIAL INSTRUMENTS INDEXED TO, AND
POTENTIALLY SETTLED IN, A COMPANY’S OWN STOCK”**

Dates Discussed: November 12–13, 1987; January 19, 1995; March 23, 1995; May 18–19, 1995; July 20–21, 1995; September 20–21, 1995; January 18, 1996; July 18, 1996; September 18–19, 1996; November 14, 1996; January 23, 1997; September 23–24, 1998; November 18–19, 1998; January 21, 1999; March 19–20, 1999; March 16, 2000; July 19–20, 2000; September 20–21, 2000; November 15–16, 2000; January 17–18, 2001; November 14–15, 2001; January 23–24, 2002; March 20–21, 2002

References: FASB Statement No. 3, *Reporting Accounting Changes in Interim Financial Statements*
FASB Statement No. 80, *Accounting for Futures Contracts*
FASB Statement No. 123, *Accounting for Stock-Based Compensation*
FASB Statement No. 128, *Earnings per Share*
FASB Statement No. 129, *Disclosure of Information about Capital Structure*
FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*
FASB Statement No. 137, *Accounting for Derivative Instruments and Hedging Activities—Deferral of the Effective Date of FASB Statement No. 133*
FASB Statement No. 138, *Accounting for Certain Derivative Instruments and Certain Hedging Activities*
FASB Concepts Statement No. 6, *Elements of Financial Statements*
FASB Discussion Memorandum, *Recognition and Measurement of Financial Instruments*, November 18, 1991
APB Opinion No. 9, *Reporting the Results of Operations*
APB Opinion No. 14, *Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants*
APB Opinion No. 20, *Accounting Changes*
APB Opinion No. 21, *Interest on Receivables and Payables*
APB Opinion No. 22, *Disclosure of Accounting Policies*
SEC Accounting Series Release No. 268, *Presentation in Financial Statements of "Redeemable Preferred Stocks"*

ISSUE

1. For a number of business reasons, a company may enter into contracts that are indexed to, and sometimes settled in, its own stock. Examples of these contracts include written put options, written call options (and warrants), purchased put options, purchased call options, forward sale contracts, and forward purchase contracts. These contracts may be settled using a variety of settlement methods, or the issuing company or counterparty may have a choice of settlement methods. The settlement methods are:

- Physical settlement—the party designated in the contract as the buyer delivers the full stated amount of cash to the seller, and the seller delivers the full stated number of shares to the buyer
- Net-share settlement—the party with a loss delivers to the party with a gain shares with a current fair value equal to the gain
- Net-cash settlement—the party with a loss delivers to the party with a gain a cash payment equal to the gain, and no shares are exchanged.

2. The contracts described above may be either freestanding or embedded in another financial instrument. A freestanding contract is entered into separate and apart from any of the company's other financial instruments or equity transactions, or it is entered into in conjunction with some other transaction and is legally detachable and separately exercisable.

3. This Issue applies only to freestanding derivative financial instruments (for example, forward contracts, options, and warrants). This Issue applies to security price guarantees or other financial instruments indexed to, or otherwise based on, the price of the company's stock that are issued in connection with a purchase business combination and that are accounted for as contingent consideration only if those instruments meet the criteria in Issue No. 97-8, "Accounting for Contingent Consideration Issued in a Purchase Business Combination," for recording as part of the cost of the business acquired in a purchase business combination (see discussion of Issue 97-8 in the STATUS section). This Issue does not address the accounting for either the derivative component or the financial instrument when the derivative component is embedded in and not detachable from the financial instrument. This Issue also does not address the accounting for contracts that are issued (a) to compensate employees or (b) to acquire goods or services from nonemployees when performance has not yet occurred. However, this Issue applies to contracts issued to acquire goods or services from nonemployees when performance has occurred. This Issue does not address the accounting for contracts that are indexed to, and potentially settled in, the stock of a consolidated subsidiary (see discussion of Issue No. 00-6, "Accounting for Freestanding Derivative Financial Instruments Indexed to, and Potentially Settled in, the Stock of a Consolidated Subsidiary," and Issue No. 00-4, "Majority Owner's Accounting for a Transaction in the Shares of a Consolidated Subsidiary and a Derivative Indexed to the Minority Interest in That Subsidiary," in the STATUS section).

4. The Task Force observed that, pursuant to paragraphs 11(a) and 12(c) of Statement 133, if an embedded derivative is indexed to the reporting entity's own stock and would be classified in stockholders' equity if it was a freestanding derivative, that embedded derivative is not considered a derivative for purposes of Statement 133. The Task Force reached a consensus that for purposes of evaluating under Statement 133 whether an embedded derivative indexed to a company's own stock would be classified in stockholders' equity if freestanding, the requirements of paragraphs 12–32 of this Issue do not apply if the hybrid contract is a conventional convertible debt instrument in which the holder may only realize the value of the conversion option by exercising the option and receiving the entire proceeds in a fixed number of shares or the equivalent amount of cash (at the discretion of the issuer). However, the Task Force observed that the requirements

of paragraphs 12–32 of this Issue do apply when an issuer is evaluating whether any other embedded derivative instrument is an equity instrument and thereby excluded from the scope of Statement 133.

5. The issue is how freestanding contracts that are indexed to, and potentially settled in, a company's own stock should be classified and measured by the company.

EITF DISCUSSION

A. Framework for Accounting

6. The Task Force discussed the accounting for freestanding contracts that are indexed to, and potentially settled in, a company's own stock and reached several consensuses, as described below. The consensuses in this Issue are to be applied to all freestanding derivative financial instruments that are indexed to, and potentially settled in, a company's own stock; however, nonpublic companies may continue to apply the consensus in Issue No. 88-9, "Put Warrants," to the instruments covered by that Issue. Hereinafter, the framework for accounting that is established in this Issue is referred to as "the Model."

Initial Balance Sheet Classification

7. The initial balance sheet classification of the contracts addressed in this Issue generally is based on the concept that contracts that require net-cash settlement are assets or liabilities and contracts that require settlement in shares are equity instruments. If the contract provides the company with a choice of net-cash settlement or settlement in shares, the Model assumes settlement in shares; if the contract provides the counterparty with a choice of net-cash settlement or settlement in shares, the Model assumes net-cash settlement. However, this Model is not applicable when settlement alternatives do not have the same economic value attached to them or when one of the settlement alternatives is fixed or contains caps or floors. In those situations, the accounting for the instrument (or combination of instruments) should be based on the economic substance of the transaction.¹ However, the Model still applies to contracts that have settlement alternatives with different economic values if the reason for the difference is a limit on the number of shares that must be delivered by the company pursuant to a net-share settlement alternative.

8. Accordingly, unless the economic substance indicates otherwise, contracts would be initially classified as equity or as either assets or liabilities, in the following situations:

¹For example, if a freestanding contract, issued together with another instrument, requires that the company provide to the holder a fixed or guaranteed return such that the instruments are, in substance, debt, the company should account for both instruments as liabilities, regardless of the settlement terms of the freestanding contract. Another example of such an instrument was addressed by the Task Force in Issue No. 98-12, "Application of Issue No. 00-19 to Forward Equity Sales Transactions," which requires that the two specific contracts in question should be combined and accounted for as an equity instrument and accounted for similar to preferred stock.

Equity

- Contracts that require physical settlement or net-share settlement
- Contracts that give the company a choice of net-cash settlement or settlement in its own shares (physical settlement or net-share settlement), assuming that all the criteria set forth in paragraphs 12–32 have been met.

Assets or liabilities

- Contracts that require net-cash settlement (including a requirement to net cash settle the contract if an event occurs and if that event is outside the control of the company)
- Contracts that give the counterparty a choice of net-cash settlement or settlement in shares (physical settlement or net-share settlement).

Initial Measurement and Subsequent Balance Sheet Classification and Measurement

9. The Model requires that all contracts be initially measured at fair value and subsequently accounted for based on the current classification and the assumed or required settlement method in paragraph 7, above.² Contracts that are initially classified as equity are accounted for in permanent equity as long as those contracts continue to be classified as equity. If physical settlement is assumed or required and the company is obligated to deliver cash as part of the physical settlement,³ then public companies should refer to ASR 268, which provides guidance by analogy for those transactions, and account for the transactions as provided below under "Equity instruments—temporary equity."

Equity instruments—permanent equity

- Contracts that require that the company deliver shares as part of a physical settlement or a net-share settlement should be initially measured at fair value and reported in permanent equity. Subsequent changes in fair value should not be recognized as long as the contracts continue to be classified as equity.
- Contracts that give the company a choice of (a) net-cash settlement or settlement in shares (including net-share settlement and physical settlement that requires that the company deliver shares) or (b) either net-share settlement or physical settlement that requires that the company deliver cash should be initially measured at fair value and reported in permanent equity. (See discussion in paragraphs 12–32 for additional conditions that must be met to classify a contract as equity.) Subsequent changes in fair value should not be recognized as long as the contracts remain classified as equity. If such contracts are ultimately settled in a manner that requires that the company deliver cash, the amount of cash paid or received should be reported as a reduction of, or an addition to, contributed capital.

²For contracts that are classified as equity instruments that provide the company with a choice of either net-share settlement or physical settlement that may require that the company deliver cash, net-share settlement should be assumed. For contracts that are classified as equity instruments that provide the counterparty with a choice of either net-share settlement or physical settlement that may require that the company deliver cash, physical settlement should be assumed.

³For example, if the company sells put options indexed to its own stock that enable the holder to sell shares back to the company at the strike price.

Equity instruments—temporary equity⁴

- For public companies, contracts that (a) require that the company deliver cash as part of a physical settlement, (b) give the company a choice of either net-cash settlement or physical settlement that requires that the company deliver cash, or (c) give the counterparty a choice of either net-share settlement or physical settlement that requires that the company deliver cash should be initially measured at fair value and reported in permanent equity, and an amount equal to the cash redemption amount under the physical settlement should be transferred to temporary equity. (See discussion in paragraphs 12–32 for additional conditions that must be met to classify a contract as temporary equity.)

Assets or liabilities

- All other contracts are classified as assets or liabilities and should be measured at fair value, with changes in fair value reported in earnings and disclosed in the financial statements as long as the contracts remain classified as assets or liabilities. If contracts classified as assets or liabilities are ultimately settled in shares, any gains or losses on those contracts should continue to be included in earnings.

Reclassification of Contracts

10. The classification of a contract should be reassessed at each balance sheet date. If the classification required under this Issue changes as a result of events during the period (if, for example, as a result of voluntary issuances of stock the number of authorized but unissued shares is insufficient to satisfy the maximum number of shares that could be required to net-share settle the contract—see discussion in paragraph 19, below), the contract should be reclassified as of the date of the event that caused the reclassification. There is no limit on the number of times a contract may be reclassified. If a contract is reclassified from permanent or temporary equity to an asset or a liability, the change in fair value of the contract during the period the contract was classified as equity should be accounted for as an adjustment to stockholders' equity. The contract subsequently should be marked to fair value through earnings. If a contract is reclassified from an asset or a liability to equity, gains or losses recorded to account for the contract at fair value during the period that the contract was classified as an asset or a liability should not be reversed.

11. If a contract permits partial net-share settlement and the total notional amount of the contract no longer can be classified as permanent equity, any portion of the contract that could be net-share settled as of that balance sheet date would remain classified in permanent equity (that is, a portion of the contract could be classified as permanent equity and a portion of the contract could be classified as an asset, a liability, or temporary equity, as appropriate). If a company has more than one contract subject to this Issue, and partial reclassification is required, there may be different methods that could be used to determine which contracts, or portions of contracts, should be reclassified. The Task Force observed that methods that would comply with this consensus could include (a) partial reclassification of all contracts on a proportionate basis, (b) reclassification of

⁴Classification and measurement in temporary equity is required for public companies. ASR 268 provides guidance by analogy for transactions classified as temporary equity.

contracts with the earliest inception date first, (c) reclassification of contracts with the earliest maturity date first, (d) reclassification of contracts with the latest inception or maturity date first, and (e) reclassification of contracts with the latest maturity date first. The method of reclassification must be systematic, rational, and consistently applied.

Additional Conditions Necessary for Equity Classification

12. Contracts that include *any* provision that could require net-cash settlement cannot be accounted for as equity of the company (that is, asset or liability classification is required for those contracts), except in those limited circumstances in which holders of the underlying shares also would receive cash (see discussion in the last sentence of this paragraph and in paragraph 27, below). Similarly, for SEC registrants, equity derivative contracts with any provision that could require physical settlement by a cash payment to the counterparty in exchange for the company's shares cannot be accounted for as permanent equity (that is, temporary equity classification under ASR 268 would be required unless net-cash settlement can be imposed on the company, in which case, the contract would be classified as an asset or a liability). Those conclusions do not allow for an evaluation of the likelihood that an event would trigger cash settlement (whether net cash or physical), except that if the payment of cash is only required upon the final liquidation of the company, then that potential outcome need not be considered when applying the consensuses in this Issue.

13. Because any contract provision that could require net-cash settlement precludes accounting for a contract as equity of the company (except for those circumstances in which the holders of the underlying shares would receive cash, as discussed in paragraphs 27 and 28), all of the following conditions must be met for a contract to be classified as equity:

The contract permits the company to settle in unregistered shares.

14. The events or actions necessary to deliver registered shares are not controlled by a company and, therefore, except under the circumstances described in paragraph 18, below, if the contract permits the company to net-share or physically settle the contract only by delivering registered shares, it is assumed that the company will be required to net-cash settle the contract. As a result, the contract must be classified as an asset or a liability. Delivery of unregistered shares in a private placement to the counterparty is within the control of a company, as long as a failed registration statement (that is, a registration statement that was filed with the SEC and subsequently withdrawn) has not occurred within six months prior to the classification assessment date. If a failed registration statement has occurred within six months of the classification assessment date, whether a company can deliver unregistered shares to the counterparty in a net-share or physical settlement is a legal determination. Accordingly, assuming (a) a failed registration statement does not preclude delivery of unregistered shares, (b) the contract permits a company to net-share settle the contract by delivery of unregistered shares, and (c) the other conditions in this Issue are met, the contract should be classified as a permanent equity instrument.

15. A contract may specify that the value of the unregistered shares to be privately placed under share settlement is to be determined by the counterparty using "commercially reasonable means." That valuation is used to determine the number of unregistered shares that must be delivered to the counterparty. The term *commercially reasonable means* is sufficiently objective from a legal perspective to prevent a counterparty from producing an unrealistic value that would then compel a company to net-cash settle the contract. Similarly, a contractual requirement to determine the fair value of unregistered shares by obtaining market quotations is sufficiently objective and would not suggest that the settlement alternatives have different economic values.

16. If a settlement alternative includes a penalty that would be avoided by a company under other settlement alternatives, the uneconomic settlement alternative should be disregarded in classifying the contract. In the case of delivery of unregistered shares, a discount from the value of the corresponding registered shares that is a reasonable estimate of the difference in fair values between registered and unregistered shares (that is, the discount reflects the fair value of the restricted shares determined using commercially reasonable means) is not considered a penalty.

17. The Task Force observed that if (a) a derivative contract requires physical or net-share settlement by delivery of registered shares and does not specify any circumstances under which net-cash settlement would be permitted or required and (b) the contract does not specify how the contract would be settled in the event that the company is unable to deliver registered shares, then net-cash settlement is assumed if the company is unable to deliver registered shares (because it is unlikely that nonperformance would be an acceptable alternative). Consequently, the derivative must be classified as an asset or a liability (subject to the transition guidance in this Issue) because share settlement is not within the company's control.

18. The Task Force reached a consensus that if a derivative involves the delivery of shares at settlement that are registered as of the inception of the derivative transaction and there are no further timely filing or registration requirements, the requirement of Issue 00-19 that share delivery be within the control of the company is met, notwithstanding the Task Force's consensus in paragraph 14, above.

The company has sufficient authorized and unissued shares available to settle the contract after considering all other commitments that may require the issuance of stock during the maximum period the derivative contract could remain outstanding.

19. If a company could be required to obtain shareholder approval to increase the company's authorized shares in order to net-share or physically settle a contract, share settlement is not controlled by the company. Accordingly, a company must evaluate whether a sufficient number of authorized and unissued shares exists at the classification assessment date to control settlement by delivering shares. In that evaluation, a company must compare (a) the number of currently authorized but unissued shares, less the maximum number of shares that could be required to be delivered during the contract period under existing commitments (for example, outstanding convertible debt that is convertible during the contract period, outstanding stock options that are or will become

exercisable during the contract period, or other derivative financial instruments indexed to, and potentially settled in, a company's own stock⁵) with (b) the maximum number of shares that could be required to be delivered under share settlement (either net-share or physical) of the contract.⁶ If the amount in (a) exceeds the amount in (b) and the other conditions in this Issue are met, share settlement is within the control of the company and the contract should be classified as a permanent equity instrument. Otherwise, share settlement is not within the control of the company and asset or liability classification is required.

The contract contains an explicit limit on the number of shares to be delivered in a share settlement.

20. For certain contracts, the number of shares that could be required to be delivered upon net-share settlement is essentially indeterminate. For example, assume that a company writes a put option to a counterparty that permits the counterparty to sell 100,000 of the company's shares to the company at \$100 per share. The contract permits the company to net-share settle the contract. If the market price of the company's shares falls to \$1 as of the settlement date, the company would be required to deliver 9,900,000 shares. If the market price of the shares falls to \$0.125, the company would be required to deliver 79,900,000 shares. If the number of shares that could be required to be delivered to net-share settle the contract is indeterminate, a company will be unable to conclude that it has sufficient available authorized and unissued shares and, therefore, net-share settlement is not within the control of the company.

21. If a contract limits or caps the number of shares to be delivered upon expiration of the contract to a fixed number, that fixed maximum number can be compared to the available authorized and unissued shares (the available number after considering the maximum number of shares that could be required to be delivered during the contract period under existing commitments as addressed in paragraph 19 of this Issue and including top-off or make-whole provisions as discussed in paragraph 26 of this Issue) to determine if net-share settlement is within the control of the company. A contract termination trigger alone (for example, a provision that requires that the contract will be terminated and settled if the stock price falls below a specified price) would not satisfy this requirement because, in that circumstance, the maximum number of shares deliverable under the contract is not known with certainty unless there is a stated maximum number of shares.

22. The Task Force discussed a proposed contract structure that would include a cap on the number of shares that must be delivered upon net share settlement but would also

⁵For purposes of this calculation, if a contract permits both (a) net-share and (b) physical settlement by delivery of shares at the company's option (both alternatives would permit equity classification if the other conditions of this Issue are met), the alternative that results in the lesser number of maximum shares should be included in this calculation. If a contract is classified as either an asset or a liability because the counterparty has the option to require settlement of the contract in cash, then the maximum number of shares that the counterparty could require to be delivered upon settlement of the contract (whether physical or net share) should be assumed for purposes of this calculation.

⁶See footnote 5.

provide that any contract valued in excess of that capped amount may be delivered to the counterparty in cash or by delivery of shares (at the company's option) when authorized, unissued shares become available. The proposed structure would require the company to use its best efforts to authorize sufficient shares to satisfy the obligation. It is assumed that under the proposed structure, the number of shares specified in the cap is less than the company's authorized, unissued shares less the number of shares that are part of other commitments (see paragraph 19, above).

23. The Task Force concluded that use of the company's best efforts to obtain sufficient authorized shares to settle the contract is within the company's control. Accordingly, the Task Force reached a consensus that if the contract provides that the number of shares required to settle the excess obligation is fixed on the date that net-share settlement of the contract occurs, the excess shares need not be considered when determining whether the company has sufficient, authorized, unissued shares to net-share settle the contract pursuant to paragraph 19, above. However, the contract may provide that the number of shares that must be delivered to settle the excess obligation is equal to a dollar amount that is fixed on the date of net share settlement (which may or may not increase based on a stated interest rate on the obligation) and that the number of shares to be delivered will be based on the market value of the stock at the date the excess amount is settled. In that case, the excess obligation represents stock-settled debt and would preclude equity classification of the contract (or, if partial net-share settlement is permitted under the contract pursuant to paragraph 11, above, would preclude equity classification of the portion represented by the excess obligation).

24. As discussed in paragraphs 50–54, a company may have existing derivative contracts as of September 20, 2000, that are not subject to the consensus in paragraphs 10–32 of this Issue until June 30, 2001 (if they remain outstanding at that date), and that do not have a limit on the number of shares that could be delivered in a net-share settlement. Therefore, the number of shares that could be delivered under those derivative contracts in a net-share settlement is essentially indeterminate. The Task Force observed that if one of those contracts is outstanding at the date the company enters into a new contract subject to this Issue, the company could be precluded from concluding that it has sufficient shares authorized and unissued to net-share settle the new contract as a result of the absence of a cap in the preexisting contract. The Task Force reached a consensus that, until June 30, 2001, contracts outstanding as of the date of the consensus in paragraphs 10–32 (September 20, 2000) that do not include a cap should be deemed to have a cap equal to the number of shares that would be required to net-share settle the contract on September 20, 2000, as if the contract matured on that date. That deemed cap is the number of shares that should be considered in determining whether there are sufficient authorized, unissued shares to permit net-share or physical settlement of new contracts entered into after September 20, 2000. If on June 30, 2001, those preexisting contracts remain outstanding, the deemed cap no longer applies. After that date, if the absence of the deemed cap causes share settlement of contracts to be outside the control of the company, those preexisting contracts and any new contracts entered into after September 20, 2000 that were classified as equity instruments must be reclassified to assets or liabilities on June 30, 2001. Refer to the transition discussion in paragraph 50 for guidance on how the reclassification should be accounted for.

There are no required cash payments to the counterparty in the event the company fails to make timely filings with the SEC.

25. The Task Force reached a consensus that the ability to make timely SEC filings is not within the control of the company. Accordingly, if a contract permits share settlement but requires net-cash settlement in the event that the company does not make timely filings with the SEC, that contract must be classified as an asset or a liability.

There are no required cash payments to the counterparty if the shares initially delivered upon settlement are subsequently sold by the counterparty and the sales proceeds are insufficient to provide the counterparty with full return of the amount due (that is, there are no cash settled "top-off" or "make-whole" provisions).

26. Some contracts include top-off or make-whole provisions. While the exact terms of such provisions vary, they generally are intended to reimburse the counterparty for any losses it incurs or to transfer to the company any gains the counterparty recognizes on the difference between the settlement date value and the value received by the counterparty in subsequent sales of the securities within a specified time after the settlement date. If such a provision can be net-share settled and the maximum number of shares that could be required to be delivered under the contract (including "top-off" or "make-whole" provisions) is fixed and less than the number of available authorized shares (authorized and unissued shares less the maximum number of shares that could be required to be delivered during the contract period under existing commitments as discussed in paragraph 19, above), a top-off or make-whole provision would not preclude equity classification. If those conditions are not met, equity classification would be precluded.

The contract requires net-cash settlement only in specific circumstances in which holders of shares underlying the contract also would receive cash in exchange for their shares.

27. Generally, if an event that is not within the company's control could require net-cash settlement, then the contract must be classified as an asset or a liability. However, if the net-cash settlement requirement can only be triggered in circumstances in which the holders of the shares underlying the contract also would receive cash, equity classification would not be precluded. For example, an event that causes a change in control of a company is not within the company's control and, therefore, if a contract requires net-cash settlement upon a change in control, the contract generally must be classified as an asset or a liability. However, if a change-in-control provision requires that the counterparty receive, or permits the counterparty to deliver upon settlement, the same form of consideration (for example, cash, debt, or other assets) as holders of the shares underlying the contract, permanent equity classification would not be precluded as a result of the change-in-control provision. In that case, if the holders of the shares underlying the contract were to receive cash in the transaction causing the change in control, the counterparty to the contract could also receive cash based on the value of its position under the contract. If instead of cash, holders of the shares underlying the contract receive other forms of consideration (for example, debt), the counterparty also must receive debt (cash in an amount equal to the fair value of the debt would not be considered the same

form of consideration as debt). Similarly, a change-in-control provision could specify that if all stockholders receive stock of an acquiring company upon a change in control, the contract will be indexed to the shares of the purchaser (or issuer in a business combination accounted for as a pooling of interests) specified in the business combination agreement, without affecting classification of the contract.

28. The Task Force was advised that, in the event of nationalization, cash compensation would be the consideration for the expropriated assets and, as a result, a counterparty to the contract could receive only cash, as is the case for a holder of the stock underlying the contract. Because the contract counterparty would receive the same form of consideration as a stockholder, a contract provision requiring net-cash settlement in the event of nationalization does not preclude equity classification of the contract.

There are no provisions in the contract that indicate that the counterparty has rights that rank higher than those of a shareholder of the stock underlying the contract.

29. To be classified as equity, a contract cannot give the counterparty any of the rights of a creditor in the event of the company's bankruptcy. Because a breach of the contract by the company is within its control, the fact that the counterparty would have normal contract remedies in the event of such a breach does not preclude equity classification.

30. As a result of the requirement described in the preceding paragraph, a contract cannot be classified as equity if the counterparty's claim in bankruptcy would receive higher priority than the claims of the holders of the stock underlying the contract. The Task Force was advised that, generally, based on existing law, a net-share settled derivative that a company has a right to settle in shares even upon termination could be net-share settled in bankruptcy. The Task Force also was advised that if the contract is not net-share settled, the claim of the counterparty would not have priority over those of the holders of the underlying stock, even if the contract specified cash settlement in the event of bankruptcy. The Task Force was advised that in federal bankruptcy proceedings, a debtor cannot be compelled to affirm an existing contract that would require it to pay cash to acquire its shares (which could be the case, for example, with a physically settled forward purchase or written put). As a result, even if the contract requires that the company (debtor) pay cash to settle the contract, the company could not be required to do so in bankruptcy.

31. Because of the complexity of federal bankruptcy law and related case law, and because of the differences in state laws affecting derivative contracts, it is not possible to address all of the legal issues associated with the status of the contract and the claims of the counterparty in the event of bankruptcy. A contract provision requiring net-cash settlement in the event of bankruptcy would not preclude equity classification if it can be demonstrated that, notwithstanding the contract provisions, the counterparty's claims in bankruptcy proceedings in respect of the company could be net-share settled or would rank no higher than the claims of the holders of the stock underlying the contract. Determination of the status of a claim in bankruptcy is a legal determination.

There is no requirement in the contract to post collateral at any point or for any reason.

32. A requirement to post collateral of any kind (other than the company's shares underlying the contract, but limited to the maximum number of shares that could be delivered under the contract) under any circumstances is inconsistent with the concept of equity and, therefore, would preclude equity classification of the contract.

B. Hedging

33. The SEC Observer stated that the SEC staff has consistently held the position that hedge accounting is not permitted for transactions involving the contracts within the scope of this Issue that are classified as equity because those transactions have not met all the criteria of Statement 80. The SEC staff also believes that hedge accounting for transactions involving those contracts is inconsistent with paragraph 28 of Opinion 9. (See discussion of Statement 133 in the STATUS section.)

34. Because of the SEC staff's position, the Task Force decided to end its discussion of whether the contracts described above can qualify for hedge accounting.

C. Application of the Model to Specific Instruments

35. The following reflects the application of the Model, described in Section A, above, to certain freestanding derivative financial instruments that are indexed to, and potentially settled in, a company's own stock.

Written Put Options⁷ and Forward Purchase Contracts

Description

36. The company (the buyer) agrees to buy from the seller shares at a specified price at some future date. The contract may be settled by physical settlement, net-share settlement, or net-cash settlement, or the issuing company or the counterparty may have a choice of settlement methods.⁸

Consensus

37. The Model would be applied as follows:

⁷Includes shareholder rights (SHARP rights) issued by the company to shareholders that give the shareholders the right to put a specified number of common shares to the company for cash.

⁸Application of the Model to purchased call options is discussed in paragraph 41.

	<u>One Settlement Method</u>			<u>Company Choice</u>			<u>Counterparty Choice</u>		
	<u>Physi- cal (a)</u>	<u>Net Share</u>	<u>Net Cash</u>	<u>Net Share or Physi- cal (a)</u>	<u>Net Share or Net Cash</u>	<u>Net Cash or Physi- cal (a)</u>	<u>Net Share or Physi- cal (a)</u>	<u>Net Share or Net Cash</u>	<u>Net Cash or Physi- cal (a)</u>
(1) Initial Classification:									
Equity (b)	x	x		x	x	x	x		
Asset/Liability			x					x	x
(2) Initial Measurement, Subsequent Classification, and Measurement:									
Fair value, permanent equity—no changes in fair value (b)		x		x(c)	x(c)				
Fair value, transfer to temporary equity an amount equal to cash redemption amount (b) (d)	x					x(e)	x(e)		
Fair value, asset/liability—adjusted for changes in fair value (f)			x					x(g)	x(g)

- (a) Physical settlement of the contract requires that the company deliver cash to the holder in exchange for the shares.
- (b) Equity or temporary equity classification is only appropriate if the conditions in paragraphs 12–32 do not require asset or liability classification of the contract.
- (c) If the contracts are ultimately physically settled by the company, requiring that the company deliver cash, or are ultimately settled in net cash, the amount of cash paid or received should be reported as a reduction of, or as an addition to, contributed capital.
- (d) Classification and measurement guidance within temporary equity applies only to public companies.
- (e) If the contracts are ultimately settled in net cash or net shares, the amount reported in temporary equity should be transferred and reported as an addition to permanent equity.
- (f) Subsequent changes in fair value should be reported in earnings and disclosed in the financial statements.
- (g) If the contracts are ultimately settled in shares, any gains or losses on those contracts should continue to be included in earnings.

Note: In all cases above, the contracts must be reassessed at each reporting period in order to determine whether or not the contract must be reclassified.

Forward Sale Contracts, Written Call Options or Warrants, and Purchased Put Options

Description

38. The issuing company (the seller) agrees to sell shares of its stock to the buyer of the contract at a specified price at some future date. The contract may be settled by physical settlement, net-share settlement, or net-cash settlement, or the issuing company or counterparty may have a choice of settlement methods.

Consensus

39. The Model would be applied as follows:

	<u>One Settlement Method</u>			<u>Company Choice</u>			<u>Counterparty Choice</u>		
	<u>Physical (a)</u>	<u>Net Share</u>	<u>Net Cash</u>	<u>Net Share or Physical (a)</u>	<u>Net Share or Cash</u>	<u>Net Cash or Physical (a)</u>	<u>Net Share or Physical (a)</u>	<u>Net Share or Net Cash</u>	<u>Net Cash or Physical (a)</u>
(1) Initial Classification:									
Equity (b)	x	x		x	x	x	x		
Asset/Liability			x					x	x
(2) Initial Measurement, Subsequent Classification, and Measurement:									
Fair value, permanent equity—no changes in fair value (b)	x	x		x	x(c)	x(c)	x		
Fair value, asset/liability—adjusted for changes in fair value (d)			x					x (e)	x(e)

- (a) Physical settlement of the contract requires that the company deliver shares to the holder in exchange for cash.
- (b) Equity classification is only appropriate if the conditions in paragraphs 12–32 do not require asset or liability classification of the contract.
- (c) If the contracts are ultimately settled in net cash, the amount of cash paid or received should be reported as a reduction of, or an addition to, contributed capital.
- (d) Subsequent changes in fair value should be reported in earnings and disclosed in the financial statements.
- (e) If the contracts are ultimately settled in shares, any gains or losses on those contracts should continue to be included in earnings.

Note: In all cases above, the contracts must be reassessed at each reporting period in order to determine whether or not the contract must be reclassified.

Purchased Call Options

Description

40. The company (the buyer) purchases call options that provide it with the right, but not the obligation, to buy from the seller, shares of the company's stock at a specified price. If the options are exercised, the contract may be settled by physical settlement, net-share settlement, or net-cash settlement, or the issuing company or the counterparty may have a choice of settlement methods.

Consensus

41. The company should follow the table included in the "Forward Sale Contracts, Written Call Options or Warrants, and Purchased Put Options" section, above, in accounting for the call options.

Detachable Stock Purchase Warrants

Description

42. An enterprise issues senior subordinated notes with a detachable warrant that gives the holder both the right to purchase 6,250 shares of the enterprise's stock for \$75 per

share and the right (that is, a put) to require that the enterprise repurchase all or any portion of the warrant for at least \$2,010 per share at a date several months after the maturity of the notes in about 7 years.

Consensus

43. The proceeds should be allocated between the debt liability and the warrant based on their relative fair values, and the resulting discount should be amortized in accordance with Opinion 21. The warrants should be considered, in substance, debt and accounted for as a liability because the settlement alternatives for the warrants do not have the same economic value attached to them and they provide the holder with a guaranteed return in cash that is significantly in excess of the value of the share-settlement alternative on the issuance date.

Put Warrants

Description

44. Put warrants are instruments with characteristics of both warrants and put options. The holder of the instrument is entitled to exercise (a) the warrant feature to acquire the common stock of the company at a specified price, (b) the put option feature to put the instrument back to the company for a cash payment, or, in some cases, (c) both the warrant feature to acquire the common stock and the put option feature to put that stock back to the company for a cash payment. Put warrants are frequently issued concurrently with debt securities of the company, are detachable from the debt, and may be exercisable only under specified conditions. The put feature of the instrument may expire under varying circumstances, for example, with the passage of time or if the company has a public stock offering. Under Opinion 14, a portion of the proceeds from the issuance of debt with detachable warrants must be allocated to those warrants.

Consensus

45. Because the contract gives the counterparty the choice of cash settlement or settlement in shares, public companies should report the proceeds from the issuance of put warrants as liabilities and subsequently measure the put warrants at fair value with changes in fair value reported in earnings. Nonpublic companies may continue to classify and measure the put warrants in accordance with the consensus in Issue 88-9.

D. Multiple Settlement Alternatives

46. The Task Force reached a consensus that a contract indexed to, and potentially settled in, a company's own stock, with multiple settlement alternatives that require the company to receive net cash when the contract is in a gain position but pay (a) net stock or (b) either net cash or net stock at the company's option when the contract is in a loss position should be accounted for as an equity instrument. The Task Force observed that the consensus does not apply to a contract that is predominantly a purchased option in which the amount of cash that could be received when the contract is in a gain position is significantly larger than the amount that could be paid when the contract is in a loss

position because, for example, there is a small contractual limit on the amount of the loss. Those contracts should be accounted for as assets or liabilities.

47. The Task Force also reached a consensus that a contract indexed to, and potentially settled in, a company's own stock, with multiple settlement alternatives that require the company to pay net cash when the contract is in a loss position but receive (a) net stock or (b) either net cash or net stock at the company's option when the contract is in a gain position should be accounted for as an asset or a liability.

E. Earnings per Share

48. In computing diluted earnings per share (EPS), Statement 128 requires use of the reverse treasury stock method to account for the dilutive effect of written put options and similar contracts that are "in the money" during the reporting period. Under that method, the incremental number of shares is computed as (a) the number of shares that would need to be issued for cash at the average market price during the period to obtain cash to satisfy the put obligation less (b) the number of shares received from satisfying the put. Statement 128 states that purchased options should not be reflected in the computation of diluted EPS because to do so would be antidilutive.

49. At the July 23 and November 18–19, 1998 meetings, an FASB staff representative made an announcement (Topic No. D-72, "Effect of Contracts That May Be Settled in Stock or Cash on the Computation of Diluted Earnings per Share") that for those contracts that provide the company with a choice of settlement methods, the company should assume that the contract will be settled in shares. That presumption may be overcome if past experience or a stated policy provides a reasonable basis to believe that it is probable that the contract will be paid partially or wholly in cash. For contracts in which the counterparty controls the means of settlement, past experience or a stated policy is not determinative. Accordingly, in those situations, the more dilutive of cash or share settlement should be used.

F. Disclosures

50. At the March 20–21, 2002 meeting, the Task Force reached a consensus that the disclosures required by Statement 129 apply to *all* contracts within the scope of this Issue as follows:

- In the case of an option or forward contract indexed to the issuer's equity, the pertinent information to be disclosed about the contract includes the forward rate, the option strike price, the number of issuer's shares to which the contract is indexed, the settlement date or dates of the contract, and the issuer's accounting for the contract (that is, as an asset, liability, or equity).
- If the terms of the contract provide settlement alternatives, those settlement alternatives should be disclosed, including who controls the settlement alternatives and

the maximum number of shares that *could be required to be issued*⁹ to net share settle a contract, if applicable. If a contract does not have a fixed or determinable maximum number of shares that may be required to be issued, the fact that a potentially infinite number of shares could be required to be issued to settle the contract should be disclosed.

- A contract's current fair value for each settlement alternative (denominated, as relevant, in monetary amounts or quantities of shares) and how changes in the price of the issuer's equity instruments affect those settlement amounts (for example, the issuer is obligated to issue an additional x shares or pay an additional y dollars in cash for each \$1 decrease in stock price) should also be disclosed¹⁰
- The disclosures required by paragraph 8 of Statement 129 should be made for any equity instrument in the scope of this Issue that is (or would be if the issuer were a public company) classified as temporary equity.¹¹

51. Some contracts that are classified as assets or liabilities meet the definition of a derivative instrument under the provisions of Statement 133. The disclosures that are required by paragraphs 44 and 45 of Statement 133 also are required for those contracts.

52. Contracts within the scope of this Issue may be reclassified into (or out of) equity during the life of the instrument (in whole or in part) pursuant to the provisions of paragraphs 10 and 11 of this Issue. The Task Force reached a consensus that an issuer should disclose contract reclassifications (including partial reclassifications), the reason for the reclassification, and the impact on the issuer's financial statements. The determination of how to partially reclassify contracts subject to this Issue is an accounting policy decision that must be disclosed pursuant to Opinion 22.

G. Transition

53. The Task Force reached a consensus that the guidance in paragraphs 10–32 is effective for all new contracts and contract modifications entered into after September 20, 2000. For contracts that exist on September 20, 2000, the consensus in those paragraphs should be applied on June 30, 2001, to those contracts that remain outstanding at June 30, 2001, based on the contract terms then in place (see additional discussion of pre-consensus contracts in paragraph 24). The effect of the application of the consensus in paragraphs 10–32 that require asset or liability classification for those contracts that existed as of September 20, 2000, would be calculated as of June 30, 2001, and presented on that date in a manner similar to a cumulative effect of a change in accounting principle as described in paragraph 20 of Opinion 20 (the pro forma disclosures described in paragraph 21 of Opinion 20 are not required). The requirement in paragraph 10 of Statement 3 that a cumulative effect of a change in accounting principles be applied and reported in the first quarter of a fiscal year does not apply to a change to adopt the

⁹Paragraph 5 of Statement 129 requires additional disclosures for actual issuances and settlements that occurred during the accounting period.

¹⁰For some issuers, a tabular format may provide the most concise and informative presentation of these data.

¹¹Paragraph 8 of Statement 129 applies to redeemable stock issued by nonpublic companies, regardless of whether the private company chooses to classify those securities as temporary equity.

consensuses. If new contracts entered into after September 20, 2000, that were classified as equity instruments must be reclassified to assets or liabilities on June 30, 2001 as a result of eliminating the deemed cap on preexisting contracts pursuant to paragraph 24 of this Issue, the effect of that reclassification should be accounted for as an adjustment to stockholders' equity on June 30, 2001. Prior periods would not be restated. The SEC Observer noted that registrants would be required to provide the disclosures required by SAB 74 for the financial statements filed prior to the period in which this change is adopted.

54. The Task Force reached a consensus that derivative instruments entered into with more than one counterparty in a single offering prior to September 20, 2000, and not modified on or after September 20, 2000, are not subject to the consensuses described in paragraphs 10–32, above (although those contracts are subject to the consensuses in Issue 96-13 that have been codified in paragraphs 1–9 and 33–49, above). Further, for those derivative contracts, the deemed cap described in paragraph 24, above, would apply to the contract until its maturity or modification in assessing whether the company controls the delivery of shares for other contracts.

55. The SEC Observer indicated that derivative instruments indexed to, and potentially settled in, a company's own stock are subject to ASR 268. Derivative contracts that were issued prior to September 20, 2000, and that would be classified as permanent equity under the previous consensuses in Issue 96-13 (described in paragraphs 1–9 and 33–44, above), but would be classified as asset, liability, or temporary equity contracts under the consensuses in Issues 00-7 and 00-19 (described in paragraphs 10–32, above) had these consensuses been applied as of December 31, 2000, should be classified as temporary equity as of December 31, 2000.

56. The SEC Observer also indicated that derivative instruments sold to more than one counterparty in a single offering prior to September 20, 2000, that (a) are not subject to the additional consensuses in Issues 00-19 or 00-7 as described in paragraphs 10–32, above, because of the guidance in paragraph 51, above, (b) do not contain any provisions that could contractually require either net cash settlement or physical settlement by delivery of cash by the issuer (that is, according to the terms of the contract, the issuer always has the option to settle the contract either through delivery of net shares or delivery of shares under physical settlement), and (c) were appropriately classified as permanent equity under the consensuses in Issue 96-13 (described in paragraphs 1–9 and 33–44, above), may continue to be classified as permanent equity after September 20, 2000.

57. The SEC Observer also stated that ASR 268 requires that to the extent conditions exist whereby holders may demand cash in exchange for their securities, the issuer must reflect the maximum possible cash obligation related to those securities outside of permanent equity. If the maximum amount that could be required to settle the contract is not known because it is contingent on the market value of the underlying security, then the amount to be classified outside of permanent equity should be calculated based on the market price of the underlying security as of the balance sheet date.

STATUS

58. At the July 23–24, 1997 meeting, the Task Force addressed the accounting for contingent consideration issued to effect a purchase business combination in Issue No. 97-8, "Accounting for Contingent Consideration Issued in a Purchase Business Combination." The Task Force observed that Issue 00-19 should be applied to freestanding contracts that are indexed to, and potentially settled in, a company's own stock if those instruments meet the criteria in Issue 97-8 for recording as part of the cost of the business acquired in a purchase business combination.

59. A related issue was discussed in Issue No. 98-12, "Application of Issue No. 96-13 to Forward Equity Sales Transactions" (now titled "Application of Issue No. 00-19 to Forward Equity Sales Transactions"). Issue 98-12 deals with the accounting and earnings per share treatment of situations in which a freestanding derivative instrument (a forward contract) that is indexed to, and potentially settled in, a company's own stock is issued concurrent with the issuance of shares of the company's stock. Issue 98-12 is limited to situations in which the party to whom the common stock was sold is also the counterparty to the forward contract.

60. Another related issue was discussed in Issue No. 99-1, "Accounting for Debt Convertible into the Stock of a Consolidated Subsidiary." Issue 99-1 deals with the accounting in the consolidated financial statements for debt issued by a consolidated subsidiary or a parent company that is convertible into the stock of a consolidated subsidiary.

61. The Task Force discussed another related issue in Issue No. 99-7, "Accounting for an Accelerated Share Repurchase Program." Issue 99-7 addresses the accounting for, and pooling-of-interests implications of, purchasing treasury stock and simultaneously entering into a forward contract indexed to the company's own shares.

62. A related issue was discussed in Issue No. 00-4, "Majority Owner's Accounting for a Transaction in the Shares of a Consolidated Subsidiary and a Derivative Indexed to the Minority Interest in That Subsidiary." Issue 00-4 addresses how a controlling majority owner should account for a derivative contract that is indexed to the subsidiary's equity shares in which the counterparty owns the minority interest in the consolidated subsidiary.

63. The Task Force discussed another related issue in Issue No. 00-6, "Accounting for Freestanding Derivative Financial Instruments Indexed to, and Potentially Settled in, the Stock of a Consolidated Subsidiary." Issue 00-6 addresses how freestanding derivative instruments entered into by a parent company that are indexed to, and potentially settled in, the stock of a consolidated subsidiary should be classified and measured in the consolidated financial statements.

64. Statement 133 was issued in June 1998 and was amended by Statements 137 and 138. The effective date for Statement 133, as amended, is for all fiscal quarters of all fiscal years beginning after June 15, 2000.

65. If the company classified the contract in stockholder's equity, then paragraph 11(a) of Statement 133 would exclude it from the definition of a derivative, and the guidance in Issue 00-19 would apply. Under Statement 133, an instrument classified as temporary equity under this Issue is considered to be classified in stockholder's equity for purposes of paragraph 11(a)(2). (Refer to Statement 133 Implementation Issue No. C2, "Application of the Exception to Contracts Classified in Temporary Equity.")

66. If the company classified the contract as an asset or a liability, and the contract is within the scope of Statement 133 (as described in paragraphs 6–11 of Statement 133), Statement 133 applies and requires the issuer to recognize the contract as an asset or a liability (derivative) measured at fair value. The accounting for changes in fair value depends on the reason for holding the derivative and whether it has been designated and qualifies as part of a hedging relationship.

67. Under Statement 133, which supersedes Statement 80, an entity may not designate its own equity instruments that are reported in stockholders' equity as the hedged item or the hedging instrument. However, derivative contracts that are indexed to a company's own stock and recorded as assets or liabilities can be hedging instruments. (Refer to Statement 133 Implementation Issue No. G1, "Hedging an SAR Obligation.")

68. The comment in paragraph 3 of Issue 00-19 that states that it does not "address the accounting for either the derivative component or the financial instrument when the derivative component is embedded in and not detachable from the financial instrument," does not negate the applicability of Issue 00-19 (as further discussed in paragraph 4 of Issue 00-19) in analyzing the embedded feature under paragraph 12(c) of Statement 133 as though it were a freestanding instrument.

69. No further EITF discussion is planned.