NO. 213-B ? OCTOBER 27, 2000

Financial Accounting Series

EXPOSURE DRAFT

Proposed Statement of Financial Accounting Standards

Accounting for Financial Instruments with Characteristics of Liabilities, Equity, or Both

This Exposure Draft of a proposed Statement of Financial Accounting Standards is issued by the Board for public comment. Written comments should be addressed to:

Director of Research and Technical Activities
File Reference No. 213-B

Comment Deadline: March 31, 2001

Financial Accounting Standards Board
of the Financial Accounting Foundation

Any individual or organization may obtain one copy of this Exposure Draft without charge until March 31, 2001, on written request only. *Please ask for our Product Code No. E158.* For information on applicable prices for additional copies and copies requested after March 31, 2001, contact:

Order Department
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401 Merritt 7
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This Exposure Draft also is available on the FASB web site at www.fasb.org until March 31, 2001.

To be timely, comments should be postmarked by March 31, 2001. Comments also can be submitted by electronic mail to director@fasb.org. Respondents submitting comments by electronic mail should clearly identify themselves and the organization they represent.

Financial Accounting Standards Board
of the Financial Accounting Foundation
401 MERRITT 7, P.O. BOX 5116, NORWALK, CONNECTICUT 06856-5116

Notice for Recipients of This Exposure Draft

This proposed Statement would establish standards for accounting for financial instruments with characteristics of liabilities, equity, or both. It also would establish standards for certain issues related to accounting for the noncontrolling interest in a consolidated subsidiary. In addition, it would provide guidance on the accounting for costs incurred to issue a financial instrument that has liability or equity characteristics and on the accounting for repayments and conversions of convertible debt.

The Board invites comments on all matters in this proposed Statement and particularly on the following specific issues. Respondents need not comment on all of the issues and are encouraged to comment on additional issues. It would be helpful if comments respond to the issues as stated, include any alternatives the Board should consider, and explain the reasons for the position taken.

Scope

Issue 1: Certain financial instruments that have characteristics of liabilities, equity, or both also contain components that, if freestanding, would be assets. The Board decided not to address separation of asset components in this proposed Statement. Separate recognition of those components might be required by other authoritative pronouncements. Is the Board's decision not to address separation of asset components appropriate? If so, why? If not, why not?

Paragraphs 219–221 discuss the basis for the Board's conclusion.

Initial Classification

Issue 2: This proposed Statement would require that the issuer of a compound financial instrument separate that instrument into its liability components and its equity components if certain conditions are met. (That requirement would supersede APB Opinion No. 14, *Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants.*)

a. Is the requirement to separate a compound financial instrument into its liability components and its equity components appropriate? If so, why? If not, why not?
b. Does this proposed Statement provide enough guidance for determining when and how a compound financial instrument should be separated into components? If not, what additional guidance would be helpful?
c. What implementation issues can be expected to arise as a result of the requirement to separate a compound financial instrument into its components?

Paragraphs 149–161 discuss the basis for the Board's conclusion.

Issue 3: One of the three essential characteristics of a liability discussed in paragraph 36 of FASB Concepts Statement No. 6, *Elements of Financial Statements,* is that "it embodies a present duty or responsibility to one or more other entities that entails settlement by probable future *transfer or use of assets* at a specified or determinable date, on occurrence of a specified event, or on demand" (emphasis added). This proposed Statement would require liability classification for certain obligations that require or permit settlement by issuance of a reporting entity's equity shares (and, thus, do not require future transfer or use of the entity's assets).

Under the provisions of this proposed Statement, only those financial instrument components that establish an ownership relationship would be classified as equity. A component is deemed to establish an ownership relationship if it (1) is an outstanding equity share not subject to redemption provisions or (2) is an obligation that a reporting entity can or must settle by issuance of the issuer's equity shares and, to the extent the monetary value of the obligation changes, the change is attributable to, equal to, and in the same direction as the change in fair value of the issuer's equity shares.

a. Do you agree with the Board's conclusion that certain obligations that permit or require settlement by issuance of the reporting entity's equity shares should be classified as liabilities?
b. Do you agree with the Board's conclusion that a financial instrument component that does not establish an ownership relationship should not be classified as equity?
c. Do you believe that the Board has made an appropriate distinction between equity-settled obligations that should be classified as equity and equity-settled obligations that should be classified as liabilities?

If so, why? If not, why not?

Paragraphs 164–194 discuss the basis for the Board's conclusions.

Issue 4: Under the approach in this proposed Statement, any financial instrument that is issued in the form of shares that are subject to mandatory redemption provisions (that is, subject to redemption upon a specified date or upon the occurrence of an event that is certain to occur) are classified as liabilities. That would include shares issued by some privately held companies that require that the shares be resold to the issuer upon the holder's termination of its ownership position (whether by selling the shares or by death). That conclusion would reduce (and in some cases eliminate) the equity of some privately held entities. (Alternatively, a privately held entity's shares may be puttable to the issuer at the fair value of the shares at the date the put option is exercised. Paragraph 63 addresses stock that is puttable at its fair value.) Are there other factors that the Board should consider regarding the applicability of its conclusion on shares subject to mandatory redemption provisions to privately held entities that issue that type of security?

Initial Measurement

Issue 5: If a financial instrument has multiple settlement alternatives and the monetary values of those settlement alternatives have the potential to differ, this proposed Statement would require that the settlement alternatives be considered separate components of a compound financial instrument. For purposes of initial measurement of those components, the following general rules would apply:

a. If a compound financial instrument has no component that is an outstanding share of stock, the obligation that is classified as a liability should be considered an unconditional obligation and the obligation that is classified as equity should be considered a conditional obligation.
b. If a compound financial instrument has a component that is an outstanding share of stock (other than mandatorily redeemable stock), the instrument should be considered to comprise (1) an outstanding share of stock and (2) a conditional obligation.

Do you agree with the Board's conclusions? Are there circumstances in which those general rules would result in initial measurement of components that you consider inappropriate? If so, what are those circumstances?

Paragraphs 195–208 discuss the basis for the Board's conclusion.

Issue 6: This proposed Statement would require that the issuer of a compound financial instrument allocate the proceeds of issuance of that instrument to its separately classified liability components and equity components using the relative-fair-value method. That requirement would apply in all circumstances except when (a) the instrument contains a component that is a derivative subject to the requirements of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities,* or (b) application of the relative-fair-value method is impracticable because the fair value of one or more components cannot be reliably determined. Is the requirement to use the relative-fair-value method appropriate? If not, why not? Are there other circumstances in which that method should not be required?

Paragraphs 209–218 discuss the basis for the Board's conclusion.

Classification and Presentation of the Noncontrolling Interest in a Consolidated Subsidiary

Issue 7: This proposed Statement would require that an equity instrument that is issued by a consolidated subsidiary of the reporting entity and that represents the noncontrolling interest in that subsidiary be reported in the consolidated financial statements as a separate component of equity. Do you agree with the Board's conclusion that the noncontrolling interest is part of the equity of the consolidated entity? If not, why not? What implementation issues can be expected to arise as a result of that decision?

Paragraphs 226–233 discuss the basis for the Board's conclusion.

Issue 8: In accordance with the Board's conclusion that shares of a consolidated subsidiary that represent the noncontrolling interest are equity of the consolidated entity, sales of those shares to entities outside the consolidated group would be considered equity transactions. Accordingly, no gain or loss would be recognized on those sales as long as the subsidiary remains consolidated. Do you agree with the Board's conclusion related to recognition of gain or loss on sales of subsidiary shares? If so, why? If not, why not?

Paragraphs 234–236 discuss the basis for the Board's conclusion.

Issue 9: For an entity with one or more less-than-wholly-owned subsidiaries, this proposed Statement would require that amounts displayed as line items in the income statement and amounts displayed as components of other comprehensive income include amounts attributable to both the controlling interest and the noncontrolling interest. An entity with one or more less-than-wholly-owned subsidiaries would be required to disclose the amounts attributable to the controlling interest for the following items if they appear in the financial statements:

?? Income from continuing operations
?? Discontinued operations
?? Extraordinary items
?? Cumulative effect of changes in accounting principle
?? Net income or net loss
?? Total comprehensive income
?? Each component of other comprehensive income.

An entity with one or more less-than-wholly-owned subsidiaries that displays comprehensive income and its components in a statement of changes in equity would be required to display aggregate amounts and amounts attributable to the controlling interest and the noncontrolling interest for each component of comprehensive income. Do you agree with the Board's conclusions related to presentation and disclosure requirements for an entity with one or more less-than-wholly-owned subsidiaries?

Paragraphs 237–239 discuss the basis for the Board's conclusions.

Issue 10: This proposed Statement would require that an entity that presents earnings-per-share information in accordance with FASB Statement No. 128, *Earnings per Share,* present on the face of the income statement a total for adjustments to net income (or net loss) or to net income (or net loss) attributable to the controlling interest to arrive at the numerator for the calculation of basic earnings per share. Do you agree with the requirement to present that total on the face of the income statement?

Paragraphs 240 and 241 discuss the basis for the Board's conclusion.

Disclosures

Issue 11: The disclosure requirements of this proposed Statement are included in paragraph 45. Do you agree with those requirements? If not, what disclosure requirements would you omit or add?

Paragraphs 242–247 discuss the basis for the Board's conclusion.

Effective Date and Transition

Issue 12: This proposed Statement would require that in the initial year of adoption an entity restate all financial statements for earlier years presented for the effects of financial instruments within the scope of this Statement that were outstanding at any time during the initial year of adoption. An entity would be permitted, but not required, to restate all financial statements presented for the effects of financial instruments that were not outstanding at any time during the initial year of adoption. An entity that elects to restate for those financial instruments would be required to restate all financial statements presented for the effects of all financial instruments within the scope of this Statement that were outstanding in any period presented, beginning with the earliest year presented. The cumulative effect of adopting this proposed Statement would be required to be included in the earliest year restated.

This proposed Statement also would require that an entity whose consolidated financial statements include one or more less-than-wholly-owned subsidiaries at any time during the initial year of adoption restate all financial statements presented for earlier years that include those subsidiaries to classify the noncontrolling interest as equity. The entity also would be required to restate all financial statements presented for the effects of any gains or losses on any sales of a subsidiary's shares that were not accounted for in accordance with paragraphs 37 and 38 of this Statement. An entity would be permitted but not required to restate all financial statements presented for the classification of the noncontrolling interest and any gains or losses recognized on sales of a subsidiary's shares for the noncontrolling interest that did not exist at any time during the initial year of adoption. An entity that elects to restate for those noncontrolling interests and associated gains and losses would be required to restate all financial statements presented for the effects of all noncontrolling interests that existed and all those gains and losses that were recognized in any period presented, beginning with the earliest year presented. This proposed Statement would not require that an entity recognize a cumulative effect for gains or losses on sales of a subsidiary's shares in periods that are not restated.

Would another transition method be more appropriate? If so, what method and why?

Paragraphs 248–255 discuss the basis for the Board's conclusion.

Public Hearings

Issue 13: The Board has not yet determined whether there is a need for a public hearing or other forum. The Board will assess that need based on comment letters received. Any respondent that wishes to participate in such a meeting, if one is held, should indicate a desire to do so.

Impact of Proposed Statement on Consensuses of the Emerging Issues Task Force

This proposed Statement would impact consensuses that have been reached by the Emerging Issues Task Force (EITF) in various ways. An analysis of the impact of this proposed Statement on EITF consensuses is available on the FASB website at www.fasb.org.

Summary

This proposed Statement would establish standards for issuers' classification in the statement of financial position of financial instruments with characteristics of liabilities, equity, or both. It would require that an issuer classify liability components and equity components of a financial instrument separately. This proposed Statement would prohibit the presentation of items between the liabilities section and the equity section of the statement of financial position.

This proposed Statement reflects the Board's decision to revise the definition of liabilities in FASB Concepts Statement No. 6, *Elements of Financial Statements*, to include certain obligations that a reporting entity can or must settle by issuing its equity shares. That amendment is proposed in an FASB Exposure Draft, *Proposed Amendment to FASB Concepts Statement No. 6 to Revise the Definition of Liabilities*, that is being issued concurrently with this proposed Statement.

This proposed Statement would require that an issuer of a financial instrument classify the components of that instrument as liabilities or as equity as follows:

a. A financial instrument component that represents an outstanding share of stock of the issuer that does not embody an obligation on the part of the issuer would be classified as equity.
b. A financial instrument component that embodies an obligation that requires (or permits at the issuer's discretion) settlement by issuance of equity shares would be classified as equity if it is deemed to establish an ownership relationship between the issuer and the holder. A component that embodies an obligation establishes an ownership relationship if a reporting entity can or must settle the obligation by issuing its equity shares and, to the extent that the monetary value of the obligation changes, the change is attributable to, equal to, and in the same direction as the change in fair value of the issuer's equity shares.
c. All other financial instrument components embodying obligations would be classified as liabilities.

The Board believes that separate balance sheet presentation of liability components and equity components of compound instruments more faithfully represents the rights and obligations embedded in those instruments than does presenting those components on a combined basis entirely as liabilities or entirely as equity.

With certain exceptions, this proposed Statement would require that proceeds received from issuance of a compound financial instrument be allocated to its components based on the relative fair values of those components.

This proposed Statement would require that a gain or loss, if any, on the liability component of convertible debt be recognized in earnings when the debt is extinguished by repayment or by conversion.

This proposed Statement would require that the noncontrolling interest in a consolidated subsidiary be displayed in the consolidated statement of financial position as a separate component of equity because it meets the definition of equity of the consolidated entity. It also would require that sales of a subsidiary's shares to entities outside the consolidated group be considered equity transactions of the reporting entity as long as that subsidiary remains consolidated. Therefore, no gain or loss would be recognized on those sales. For a sale of a subsidiary's shares that results in the subsidiary's no longer being consolidated, a gain or loss would be recognized for the difference between the proceeds of that sale and the carrying amount of the interest sold in that transaction.

This proposed Statement would require that an entity with one or more less-than-wholly-owned subsidiaries include amounts attributable to both the controlling interest and the noncontrolling interest in all amounts displayed as line items in the consolidated income statement and amounts displayed as components of other comprehensive income. An entity with one or more less-than-wholly-owned subsidiaries would be required to disclose amounts attributable to the controlling interest for the following items:

?? Income from continuing operations
?? Discontinued operations
?? Extraordinary items
?? Cumulative effect of changes in accounting principle
?? Net income
?? Total comprehensive income
?? Each component of other comprehensive income.

An entity that displays comprehensive income and its components in a statement of changes in equity would be required to display aggregate amounts and amounts attributable to the controlling interest and the noncontrolling interest for total comprehensive income and for each component of other comprehensive income.

An entity that presents earnings-per-share information in accordance with FASB Statement No. 128, *Earnings per Share,* would be required to present on the face of the income statement a total for adjustment to net income (or net loss), or, for an entity with one or more less-than-wholly-owned subsidiaries, to net income (or net loss) attributable to the controlling interest to arrive at the numerator for the calculation of basic earnings per share.

This proposed Statement would be effective for fiscal years beginning after June 15, 2002. Earlier application would be permitted. Initial application of this proposed Statement would be as of the beginning of an entity's fiscal year. In the initial year of adoption, an entity would be required to restate all financial statements for earlier years presented for the effects of financial instruments within the scope of this Statement that were outstanding at any time during the initial year of adoption. An entity would be permitted, but would not be required, to restate all financial statements presented for the effects of financial instruments that were not outstanding at any time during the initial year of adoption. However, if an entity elects to restate for those financial instruments, it would be required to restate all financial statements presented for the effects of all financial instruments within the scope of this Statement that were outstanding in any period presented, beginning with the earliest year presented. The cumulative effect of adopting this proposed Statement would be required to be included in the earliest year restated.

An entity whose consolidated financial statements include one or more less-than-wholly-owned subsidiaries at any time during the initial year of adoption would be required to restate all financial statements presented for earlier years that include those subsidiaries to classify the noncontrolling interest as equity. The entity also would be required to restate all financial statements presented for the effects of any gains or losses on any sales of those subsidiary shares that were not accounted for in accordance with paragraphs 36 and 37 of this proposed Statement. An entity would be permitted but not required to restate all financial statements presented for the classification of the noncontrolling interest and any gains or losses recognized on sales of a subsidiary's shares for the noncontrolling interest that did not exist at any time during the initial year of adoption. An entity that elects to restate for those noncontrolling interests and associated gains and losses would be required to restate all financial statements presented for the effects of all noncontrolling interests that existed and all gains and losses that were recognized in any period presented, beginning with the earliest year presented. This proposed Statement would not require recognition of a cumulative effect for gains or losses on sales of a subsidiary's shares recognized in periods that are not restated.

Proposed Statement of Financial Accounting Standards

Accounting for Financial Instruments with Characteristics of Liabilities, Equity, or Both

October 27, 2000

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Proposed Statement of Financial Accounting Standards

Accounting for Financial Instruments with Characteristics of Liabilities, Equity, or Both

October 27, 2000

INTRODUCTION

1. This Statement was developed in response to concerns expressed by preparers, auditors, regulators, and others about issuers' classification in the statement of financial position of certain financial instruments that (a) have characteristics of liabilities but in practice are presented either entirely as equity or between the liabilities section and the equity section of the statement of financial position, (b) have characteristics of equity but in practice are presented between the liabilities section and the equity section of the statement of financial position, or (c) have characteristics of both liabilities and equity but in practice are classified either entirely as liabilities or entirely as equity. This Statement also addresses questions about the classification of certain financial instruments containing an **obligation**[1] to issue equity shares.

Financial Instruments with Characteristics of Liabilities, Equity, or Both

2. This Statement addresses the classification by issuers of financial instruments that have characteristics of liabilities, equity, or both.[2] It requires that an issuer classify a financial instrument component according to its liability or equity characteristics.

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[1]Terms defined in Appendix E, the glossary, are set in **boldface type** the first time they appear.

[2]Certain of those financial instruments may contain components that, if accounted for separately, would be classified as assets. As discussed in paragraph 30, this Statement does not require the separate presentation of asset components.

3. In August 1990, as part of its financial instruments project, the Board issued an FASB Discussion Memorandum, *Distinguishing between Liability and Equity Instruments and Accounting for Instruments with Characteristics of Both.* That Discussion Memorandum introduced a "fundamental financial instrument" approach as an alternative approach to recognition and measurement of financial instruments. That approach was based on the premise that all financial instruments are constructed from a set of six fundamental financial instruments.[3] Each fundamental financial instrument is considered to be a separate component for purposes of this Statement. Some financial instruments comprise only one component. Compound financial instruments comprise two or more components.

4. The approach to determining classification in this Statement focuses on (a) whether a financial instrument component imposes an obligation on the issuer of the financial instrument, (b) whether the obligation is required to be settled by a transfer[4] of assets or by issuance of the issuer's equity shares, and (c) whether the nature of the relationship between the issuer and the holder of the financial instrument that is established by the financial instrument component is deemed to be an ownership relationship. For purposes of this Statement, a financial instrument component that embodies an obligation that does

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[3]As indicated in paragraph 40 of the 1990 Discussion Memorandum, those six fundamental financial instruments are unconditional receivable-payable contracts, conditional receivable-payable contracts, financial option contracts, financial guarantees or other conditional exchange contracts, financial forward contracts, and equity instruments.

[4]The term *transfer* is used in this Statement in a broad sense consistent with its use in FASB Concepts Statement No. 6, *Elements of Financial Statements*, rather than in the narrow sense in which it is used in FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (a replacement of Statement 125). The use of the term in this Statement does not change the meaning of the term as it is used in Statement 140.

not require the issuer to transfer assets in settlement of that obligation establishes an ownership relationship if, to the extent the **monetary value** of the obligation changes, those changes are attributable to, equal to, and in the same direction as changes in the **fair value** of the issuer's equity shares.

5. Because the existence of an obligation is a key factor in determining whether a financial instrument component should be classified as a liability or as equity, an understanding of the use of the term *obligation* is fundamental to an understanding of the requirements of this Statement. The term obligation is used in this Statement to refer to a duty or responsibility on the part of the issuer either to transfer assets or to issue shares of its own equity. For example, an entity that issues debt has an obligation to transfer assets (generally cash) to repay the debt. In contrast, an entity that issues shares of stock (including preferred stock) generally is not required either to redeem the shares or to pay dividends[5] and has no duty or responsibility to transfer assets or to issue additional equity shares. Therefore, issuance of stock generally does not impose an obligation on the issuer.[6]

6. The term *monetary value* as it is used in this Statement describes the amount of value that would have to be conveyed to the holder of a financial instrument component upon settlement of an obligation at its maturity assuming no changes to current market conditions. For example, the monetary value of a component that embodies an obligation

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[5]Unless specific contractual terms provide otherwise, an entity generally is not obligated to pay dividends until those dividends are declared. Cumulative dividend provisions and stated dividend rates, absent a declaration, are not sufficient to conclude that an obligation exists.

[6]Certain instruments issued in the form of stock do embody obligations of the issuer to transfer assets or issue additional shares. For example, shares that are mandatorily redeemable obligate the issuer to transfer assets to redeem the shares.

that requires settlement by transfer of $100,000 is fixed at $100,000 even if the fair value of that component changes. Similarly, the monetary value of a component that embodies an obligation that requires settlement by issuance of $100,000 worth of equity shares is also fixed at $100,000 even if the fair value of the underlying shares changes. The monetary value of a component that embodies an obligation that requires settlement by issuance of a fixed number of equity shares changes with the fair value of the underlying shares and is equal to the current fair value of the shares multiplied by the number of shares to be issued. For example, assuming that the current fair value of the issuing entity's shares is $10, the monetary value of a component that embodies an obligation that requires settlement by issuance of 10,000 equity shares is $100,000. If the fair value of the shares later increases to $11, the monetary value would increase to $110,000.

7. The following fundamental principles underlie the requirements of this Statement:

a. A financial instrument component that does not impose an obligation on the issuer should not be classified as a liability.
b. A financial instrument component that imposes an obligation on the issuer should be classified based on the nature of the relationship it establishes between the holder and the issuer.

Noncontrolling Interests

8. This Statement also provides guidance on the following issues that arise for an entity with one or more less-than-wholly-owned subsidiaries:

a. Presentation of equity held by the **noncontrolling interest**[7] in the consolidated statement of financial position
b. Presentation of the noncontrolling interest's share of net income or loss in the consolidated income statement
c. Display in the consolidated financial statements of components of other comprehensive income
d. Accounting in the consolidated financial statements for sales of a subsidiary's shares by members of the consolidated group to entities outside the consolidated entity.

[7]Noncontrolling interests are sometimes referred to as minority interests in practice.

Other

9. This Statement also provides guidance on the presentation of adjustments to net income or net loss (or to net income or net loss attributable to the controlling interest) to arrive at the numerator for basic earnings per share.

Amendments to Concepts Statement 6

10. The conclusions in this Statement reflect the Board's decision to revise the definition of liabilities in FASB Concepts Statement No. 6, *Elements of Financial Statements,* to clarify its application to certain financial instruments and components of financial instruments. Before Concepts Statement 6 was amended, the definition of a liability was not met unless an entity had a present obligation to transfer its assets or provide services in the future as a result of past transactions or events. Under that definition, obligations that required or permitted an entity to settle the obligation by issuing shares of its own equity but that did not establish an ownership relationship were not considered liabilities. As a result, if an entity was required or permitted to settle an obligation by issuing its own equity shares, that obligation did not meet the definition of a liability, regardless of its other characteristics.

11. Concurrent with the issuance of this Statement, the Board is issuing a separate amendment to Concepts Statement 6, *Amendment to FASB Concepts Statement No. 6 to Revise the Definition of Liabilities,* to revise the definition of liabilities to include certain obligations that a reporting entity can or must settle by issuing its own equity shares.

Appendixes

12. Appendix A to this Statement provides implementation guidance on the application of this Statement to financial instrument components that have liability characteristics and equity characteristics and is an integral part of the standards provided in this Statement. It also provides examples that illustrate the application of this Statement to specific types of financial instruments. Appendix B provides an illustration of the presentation and certain disclosures of entities that have less-than-wholly-owned subsidiaries. Appendix C provides background information and the basis for the Board's conclusions. Appendix D provides amendments to existing accounting pronouncements. Appendix E provides a glossary of terms as used in this Statement. Appendix F provides an index of references to specific financial instruments and financial instrument components occurring in this Statement.

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

Scope

13. Except as discussed in paragraph 14, this Statement applies to issuers' classification of financial instrument components[8] that have characteristics of liabilities, equity, or both.[9] It applies to both single- and multiple-component financial instruments (compound financial instruments), and provides guidance on the classification and measurement of

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[8]For purposes of this Statement, the terms *financial instrument component* and *component* encompass all single-component financial instruments, including freestanding options and equity shares that do not embody obligations. Additionally, a compound financial instrument may contain more than one liability component or more than one equity component. For convenience, this Statement uses the singular term *component* rather than the term *one (or more) component(s)*.

[9]The scope of this Statement is limited to financial instruments. However, the amendment to the definition of liabilities in Concepts Statement 6 also applies to nonfinancial liabilities.

the components of those financial instruments. This Statement also provides guidance on the accounting for costs incurred to issue a financial instrument that has characteristics of liabilities, equity, or both and on the accounting for extinguishments and conversions of convertible debt. In addition, it addresses certain issues related to the reporting of the noncontrolling interest in a consolidated subsidiary.

14. The requirements of this Statement do not affect the timing of recognition of financial instruments (or components thereof) issued as contingent consideration in a business combination. The accounting for business combinations is addressed in APB Opinion No. 16, *Business Combinations*. However, upon recognition of a financial instrument issued as contingent consideration in a business combination, the components of that instrument shall be classified pursuant to the requirements of this Statement.

15. This Statement does not change the basic expense recognition criteria for stock compensation arrangements. For example, it does not change the determination of whether an award accounted for under APB Opinion No. 25, *Accounting for Stock Issued to Employees,* is fixed or variable, and it does not change the measurement method for awards accounted for under either Opinion 25 or FASB Statement No. 123, *Accounting for Stock-Based Compensation*. However, this Statement may affect the balance sheet classification of the financial instrument components of those arrangements. That, in turn, may affect the total amount of expense recognized for certain, relatively uncommon, awards under the fair value method. Under that method, accounting for an award after the grant date depends on whether the award results in a liability or an equity instrument (or perhaps both, if the award results in a compound instrument under this Statement).

16. Certain compound financial instruments that have characteristics of liabilities, equity, or both also contain components that, if freestanding, would be classified as assets. Paragraph 30 discusses the treatment of those instruments.

Initial Classification—Basic Principles

17. An entity that issues a financial instrument shall classify the components of that instrument as follows:

a. A financial instrument component that is an outstanding share of stock of the issuer and that does not embody an obligation on the part of the issuer shall be classified as equity.
b. A financial instrument component that embodies an obligation on the part of the issuer shall be classified as a liability unless it satisfies the criteria in (c) below.
c. A financial instrument component that embodies an obligation shall be classified as equity if either of the following criteria is met:
   (1) The obligation requires (or permits at the issuer's discretion) settlement by issuance of a fixed number of the issuer's equity shares.
   (2) The obligation requires (or permits at the issuer's discretion) settlement by issuance of a variable number of the issuer's equity shares and both of the following conditions are met:
      (a) Any change in the obligation's monetary value is attributable to and equal to the change in fair value of a fixed number of the issuer's equity shares.[10]
      (b) The monetary value of the obligation changes in the same direction as the change in the fair value of the underlying equity shares.

18. Items shall not be presented between the liabilities section and the equity section of the statement of financial position.

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[10]For certain obligations that require or permit settlement by issuance of a variable number of the issuer's equity shares, the change in the monetary value of the obligation is equal to the change in the fair value of a fixed number of equity shares multiplied by a specified factor. Those obligations meet the condition in paragraph 17(c)(2)(a) if both the factor and the referenced number of shares are fixed. For example, an issuer may be required to settle an obligation by issuing shares with a value equal to three times the appreciation in the fair value of 1,000 equity shares. That obligation is considered to be the same as an obligation that requires settlement by issuance of shares equal to the appreciation in the fair value of 3,000 equity shares.

Components that have an exercise price satisfy the condition in paragraph 17(c)(2)(a) if any change in the obligation's monetary value is equal to the change in the fair value of a fixed number of the issuer's equity shares above that exercise price.

19. The term *issuer's equity shares* includes other forms of ownership interests that may not take the legal form of securities (for example, partnership interests).[11] For purposes of applying the provisions of paragraph 17 to financial instruments issued by members of a consolidated group of entities, the term issuer's equity shares refers to the equity shares of any entity whose financial statements are included in the consolidated financial statements.

20. A compound financial instrument that contains (a) one or more components that would be classified as equity if freestanding and (b) one or more components that would be classified as liabilities if freestanding shall be separated into its equity components and its liability components. Except as required by the embedded derivatives provisions of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities,* all liability components of a single compound financial instrument may be presented as a single liability. Additionally, all equity components of the same class may be presented as a single equity item.

Obligations with Different Settlement Alternatives

21. Many financial instruments that embody obligations specify whether the issuer is required to settle those obligations by transferring assets or by issuing its equity shares.

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[11]Other entities with proprietary or ownership interests in a business enterprise are commonly known by specialized names, such as stockholders, partners, and proprietors, and by more general names, such as investors, but all are encompassed by the descriptive term owners. Equity of business enterprises is thus commonly known by several names, such as owners' equity, stockholders' equity, ownership, equity capital, partners' capital, and proprietorship. Some enterprises (for example, mutual organizations) do not have stockholders, partners, or proprietors in the usual sense of those terms but do have participants whose interests are essentially ownership interests, residual interests, or both.

For example, many debt instruments require settlement by a transfer of cash. Certain other financial instruments, however, provide for more than one settlement alternative (transfer of assets or issuance of equity shares). For example, an entity that issues convertible debt will be required to settle the obligation either by transferring assets or by issuing equity shares, depending on whether the holder exercises its conversion option. Another example is a financial instrument that embodies an obligation that requires settlement by transfer of assets unless a specified event beyond the control of both the issuer and the holder occurs, in which case the issuer is required to issue shares to settle the obligation.

22. Certain financial instruments contain obligations that (a) require settlement by issuance of a fixed number of equity shares and (b) require issuance of additional shares if the share price falls below a defined level. For example, a financial instrument may contain an obligation that requires settlement by issuance of 10,000 of the issuer's equity shares or $100,000 worth of the issuer's equity shares, whichever has a greater value at the date of settlement. For purposes of applying the provisions of this Statement to those instruments, the obligation to issue a fixed number of shares and the obligation to issue shares with a fixed value shall be considered different settlement alternatives.

23. If a financial instrument contains different settlement alternatives and the monetary values of the settlement alternatives have the potential to differ, the financial instrument is a compound financial instrument and each settlement alternative shall be considered a separate component. If the monetary values of the settlement alternatives do not have the potential to differ, the settlement alternatives shall not be considered separate components.

Initial Measurement

24. For purposes of initial measurement of the components of compound financial instruments, the following general rules shall be applied:

a. If a compound financial instrument has no component that is an outstanding share of stock, the obligation that is classified as a liability shall be considered an unconditional obligation and the obligation that is classified as equity shall be considered a conditional obligation.
b. If a compound financial instrument has a component that is an outstanding share of stock (other than mandatorily redeemable stock), the instrument shall be considered to comprise (a) an outstanding equity share and (b) a conditional obligation.

25. For example, assume that an entity issues two financial instruments. Financial Instrument A provides that the issuer will settle the obligation by transferring $11,000 unless the holder exercises its option to receive 1,000 of the issuer's equity shares. Financial Instrument B provides that the issuer will settle the obligation by issuing 1,000 equity shares unless the holder exercises its option to receive $11,000. Under the guidance in paragraph 24, each of those instruments would be separated into the following components: (a) an unconditional obligation to transfer $11,000 and (b) a conditional obligation (a written call option) to issue 1,000 shares of the issuer's equity. Convertible debt is an example of a financial instrument that has the characteristics listed in paragraph 24(a). Puttable common stock is an example of a financial instrument that has the characteristics listed in paragraph 24(b). Application of the guidance in paragraph 24 to those (and other) financial instruments is illustrated in Appendix A.

26. Except as provided in paragraphs 27 and 28 of this Statement, the proceeds of issuing a compound financial instrument shall be allocated to its separately classified liability components and equity components using the **relative-fair-value method.** Under that method, the fair value of each of the separately classified components is determined

independently of the fair values of the other components. The proceeds of issuing the compound financial instrument are then allocated to the components on a pro rata basis based on the relationship between those independently determined fair values.

27. If it is impracticable to apply the relative-fair-value method because the fair value of one of the components cannot be reliably determined, the proceeds shall be allocated to the components using the **with-and-without method.** Under that method, the fair value of the compound financial instrument is compared to the fair value of a hypothetical financial instrument that contains all the same components except the specific component being valued. The value of the component or components that can be reliably measured is measured directly (that is, the amount allocated equals its fair value, which is determined as if it were freestanding), and the amount allocated to the remaining component is the residual amount of the proceeds of issuance of the compound financial instrument.

28. If a financial instrument contains a component that is required to be separately accounted for as a derivative under Statement 133, the proceeds of issuing that financial instrument shall be allocated to its components using the with-and-without method, first allocating to the derivative component the amount of proceeds that would be equal to its fair value as if it were freestanding. As a result, the derivative component shall be recorded at its fair value and the amount of proceeds allocated to the nonderivative component shall be the residual amount of the proceeds.

29. For certain financial instruments, such as convertible debt, the allocation of a portion of the proceeds to the equity component results in allocation of an amount to the interest-bearing liability component that differs from its face amount. That difference shall be

accreted to income over the life of the debt using the effective interest method as described in APB Opinion No. 21, *Interest on Receivables and Payables*.

30. As discussed in paragraph 16, certain financial instruments, in addition to containing a liability component, an equity component, or both, also contain a component that, freestanding, would be classified as an asset. An example of that type of financial instrument is callable convertible debt. Those asset components may be required to be separated under other generally accepted accounting principles (for example, Statement 133). If separation of the asset component is not required under another pronouncement, the effect of that component shall be reflected in determining the fair value of the liability or equity component (or both, if the instrument contains both). For example, the call in callable convertible debt would be classified as an asset of the issuer if it were freestanding. Under this Statement, however, the effect of that call shall be incorporated into the determination of the fair values of the liability component and the equity component. The amounts allocated to the liability component and the equity component shall be based on the relative fair values of *callable* debt and a *callable* conversion option, respectively.

31. Appendix A provides guidance on (and includes examples of) the application of the relative-fair-value method and the with-and-without method to various financial instruments (including callable convertible debt).

Costs of Issuance

32. Costs incurred to issue a financial instrument shall be accounted for as a reduction of the proceeds of issuance before allocation of those proceeds to the components. For

purposes of this Statement, issuance costs comprise only those incremental costs directly attributable to issuance of an instrument that would have been avoided if the instrument had not been issued.

Repayments and Conversions of Convertible Debt

33. If convertible debt is repaid or converted according to its terms, the issuer of that debt shall recognize a gain or loss, if any, on the extinguishment of the liability component. That gain or loss shall be calculated as the difference between the portion of the consideration paid (or in the case of conversion, the fair value of the compound convertible debt instrument at the date of conversion) that is attributed to the liability component and its carrying amount at the date it is extinguished. The amount of consideration or fair value that is attributed to the liability component shall be determined using the relative-fair-value method. If use of the relative-fair-value method is impracticable, the with-and-without method shall be used.

34. Any difference between (a) the amount of consideration or fair value attributed to the liability component and (b) the carrying amount of the liability component shall be recognized as a gain or loss. That gain or loss shall be presented and classified in accordance with FASB Statement No. 4, *Reporting Gains and Losses from Extinguishment of Debt*. No gain or loss shall be recognized for the difference, if any, between the amount of consideration or fair value attributed to the equity component and the carrying amount of that component.

35. Appendix A contains examples of the accounting for repayments and conversions of convertible debt.

Noncontrolling Interests

36. An equity instrument that is issued by a less-than-wholly-owned subsidiary included in the reporting entity to an entity outside the consolidated group and thus represents the noncontrolling equity interest in that subsidiary shall be reported in the consolidated financial statements as a separate component of equity.

37. As long as a subsidiary remains consolidated, a sale of that subsidiary's shares[12] to entities outside the consolidated group that increases the noncontrolling interest is an equity transaction and shall be reported directly in equity in the consolidated financial statements. No gain or loss shall be recognized on such a sale as long as the subsidiary remains consolidated. The carrying amount of the noncontrolling interest shall be adjusted to reflect the proportionate change in ownership that results from the transaction. Any difference between the amount of that adjustment and the proceeds of the sale shall be reported as an increase or decrease in additional paid-in capital.

38. An entity shall recognize a gain or a loss on a sale of a subsidiary's shares that results in a subsidiary's no longer being consolidated. That gain or loss shall be measured based on the difference between the carrying amount of the shares sold and the proceeds received in that sale.

Reporting Comprehensive Income and Its Components

39. In determining comprehensive income for a period, an issuer shall include accruals of interest and similar returns to a holder of a liability component, as well as other

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[12]The term *subsidiary's shares* refers to shares held by the parent or previously unissued shares.

recognized changes in the fair value of those components, in the manner otherwise specified by generally accepted accounting principles for that item. For example, interest expense (including accretion of discount) shall be included in current-period earnings unless it qualifies for capitalization in accordance with FASB Statement No. 34, *Capitalization of Interest Cost*. Payments described as dividends due to holders of instruments that are issued in the form of stock but that are classified as liabilities shall be recognized in earnings in the period in which they are earned. In contrast, distributions to holders of components that are classified as equity under this Statement shall be recognized in equity as distributions to owners rather than in comprehensive income unless specified by other authoritative accounting literature.[13]

40. An entity that presents earnings-per-share information in accordance with FASB Statement No. 128, *Earnings per Share,* shall present on the face of the income statement a total for adjustments to net income (or net loss), or, for an entity with one or more less-than-wholly-owned subsidiaries, to net income (or net loss) attributable to the controlling interest to arrive at the numerator for the calculation of basic earnings per share.

Entities with One or More Less-Than-Wholly-Owned Subsidiaries

41. An entity with one or more less-than-wholly-owned subsidiaries shall include amounts attributable to both the controlling interest and the noncontrolling interest in reporting individual line items in the income statement. For example, the amount reported

[13]For example, amounts paid to purchase shares making up a noncontrolling interest shall not be recognized as distributions to owners. The accounting for those payments presently is addressed in Opinion 16 and is subject to reconsideration in the Board's project on business combinations. Other pronouncements, such as Opinion 25, as well as certain Issues of the Emerging Issues Task Force (EITF), provide guidance that requires certain changes in stockholders' equity to be recognized in comprehensive income.

as consolidated revenue shall include all of the revenue of the parent entity, any wholly owned subsidiaries, and any less-than-wholly-owned subsidiaries.

42. An entity with one or more less-than-wholly-owned subsidiaries that displays comprehensive income and its components in a statement of changes in equity shall display aggregate amounts and individual amounts attributable to both the controlling interest and the noncontrolling interest for total comprehensive income and for each component of comprehensive income.

Earnings per Share

43. In calculating earnings per share, an entity shall not adjust the numerator of the earnings-per-share calculation for any increase or decrease to additional paid-in capital related to a sale of a subsidiary's shares that decreases or increases the parent's proportionate ownership interest.

44. An entity with one or more less-than-wholly-owned subsidiaries that reports a discontinued operation, an extraordinary item, or the cumulative effect of a change in accounting principle shall use income from continuing operations attributable to the controlling interest (adjusted as described in paragraph 40) as the "control number" for purposes of determining whether a security is dilutive or antidilutive under the provisions of Statement 128.[14]

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[14]An entity with one or more less-than-wholly-owned subsidiaries that does not report a discontinued operation but reports an extraordinary item or the cumulative effect of a change in accounting principle in the period shall use that line item (for example, *income before extraordinary items attributable to the controlling interest* or *income before accounting change attributable to the controlling interest*) whenever the line item *income from continuing operations attributable to the controlling interest* is referred to in this Statement.

Disclosures

45. In addition to other disclosures required under generally accepted accounting principles, issuers of financial instruments that contain both a liability component and an equity component shall disclose the following in the fiscal year that the financial instrument is issued:

a. The nature of the financial instrument
b. A description of the components into which the financial instrument is separated
c. The proceeds of issuance and the amount allocated to each component
d. A description of the method and the key assumptions used to allocate the proceeds to the components
e. If the method used to allocate the proceeds to the components is not the relative-fair-value method, an explanation of why the relative-fair-value method was not used.

46. An entity with one or more less-than-wholly-owned subsidiaries shall disclose amounts attributable to the controlling interest for the following items:

a. Income from continuing operations
b. Discontinued operations
c. Extraordinary items
d. Cumulative effect of changes in accounting principle
e. Net income or net loss
f. Total comprehensive income
g. Components of other comprehensive income.

Effective Date and Transition

47. This Statement shall be effective for financial statements issued for fiscal years beginning after June 15, 2002. Earlier application is permitted. The provisions of this Statement shall be adopted as of the beginning of an entity's fiscal year.

48. In the initial year of adoption, an entity shall restate all financial statements for earlier years presented for the effects of financial instruments within the scope of this Statement that were outstanding at any time during that year. An entity is permitted, but not required, to restate all financial statements presented for the effects of financial

instruments that were not outstanding at any time during the year of adoption. However, if an entity elects to restate for those financial instruments, it shall restate all financial statements presented for the effects of all financial instruments within the scope of this Statement that were outstanding in any period presented, beginning with the earliest year presented. The cumulative effect of adopting this Statement shall be included in the earliest year restated.

49. An entity whose consolidated financial statements include one or more less-than-wholly-owned subsidiaries at any time during the initial year of adoption shall restate all financial statements presented for earlier years that include those subsidiaries to classify the noncontrolling interest as equity. The entity also shall restate all financial statements presented for the effects of any gains or losses on any sales of those shares that were not accounted for in accordance with paragraphs 37 and 38 of this Statement. An entity is permitted but not required to restate all financial statements presented for the classification of the noncontrolling interest and any gains or losses recognized on sales of a subsidiary's shares for noncontrolling interests that did not exist at any time during the initial year of adoption. An entity that elects to restate for those noncontrolling interests and associated gains and losses shall restate all financial statements presented for the effects of all noncontrolling interests that existed and all those gains and losses that were recognized in any period presented, beginning with the earliest year presented. An entity is not required to recognize the cumulative effect of reclassification of gains and losses recognized on sales of a subsidiary's shares for periods that are not restated.

The provisions of this Statement need not be applied to immaterial items.

Appendix A

IMPLEMENTATION GUIDANCE

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Paragraph
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Appendix A

IMPLEMENTATION GUIDANCE

Introduction

50. This appendix illustrates the application of the requirements of this Statement to financial instruments with liability characteristics, equity characteristics, or both. It provides examples of application of the requirements of this Statement to (a) classification and initial measurement of financial instrument components and (b) repayments and conversions of convertible debt. Components potentially have a variety of characteristics that must be considered in applying the requirements of this Statement. Those characteristics also are discussed and illustrated in this appendix. This appendix also provides examples of the application of the requirements of this Statement to sales of a subsidiary's shares.

Application of Classification and Measurement Provisions

51. As discussed in paragraph 3, certain financial instruments comprise a single component. Other financial instruments, referred to as compound financial instruments, comprise multiple components. This Statement requires that a compound financial instrument be separated into its liability components and equity components. Except as otherwise required by Statement 133, all liability components of a single compound instrument may be presented as a single liability. All equity components of the same class may be presented as a single equity item.

52. The approach in this Statement is based on the fundamental components approach introduced by the liabilities and equity Discussion Memorandum. That Discussion

Memorandum introduced a set of six fundamental financial instruments: unconditional receivable-payable contracts, conditional receivable-payable contracts, financial option contracts, financial guarantees or other conditional exchange contracts, financial forward contracts, and equity instruments. Each of those fundamental financial instruments is a separate component for purposes of this Statement. Once the components of a compound financial instrument have been identified, the components are classified based on their attributes.

53. The remainder of this appendix discusses the initial classification provisions of this Statement and provides examples of application of those provisions to various financial instruments. The discussion and the examples are presented in the following subsections:

a. Financial instrument components that do not embody obligations
b. Financial instrument components that embody obligations requiring settlement by a transfer of assets
c. Financial instrument components that embody obligations that require (or permit at the issuer's discretion) settlement by issuance of a fixed number of equity shares
d. Financial instrument components that embody obligations that require (or permit at the issuer's discretion) settlement by issuance of a variable number of equity shares
e. Financial instruments containing obligations for which the settlement alternatives are conditioned on the occurrence (or nonoccurrence) of a specified event beyond the control of both the issuer and the holder
f. Financial instruments that provide the holder with the discretion to determine whether the issuer will be required to settle the obligation by transferring assets or by issuing equity shares
g. Financial instrument components with minimum limitations on monetary value.

This appendix also provides examples of accounting for repayments and conversions of convertible debt and accounting for sales of a subsidiary's shares.

Financial Instrument Components That Do Not Embody Obligations

54. Certain financial instrument components do not embody obligations on the part of the issuer. Because those components do not obligate the issuer in any way, they lack the

essential characteristics of liabilities and should not be recognized as liabilities.[15] Therefore, any financial instrument component that is within the scope of this Statement and does not embody an obligation on the part of the issuer should be classified as equity. Common examples of components that do not embody an obligation include shares of common or preferred stock that are not mandatorily redeemable.

55. Preferred stock is sometimes issued in the form of shares that pay either no dividends or below-market-rate dividends during the first few years that they are outstanding. After that initial period, the dividend rate increases. Those instruments are sometimes referred to as increasing-rate preferred stock (or other similar terms). As with other preferred stock, declarations of dividends on increasing-rate preferred stock generally are at the issuing entity's discretion.[16] The terms of increasing-rate preferred stock may make it highly probable that the issuer will redeem the shares. (Many issuances of increasing-rate preferred stock are redeemable at the issuer's discretion after some specified period.) However, an increased dividend rate does not, by itself, obligate the issuer to redeem the shares because, absent terms to the contrary, the issuer retains discretion to avoid paying the dividends. If increasing-rate preferred stock is not mandatorily redeemable and payment of dividends is not required unless declared, it does not embody an obligation on the part of the issuer, and, therefore, should not be classified as a liability. It should be classified as equity.

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[15]As discussed in paragraph 17, certain components that obligate the issuer are also classified as equity.

[16]If the dividends on the increasing-rate preferred stock are cumulative, those dividends are subject to the provisions of paragraph 9 of Statement 128.

56. Shares of stock that represent the noncontrolling interest in a subsidiary and that are not mandatorily redeemable do not embody obligations. Unless an entity within the reporting entity is obligated to redeem the equity shares underlying the noncontrolling interest, the noncontrolling interest should be classified as equity in the consolidated financial statements.

57. The following examples illustrate the application of this Statement to common stock that is not mandatorily redeemable and to puttable common stock.

Example: Common Stock

58. An entity issues 5 million shares of common stock for $15 per share. The shares convey an ownership interest to the holder and do not embody an obligation on the part of the issuer. Therefore, under the classification criteria in paragraph 17(a) of this Statement, the shares are classified as equity.

Example: Common Stock That Is Puttable at a Fixed Price

59. An entity issues 5 million shares of common stock for $15 per share. Each share contains a provision that the holder may require that the entity repurchase the stock for $14 per share at any time after 2 years (puttable common stock).[17] On the date of issuance, the market price of the entity's nonputtable common stock is $10 per share. In accordance with paragraph 24 of this Statement, because the instrument contains a component that is an outstanding share of stock, the instrument is separated into the

[17]Although this example illustrates puttable common stock, the same analysis would be applied to puttable preferred stock or other classes of stock, including noncontrolling interests, issued with a put option.

following components: (a) an outstanding share of common stock and (b) a written put option that obligates the issuer to transfer assets if the put option is exercised.

60. Component (a), the outstanding share of common stock, does not embody an obligation on the part of the issuer. Therefore, under the classification criteria in paragraph 17(a) of this Statement, component (a) is classified as equity.

61. Component (b), the written put option, embodies an obligation that requires settlement by a transfer of assets (cash). Because it does not require or permit settlement by issuance of equity shares, the criteria of paragraph 17(c) are not met, and, therefore, the component is not classified as equity. Instead, the component is classified as a liability. Because the financial instrument has a component that is classified as a liability and a component that is classified as equity, the financial instrument must be separated into its liability component and its equity component.

62. If freestanding, the put option might meet the definition of a derivative under Statement 133.[18] Assuming the put option meets the definition of a derivative, unless the put option meets one of the exceptions under Statement 133, in accordance with paragraph 28 of this Statement, the with-and-without method (rather than the relative-fair-value method) is used to allocate the proceeds of issuance ($75 million) to the components. If the fair value of the put option is determined (using an option pricing model) to be $27.6 million, that amount is allocated to the liability component. The residual amount of $47.4 million is allocated to the equity component.

[18]The option does not meet the exception in paragraph 11(a) of Statement 133 because it is a liability and, therefore, would not be classified in stockholders' equity in the statement of financial position.

Example: Common Stock That Is Puttable at Its Fair Value

63. Certain entities enter into agreements with their stockholders that allow the stockholders to put shares back to the entity at the fair value of the shares. When shares are puttable at the fair value of the underlying shares at the date the put option is exercised, the effect of the put option is to add liquidity to the underlying stock—a value that traditional option-pricing models cannot measure. Moreover, although adding liquidity adds value, the value added may be relatively small. Therefore, it is likely that only a small amount (if any) of the proceeds would be assigned to the liability component.

Financial Instrument Components That Embody Obligations That Require Settlement by a Transfer of Assets

64. Financial instrument components that embody obligations requiring settlement by a transfer of assets meet the definition of liabilities in Concepts Statement 6 and, therefore, should be reported as liabilities. Common examples of that type of component include:

a. Debt that must be repaid in cash (including the liability component of convertible debt)
b. Written put options, whether embedded in shares of stock or freestanding
c. Shares of stock that contain mandatory redemption provisions.

65. Debt that must be repaid in cash (including the liability component of convertible debt) comprises an obligation to repay principal and an obligation to make periodic interest payments. Both obligations require settlement by a transfer of assets and should be classified as liabilities under the requirements of this Statement. As discussed in paragraph 20, because neither obligation is subject to the requirements of Statement 133, they may be combined for presentation purposes.

66. Freestanding written put options on equity of the writer (issuer) of the option that require **physical settlement** were previously classified as equity under EITF Issue

No. 96-13, "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock."[19] Under this Statement, those written put options are classified as liabilities because they embody obligations that require the issuer to settle by a transfer of assets. Freestanding written put options that require **net share settlement**, which were previously classified as equity under Issue 96-13, are classified as liabilities under this Statement. Although they embody obligations that will be settled by issuance of equity shares, changes in the monetary value of the obligations are in the opposite direction from changes in the fair value of the issuer's equity shares. Therefore, the criterion in paragraph 17(c)(2) is not met. Because written put options are classified as liabilities under this Statement, they do not meet the exception for equity instruments of the issuer in paragraph 11(a) of Statement 133.

67. Various other financial instruments are issued in the form of shares but actually embody obligations that must be settled by a transfer of assets. Examples of those instruments are mandatorily redeemable preferred stock and certain forms of trust-preferred securities. Mandatorily redeemable preferred stock embodies a nondiscretionary obligation to transfer assets to the holder to redeem the shares at a specified price and time. Trust-preferred securities may be issued in many forms, including those referred to as monthly-income-preferred securities, trust-preferred securities, and trust-originated-preferred securities.

68. Many trust-preferred securities are issued with the following characteristics: an entity establishes a special-purpose entity (SPE) or trust that is controlled by the parent.

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[19]Under the provisions of Issue 96-13, a public company would classify the written put options discussed in this paragraph as temporary equity.

The SPE or trust issues preferred securities to investors and lends the proceeds of issuance to the parent entity. Generally, such loans take the form of debentures with stated maturities. The majority of trust-preferred securities require redemption upon maturity or redemption of the underlying debenture.

69. Although mandatorily redeemable preferred stock and trust-preferred securities are issued in the form of shares, they are not classified as equity under this Statement because the terms of those instruments embody an obligation on the part of the issuer to transfer assets to redeem the shares. For that reason, they are classified as liabilities, as illustrated in the following example.

Example: Trust-Preferred Securities

70. An entity establishes an SPE that issues trust-preferred securities to outside investors. The SPE uses the proceeds of the issuance of those securities to purchase an equivalent amount of junior subordinated debentures of the parent entity with a maturity of 30 years. The debentures are the only assets of the SPE. When the parent entity makes its quarterly payment of interest on the debentures, the SPE distributes the cash to the holders of the trust-preferred securities. The trust-preferred securities must be redeemed upon maturity of the debentures. The entity consolidates the SPE.

71. Because the trust-preferred securities are mandatorily redeemable, the entire instrument represents an obligation to transfer assets to redeem the shares. Because the obligation does not permit or require settlement by issuance of equity shares, the criteria

of paragraph 17(c) are not met. Therefore, the entire instrument is classified as a liability in the consolidated financial statements.[20]

Financial Instrument Components That Embody Obligations That Require (or Permit at the Issuer's Discretion) Settlement by Issuance of a Fixed Number of Equity Shares

72. Certain financial instrument components embody obligations that require (or permit at the issuer's discretion) the issuer to settle the obligations by issuing a *fixed* number of its own equity shares. For example, an entity may receive $100,000 in exchange for a promise to issue 10,000 of its equity shares for no additional consideration at a future date. That type of component meets the criterion in paragraph 17(c)(1) because it requires settlement by issuance of a fixed number of the issuer's equity shares. Therefore, the component is classified as equity.

73. Other examples of that type of component include certain conversion options embedded in convertible debt. Paragraphs 99–106 illustrate application of this Statement to convertible debt.

Financial Instrument Components That Embody Obligations That Require (or Permit at the Issuer's Discretion) Settlement by Issuance of a Variable Number of Equity Shares

74. Certain financial instrument components embody obligations that require (or permit at the issuer's discretion) settlement by issuance of a *variable* number of equity shares. For example, an instrument similar to that described in paragraph 72 could be structured to require issuance of equity shares with a value of $110,000 at the date of settlement. In that circumstance, regardless of the fair value of the shares on the date of settlement, the holder receives $110,000 of value. The monetary value of the obligation is fixed and will

[20] If the entity does not consolidate the SPE, the debentures would be classified as liabilities.

not change if the fair value of a fixed number of shares changes. Therefore, neither of the criteria in paragraph 17(c) of this Statement is met and the component does not qualify for classification as equity. Instead, it is classified as a liability.

75. Other financial instrument components embody obligations that require settlement by issuance of a variable number of equity shares but have monetary values that are not fixed. For example, an entity may issue a stock appreciation right (SAR) that is required to be settled by issuance of equity shares with a value equal to the appreciation in 1,000 shares. In those circumstances, although the number of shares to be issued to settle the obligation is variable, any changes in the monetary value of the component are attributable to, equal to, and in the same direction as changes in the fair value of a fixed number of the issuer's equity shares. Therefore, the component establishes an ownership relationship and is classified as equity. Paragraphs 79–81 illustrate the application of this Statement to SARs.

76. Finally, certain other financial instrument components that embody obligations that require settlement by issuance of a variable number of equity shares have monetary values whose changes are attributable to and equal to changes in the fair value of the issuer's equity shares, but those changes in the monetary value are in the opposite direction of the changes in the fair value of the issuer's equity shares. Therefore, the criterion in paragraph 17(c)(2)(b) is not met. Those financial instrument components do not establish ownership relationships and thus do not qualify for classification as equity. Paragraphs 82-85 illustrate the application of this Statement to that type of component.

77. The following examples illustrate the application of this Statement to (a) an obligation to issue a variable number of shares at a future date, (b) SARs, and (c) financial instrument components that embody obligations for which the changes in the monetary value are in the opposite direction of changes in the fair value of the issuer's equity shares.

Example: Obligation to Issue a Variable Number of Shares

78. An entity receives $100,000 in exchange for a promise to issue shares worth $110,000 at a future date. The number of shares required to be issued to settle that obligation will be determined by the fair value of the issuer's shares on the date of settlement and, therefore, is not fixed. Regardless of the fair value of the shares on the date of settlement, the holder will receive $110,000 worth of value. The financial instrument component does not establish an ownership relationship and, therefore, is not classified as equity. Instead, it is classified as a liability.

Example: SARs That Require Net Share Settlement

79. At a time when the fair value of its shares is $20, an entity grants to its employees 1,000 SARs. The SARs convey to the holders the right to the appreciation in the fair value of the equity shares above $20. That appreciation will be paid by issuing a variable number of the issuer's equity shares. After the SARs are issued, the fair value of the entity's shares increases to $25 per share. The entity then is required to issue shares worth $5,000 [($25 – $20) ? 1,000], or 200 shares.

80. Because the SARs contain an obligation to issue a variable number of equity shares, classification depends on whether the criteria in paragraph 17(c)(2) are met. Changes in the monetary value of the obligation are attributable to and equal to the appreciation of a

fixed number (1,000) of the issuer's equity shares above the strike price; therefore, the criterion in paragraph 17(c)(2)(a) is met. Additionally, the criterion in paragraph 17(c)(2)(b) is met because an increase in the fair value of the issuer's equity shares results in an increase in the monetary value of the obligation. (Note that the increase in fair value of the equity shares from $20 to $25 resulted in an increase in the monetary value of the obligation [from $0 to $5,000].) If the fair value of the equity shares increases further (for example, to $30 per share), the monetary value of the obligation increases as well (to $10,000 [($30 – $20) ? 1,000]). If the fair value of the equity shares then decreases (for example, from $30 to $27), the monetary value of the obligation decreases (to $7,000 [($27 – $20) ? 1,000]).

81. Because any change in the monetary value of the obligation (a) is attributable to and equal to the change in the fair value of a fixed number of the issuer's equity shares and (b) changes in the same direction as the change in the fair value of the issuer's equity shares, both of the criteria in paragraph 17(c)(2) are met. Consequently, the SAR is classified as equity. In accordance with FASB Interpretation No. 28, *Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans*, changes in the fair value of the SARs between the date of grant and the date of exercise result in a change in the measure of compensation cost. Increases or decreases in the measure of compensation cost are offset by a charge or credit to equity.

Example: Net Share Settlement—Monetary Value Changes in Opposite Direction of Fair Value of Equity Shares

82. Entity A enters into a forward contract with Entity X. Under that contract, if the per-share value of Entity A's shares is greater than $10 on the specified date, Entity X

must transfer shares of Entity A with a value equal to the per share value in excess of $10 multiplied by 1 million to Entity A. If the per-share value is less than $10 on the specified date, Entity A must transfer shares of its own equity with a value equal to the excess of $10 over the per-share price multiplied by 1 million to Entity X.

83. That forward contract contains an obligation on the part of Entity A to issue equity shares if the fair value of its equity shares is less than $10 on a certain date. Therefore, its classification depends on whether the criteria in paragraph 17(c)(2) are met. Changes in the monetary value of the obligation are attributable to and equal to changes in the fair value of a fixed number (1 million) of the issuer's equity shares; therefore, the criterion in paragraph 17(c)(2)(a) is met.

84. However, the monetary value of the obligation changes in the opposite direction of the changes in the fair value of the issuer's equity shares. If the fair value of the equity shares increases, the monetary value of the obligation decreases (and may, in fact, be reduced to zero or result in a receivable). If the fair value of the equity shares decreases, the monetary value of the obligation increases.

85. That type of obligation was classified as equity under Issue 96-13. Under this Statement, because the monetary value of the obligation does not change in the same direction as the change in the fair value of the equity shares, the obligation does not meet the criterion in paragraph 17(c)(2)(b) and, therefore, is not classified as equity. Rather, the instrument is a forward contract that may be either an asset or a liability depending on the price of the underlying stock. Because it is not classified as equity, it does not meet the criteria for an exception to the definition of a derivative in paragraph 11(a) of

Statement 133. Therefore, if the other criteria of Statement 133 are met, the instrument qualifies as a derivative.

Financial Instruments Containing Obligations for Which the Settlement Alternatives Are Conditioned on the Occurrence (or Nonoccurrence) of a Specified Event beyond the Control of both the Issuer and the Holder

86. Certain financial instruments contain obligations that require the issuer to settle the obligation by transferring assets or by issuing equity shares, but the settlement alternative is conditioned on the occurrence (or nonoccurrence) of a specified event beyond the control of both the issuer and the holder. Examples of that type of financial instrument include the following:

a. A financial instrument that requires settlement in 1 year by issuance of 10 equity shares unless the event occurs, in which case the issuer must transfer cash equal to the fair value of the 10 equity shares at that settlement date
b. A financial instrument that requires settlement in 1 year by transfer of $100 unless the event occurs, in which case the issuer must issue a variable number of equity shares with a value equal to $100
c. A financial instrument that requires settlement in 1 year by issuance of 10 equity shares unless the event occurs, in which case the issuer must transfer $100
d. A financial instrument that requires settlement in 1 year by transfer of $100 unless the event occurs, in which case the issuer must issue 10 shares of its own equity.

87. The treatment of those instruments depends on the monetary values of the components. In applying paragraph 23 of this Statement, if the monetary value of the obligation to issue shares will always be the same as the monetary value of the obligation to transfer assets, the financial instrument should be treated as a single component and classified as a liability. That is the case for the financial instruments described in paragraphs 86(a) and 86(b). If the monetary values of the two obligations have the potential to differ, the financial instrument should be treated as a compound financial instrument and the classification of the components should be considered independently. The financial instruments described in paragraphs 86(c) and 86(d) fit that description.

Therefore, they should be separated into components, and the proceeds of issuance should be allocated to each component using the relative-fair-value method unless impracticable. Neither of those compound instruments contains a component that is an outstanding share of stock. Therefore, in accordance with paragraph 24 of this Statement, the instruments are separated into (a) an obligation to transfer cash (a liability component) and (b) a written option that, if exercised, would require the issuer to issue equity shares (an equity component).

88. The following examples illustrate application of this Statement to the types of financial instruments described in paragraph 86.

Example: Obligation Conditioned on the Occurrence of a Specified Event beyond the Control of both the Issuer and the Holder—Monetary Values of Settlement Alternatives Cannot Differ

89. An entity issues a financial instrument that requires settlement in 1 year by issuance of 100 shares of its own equity unless interest rates increase by 100 basis points, in which case the issuer must settle the instrument by a transfer of cash in an amount equal to the fair value of 100 equity shares at the settlement date.

90. That financial instrument consists of a single obligation to convey to the holder value equal to the fair value of 100 equity shares in 1 year. The settlement alternatives (100 shares or cash equal to the fair value of 100 shares) are nondiscretionary but are conditioned on a future event. The monetary values of both settlement alternatives are equal to the fair value of 100 equity shares in 1 year. Because the monetary values of the settlement alternatives do not have the potential to differ, in accordance with paragraph 23 of this Statement, the instrument consists of a single component. If interest rates increase by 100 basis points, the obligation must be settled by a transfer of cash. Therefore, the

single component does not require or permit at the issuer's discretion settlement by issuance of equity shares. The criteria of paragraph 17(c) are not met and the financial instrument does not qualify for classification as equity. Therefore, it is classified as a liability.

91. Application of the requirements of this Statement results in the same conclusion if the terms of the financial instrument fix its monetary value. For example, assume that the financial instrument embodies an obligation that requires settlement by transfer of $10,000 unless interest rates rise by 100 basis points, in which case the obligation requires settlement by issuance of equity shares worth $10,000. In accordance with paragraph 23, that financial instrument is not separated into components because the monetary values of the settlement alternatives do not have the potential to differ. Like the instrument in paragraph 90, the instrument is classified in its entirety as a liability.

Example: Obligation Conditioned on the Occurrence of a Specified Event beyond the Control of both the Issuer and the Holder—Monetary Values of Settlement Alternatives Have the Potential to Differ

92. An entity issues a financial instrument for $10,000 embodying an obligation that requires settlement in 1 year by issuance of 100 shares of its own equity unless interest rates increase by 100 basis points, in which case the obligation must be settled by a transfer of $10,000.

93. Because the monetary values of the settlement alternatives have the potential to differ (the value of 100 shares can be more or less than $10,000), the financial instrument comprises 2 components: (a) an obligation to transfer $10,000 and (b) an obligation to issue 100 equity shares with an unknown value. The classification criteria in paragraph 17

of this Statement must be applied to each component individually. Applying those classification criteria to component (b) (the obligation to issue equity shares) results in equity classification for that component because it requires settlement by issuance of a fixed number of equity shares.

94. Applying those classification criteria to component (a) (the obligation to transfer cash) results in liability classification. The obligation neither requires nor permits at the issuer's discretion settlement by issuance of equity shares. Therefore, it is classified as a liability.

95. For purposes of this example, assume that the entity has determined that the fair value of component (b) cannot be determined reliably. Therefore, the with-and-without method is used to allocate the proceeds. If the interest rate is 10 percent, the fair value of the obligation to transfer cash of $10,000 is $9,100. That amount is allocated to the liability component. The residual amount of proceeds ($900) is allocated to the equity component. In accordance with paragraph 29 of this Statement, the $9,100 allocated to the liability component is accreted to the face amount of the liability ($10,000) over the life of the instrument using the effective-interest method described in Opinion 21.

Financial Instruments That Provide the Holder with the Discretion to Determine Whether the Issuer Will Be Required to Settle the Obligation by Transferring Assets or by Issuing Equity Shares

96. Certain compound financial instruments provide the holder with the discretion to specify whether the issuer will be required to settle the obligation by transferring assets or by issuing equity shares. The holder's discretion may be structured in several ways,

which can be illustrated with three different instruments. The holder pays $10,000 for each instrument.

a. Financial Instrument A requires that the issuer repay $11,000 in 1 year unless the holder exercises an option to receive 100 shares of stock. (Convertible debt is an example of an instrument structured in that manner.)
b. Financial Instrument B requires that the issuer issue 100 shares of stock to the holder in 1 year unless the holder chooses to receive $11,000 in cash.
c. Financial Instrument C states that at the end of 1 year the holder will indicate to the issuer whether it wishes to receive $11,000 in cash or 100 shares of stock.

97. For compound financial instruments that provide the holder with the discretion to determine whether the issuer will be required to settle the obligation by transferring assets or by issuing shares, paragraph 23 of this Statement requires that the settlement alternatives be considered separate components if the monetary values of the settlement alternatives have the potential to differ. Because the monetary value of 100 shares has the potential to differ from $11,000, each of the financial instruments in paragraph 96 has two components. Therefore, all of the financial instruments should be considered to comprise (a) an unconditional obligation to transfer cash and (b) a call option written on the issuer's stock.

98. The following examples illustrate the application of this Statement to convertible debt and callable convertible debt.

Example: Convertible Debt

99. An entity issues 50,000 noncallable convertible bonds with a face value and issue price of $1,000 per bond. Each bond may be converted by the holder into 100 shares of the issuer's equity. The financial instrument contains (a) an obligation to repay principal, (b) an obligation to make periodic interest payments, and (c) an obligation to issue equity shares if the conversion option is exercised.

100. Obligations (a) and (b) require settlement by a transfer of assets and do not meet the criteria for equity classification in paragraph 17(c) of this Statement. Accordingly, both obligations are classified as liabilities. Because neither the obligation to repay principal nor the obligation to make periodic cash interest payments is subject to the requirements of Statement 133, they may be displayed as a single liability. Because obligation (c) requires settlement by issuance of equity shares, the equity classification criteria in paragraph 17(c) must be applied to determine whether the obligation is classified as a liability or as equity. If exercised, the conversion option requires settlement by issuance of a fixed number of shares, which meets the requirement of paragraph 17(c)(1). Therefore, the option is classified as equity.

101. In accordance with paragraph 24 of this Statement, because none of the components are outstanding shares of stock, the obligation to transfer assets (the liability component) is considered unconditional. The amounts allocated to the liability component and the equity component are determined by the relative-fair-value method. If application of appropriate pricing models produces a value of $790 for comparable nonconvertible debt and a value of $240 for the conversion option, the $50,000,000 proceeds are allocated to the components as follows:

Liability components	$1,000 ? [$790/($790 + $240)] = $767	
	$767 ? 50,000 =	$38,350,000
Conversion option	$1,000 ? [$240/($790 + $240)] = $233	
	$233 ? 50,000 =	11,650,000
Proceeds		$50,000,000

102. The amount allocated to the conversion option would be recorded as equity. The entity is also required to accrete the amount allocated to the liability component

($38,350,000) to its face amount ($50,000,000) using the effective interest method in accordance with Opinion 21.

103. The other financial instruments listed in paragraph 96 (a financial instrument that requires settlement by issuance of equity shares unless the holder elects to receive assets and a financial instrument that does not specify a settlement provision but gives the holder the choice) are separated in the same fashion as convertible debt. Because neither of those instruments contains a component that is an outstanding share of stock, the instruments comprise (a) an unconditional obligation to transfer cash and (b) a conditional obligation to issue shares.

Example: Callable Convertible Debt

104. An entity issues 50,000 callable convertible bonds with a face value of $1,000 per bond and an issue price of $960 per bond. The holders may convert each bond into 100 shares of the issuer's equity. Under paragraph 30 of this Statement, the call option in callable convertible debt is not treated as a separate component. The financial instrument consists of (a) a callable obligation to repay principal, (b) an obligation to make periodic interest payments, and (c) a callable conversion option exercisable by the holder. Because neither the obligation to repay principal nor the obligation to make periodic cash interest payments is subject to the requirements of Statement 133, they may be displayed as a single liability. Application of appropriate pricing models produces a value of $780 for comparable callable debt and a value of $225 for a callable conversion option. The $48,000,000 proceeds are allocated to the components as follows:

Liability components	$960 ? [$780/($780 + $225)] = $745	
	$745 ? 50,000 =	$37,250,000
Conversion option	$960 ? [$225/($780 + $225)] = $215	
	$215 ? 50,000 =	10,750,000
Proceeds		$48,000,000

105. The amount allocated to the conversion option is recorded as equity. The entity also is required to accrete the amount allocated to the liability component ($37,250,000) to its face amount ($50,000,000) in accordance with Opinion 21.

106. If the fair value of a callable conversion option is not obtainable, application of the relative-fair-value method would be impracticable, and the proceeds are allocated using the with-and-without method. Under that method, $39,000,000 ($780 ? 50,000) is allocated to the liability components, and the residual amount of proceeds ($9,000,000) is allocated to the callable conversion option.

Financial Instrument Components with Minimum Limitations on Monetary Value

107. Certain financial instruments embody obligations that require (or permit at the issuer's discretion) settlement by issuance of a fixed number of equity shares but require issuance of more shares if the share price falls below a defined point so that the monetary values are subject to minimum limitations (floors). In accordance with paragraph 22 of this Statement, the obligation to issue a fixed number of shares and the obligation to issue shares with a fixed value should be considered different settlement alternatives. Because the monetary values of those settlement alternatives have the potential to differ, the settlement alternatives should be considered separate components. In accordance with paragraph 24(a) of this Statement, because no component is an outstanding share of stock, those financial instruments should be separated into (a) an unconditional obligation to issue equity shares worth the minimum monetary value (a liability component) and (b) a

conditional obligation, similar to an SAR, to issue shares equal to the amount of appreciation of the fixed number of equity shares above some fair value. The obligation to deliver the minimum value does not establish an ownership relationship because it does not expose the holder to the risks of changes in the fair value of the issuer's equity shares. Therefore, it should be classified as a liability under the requirements of this Statement. The conditional obligation does establish an ownership relationship and should be classified as equity, as illustrated in paragraphs 108 and 109.

Example: Obligation That Requires Settlement by Issuance of a Fixed Number of Equity Shares and Contains a Floor

108. An entity issues a compound financial instrument for $100,000. At the time of issuance, the per-share value of the entity's common equity shares is $10. Under the terms of the arrangement, 1 year from the date of issuance the issuing entity will issue either (a) 10,000 equity shares or (b) $100,000 worth of equity shares, whichever has a greater value. The alternative settlement amount of $100,000 worth of equity shares represents the minimum amount of value that will be conveyed to the holder at settlement.

109. In accordance with paragraph 24, because none of the components are outstanding shares of stock, the financial instrument is separated into (a) an obligation to issue equity shares worth $100,000 and (b) an obligation (similar to an SAR) to issue shares equal to the amount of appreciation of 10,000 equity shares above a fair value of $10 per share. The obligation to issue shares worth a specified value does not establish an ownership relationship and, therefore, is a liability component. The obligation to issue shares equal to the amount of appreciation of 10,000 equity shares above a fair value of $10 per share is an equity component because it meets the criterion in paragraph 17(c)(2). Assume that

the fair value of the obligation to issue shares with a value of $100,000 is determined to be $90,909. The fair value of the equity component is determined to be $12,000. The proceeds are allocated as follows:

Liability component	$100,000 ? [$90,909/($90,909 + $12,000)] =	$ 88,339
Equity component	$100,000 ? [$12,000/($90,909 + $12,000)] =	11,661
Proceeds		$100,000

Repayments and Conversions of Convertible Debt

110. This Statement requires that on the date of repayment or conversion of convertible debt, the fair value of the convertible debt be allocated to its liability component and its equity component using the relative-fair-value method unless impracticable. The difference, if any, between the carrying amount of the liability component and the amount of consideration paid to extinguish that component should be recognized as a gain or loss upon repayment or conversion in accordance with Statement 4. Paragraphs 111–118 illustrate the application of those provisions.

Example: Repayment of Convertible Debt

111. An entity issues convertible debt with a 10-year term for $1,000. The debenture is convertible into common shares of the entity at a conversion price of $25 per share. Interest of 10 percent is payable semiannually in cash. At the date of issuance, the entity could have issued nonconvertible debt with a 10-year term that would have had an interest rate of 12 percent.

112. At the date of issuance, the fair value of the option component, determined using an option pricing model, is $60. The fair value of the liability component is $886, determined as follows:

Present value of 20 semiannual interest payments of $50, discounted at 12%	$574
Present value of $1,000 due in 10 years, discounted at 12%, compounded semiannually	312
	$886

113. The following allocation is made:

Liability component	$1,000 ? [$886/($886 + $60)] =	$937
Equity component	$1,000 ? [$60/($886 + $60)] =	$63

114. Five years later, the convertible debenture has a fair value of $1,700 and the entity enters into an agreement with the holder to repurchase the debenture at that amount. At the date of repurchase, the entity could have issued nonconvertible debt with a 5-year term bearing an interest rate of 8 percent. At that date, the carrying amount of the liability component is $979, representing the $937 originally allocated to the liability component adjusted for 5 years of accretion. The fair value of that component at that date is $1,081, determined as follows:

Present value of 10 remaining semiannual interest payments, discounted at 8%	$ 405
Present value of $1,000 due in 5 years, discounted at 8%, compounded semiannually	676
	$ 1,081

115. The fair value of the equity component (determined using an option pricing model) is $600. The consideration of $1,700 is attributed to the liability component and the equity component based on their fair values at the date of repayment as follows:

Liability component	[$1,081/($1,081 + $600)] ? $1,700 = $1,093
Equity component	[$600/($1,081 + $600)] ? $1,700 = $607

116. The loss on settlement is $114, representing the difference between the amount of consideration attributable to the liability component ($1,093) and the carrying amount of

that component ($979). The portion of the consideration allocated to the equity component ($607) is charged to additional paid-in capital.

Example: Conversion Based on Terms

117. Assume the same facts as in the previous example except that, five years after issuance, the holder of the convertible debenture elects to exercise its conversion option. At the time of conversion, the convertible debenture has a fair value of $1,700. At the date of conversion, the entity could have issued otherwise similar nonconvertible debt with a 5-year term that would have an interest rate of 8 percent. The fair value of the liability component at that date is $1,081 (as determined in paragraph 114). The carrying amount of the liability component is $979 (representing the $937 originally allocated to the liability component adjusted for 5 years of accretion). The fair value of the equity component (determined using an option pricing model) is $600.

118. Based on their relative fair values, the portion of the fair value of $1,700 attributable to the liability component is $1,093, and the portion attributable to the equity component is $607. As in the previous example, the entity recognizes a loss of $114, representing the difference between the portion of fair value attributable to the liability component at the date of conversion ($1,093) and its carrying value ($979). (In this example, the net amount credited to additional paid-in capital is $1,093.) The total proceeds from issuing the shares is $1,156 (the $63 originally allocated to the equity component plus the $1,093 allocated upon conversion).

Sales of a Subsidiary's Shares

119. This Statement requires that no gain or loss be reported on sales of a subsidiary's shares if the subsidiary remains consolidated. For those sales that result in the subsidiary's no longer being consolidated, a gain or loss should be recognized for the difference between the carrying amount of the shares sold in that transaction and the proceeds received in that transaction.

Example: Sales of a Subsidiary's Shares

120. An entity establishes Subsidiary A by contributing $100,000. Subsequently, the parent sells 10 percent of its interest in Subsidiary A to a third party for $15,000. After that transaction, the subsidiary remains consolidated. Therefore, the transaction is a transaction in the equity of the consolidated entity. In accordance with paragraph 37 of this Statement, no gain or loss is recognized on that transaction. The difference between the $10,000 carrying value of the portion of the subsidiary sold and the $15,000 in proceeds is credited to paid-in capital of the consolidated entity. The following journal entry illustrates the effect on the consolidated financial statements:

Cash	$15,000	
Noncontrolling interest		$10,000
Paid-in capital		5,000

121. In a subsequent transaction, the entity sells the remainder of its interest to a third party for $100,000. That transaction results in the subsidiary's no longer being consolidated. In accordance with paragraph 38 of this Statement, a gain is recognized based on the difference between the carrying amount of the shares sold ($90,000) and the proceeds. The following journal entry illustrates the effect on the consolidated financial statements:

Cash	$100,000	
Noncontrolling interest	10,000	
Investment in Subsidiary A		$100,000
Gain		10,000

122. Note that the $5,000 credited to paid-in capital as a result of the transaction in paragraph 120 is not reversed to income upon sale of the remainder of the shares in the subsidiary. The $5,000 amount also does not affect the computation of income available to common stockholders of the parent company for purposes of calculating earnings per share.

Appendix B

DISPLAY AND DISCLOSURE REQUIREMENTS FOR ENTITIES WITH ONE OR MORE LESS-THAN-WHOLLY-OWNED SUBSIDIARIES

123. This appendix illustrates application of the presentation and disclosure requirements of this Statement for an entity with one or more less-than-wholly-owned subsidiaries. In addition, it provides examples of application of the requirement in paragraph 40 of this Statement.

124. The illustrations are based on the following assumptions:

?? As of January 1, 20X2, Entity X has a wholly owned subsidiary. Entity X has a balance of ($500) in accumulated other comprehensive income, which is attributable to the subsidiary's foreign currency translation adjustment. On January 1, 20X2, Entity X sells 20 percent of its interest in the previously wholly owned subsidiary for $60,000. The proceeds of the sale are equal to the carrying amount of the interest sold. Also on January 1, 20X2, the subsidiary purchases a portfolio of securities that it classifies as available for sale.

?? On June 30, 20X3, Entity X issues 5,000 shares of preferred stock for proceeds of $50,000. On December 31, 20X3, Entity X pays dividends of $1 per share on those preferred shares. The subsidiary's available-for-sale securities (valued at $112,000 on December 31, 20X2) are sold in 20X3 for $26,667 over their carrying amount.

?? The subsidiary has pretax income from continuing operations of $8,000 in 20X2 and $10,000 in 20X3.

?? Entity X has 200,000 shares of common stock outstanding throughout 20X2 and 20X3 and pays dividends of $10,000 each year on those common shares. The effective tax rate for both the parent and the subsidiary is 25 percent.

?? Additional information about the operations of Entity X for the years 20X2 and 20X3 is presented in the following table:

	20X3			20X2		
	Controlling Interest	**Noncontrolling Interest**	**Consolidated**	**Controlling Interest**	**Noncontrolling Interest**	**Consolidated**
Discontinued operations	0	0	0	(5,600)	(1,400)	(7,000)
Extraordinary items	0	0	0	(16,800)	(4,200)	(21,000)
Cumulative effect of accounting change	0	0	0	(2,500)	0	(2,500)
Foreign currency translation adjustment	4,400	1,100	5,500	6,400	1,600	8,000
Unrealized holding gains (on securities) arising during period	6,800	1,700	8,500	9,200	2,300	11,500
Reclassification adjustment (for securities)	(16,000)	(4,000)	(20,000)	0	0	0
Minimum pension liability	0	0	0	(2,500)	0	(2,500)

125. FASB Statement No. 130, *Reporting Comprehensive Income*, includes examples of a one-statement approach and a two-statement approach to reporting comprehensive income. The following example uses the two-statement approach. The example illustrates (a) the requirement of this Statement to present on the face of the income statement preferred stock dividends as an adjustment to net income (loss) attributable to the controlling interest and (b) the requirement to disclose amounts attributable to the controlling interest.

Entity X
Statement of Financial Position
December 31

	20X3	20X2
Assets:		
Cash	$ 225,000	$ 210,000
Accounts receivable	170,000	175,000
Available-for-sale securities	—	112,000
Plant and equipment	1,102,500	959,500
Total assets	$1,497,500	$1,456,500
Liabilities:		
Accounts payable	$ 125,500	$ 112,500
Accrued liabilities	89,000	79,250
Pension liability	131,000	128,000
Notes payable	187,250	318,500
Total liabilities	532,750	638,250
Equity:		
Controlling interest:		
Common stock, $1 par	200,000	200,000
Preferred stock, $10 par	50,000	—
Paid-in capital	400,000	400,000
Retained earnings	247,150	146,150
Accumulated other comprehensive income	7,900	12,700
Total controlling interest	905,050	758,850
Noncontrolling interest:		
Noncontrolling interest	57,100	55,600
Accumulated other comprehensive income	2,600	3,800
Total noncontrolling interest	59,700	59,400
Total equity	964,750	818,250
Total liabilities and equity	$1,497,500	$1,456,500

Entity X
Statement of Income
Year Ended December 31

	20X3	20X2
Revenues	$165,000	$152,000
Expenses	(35,000)	(27,000)
Gain on sale of securities	26,667	—
Income from operations before tax	156,667	125,000
Income tax expense	(39,167)	(31,250)
Income before discontinued operations, extraordinary items, and cumulative effect of accounting change (DO, EI, and CEAC)	117,500	93,750
Discontinued operations, net of tax	—	(7,000)
Extraordinary item, net of tax	—	(21,000)
Cumulative effect of accounting change, net of tax	—	(2,500)
Consolidated net income	117,500	63,250
Less: Net income (loss) attributable to noncontrolling interests	1,500	(4,400)
Net income attributable to controlling interests	116,000	67,650
Preferred stock dividend	(5,000)	—
Net income attributable to common stock	$111,000	$ 67,650
Earnings per share:		
Net income (loss) per common share—basic and diluted:		
Income before DO, EI, and CEAC	$ 0.56	$ 0.46
Discontinued operations	—	(0.03)
Extraordinary items	—	(0.08)
Cumulative effect of accounting change	—	(0.01)
Net income	$ 0.56	$ 0.34

Amounts Attributable to Controlling Interest*
Year Ended December 31

	20X3	20X2
Controlling interest, net of tax:		
Continuing operations	$116,000	$92,550
Discontinued operations	—	(5,600)
Extraordinary items	—	(16,800)
Cumulative effect of accounting change	—	(2,500)
Net income	$116,000	$67,650

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*This information is required to be disclosed. Entities are not precluded from showing the total adjustment to net income or loss in this schedule (in addition to the required presentation on the face of the income statement).

Entity X
Statement of Comprehensive Income
Year Ended December 31

	20X3	20X2
Consolidated net income	$117,500	$63,250
Other comprehensive income, net of tax:		
Foreign currency translation adjustments	5,500	8,000
Unrealized gains on securities:		
Unrealized holding gains arising during period	8,500	11,500
Less: Reclassification adjustment for gains included in net income	(20,000)	—
Minimum pension liability adjustment	—	(2,500)
Other comprehensive income	(6,000)	17,000
Total comprehensive income	$111,500	$80,250

Amounts Attributable to Controlling Interest*
Year Ended December 31

	20X3	20X2
Controlling interest, net of tax:		
Net income	$116,000	$67,650
Foreign currency translation adjustments	4,400	6,400
Unrealized gains on securities	(9,200)	9,200
Minimum pension liability adjustment	—	(2,500)
Other comprehensive income	(4,800)	13,100
Comprehensive income	$111,200	$80,750

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*This information is required to be disclosed on the face of the income statement or in the notes.

126. Statement 130 requires disclosure of the tax effects allocated to each component of other comprehensive income, either on the face of the statement in which those components are displayed or in the notes to the financial statements. The following illustration provides an example of disclosure in the notes.

Entity X
Notes to Financial Statements
Disclosure of Related Tax Effects Allocated to Each Component of Other Comprehensive Income
Year Ended December 31, 20X2

	Before-Tax Amount	Tax (Expense) or Benefit	Net-of-Tax Amount
Foreign currency translation adjustments	$10,667	$(2,667)	$8,000
Unrealized gains on securities:			
Unrealized holding gains arising during period	15,333	(3,833)	11,500
Less: Reclassification adjustment for gains included in net income	—	—	—
Net unrealized gains	15,333	(3,833)	11,500
Minimum pension liability adjustment	(3,333)	833	(2,500)
Other comprehensive income	$22,667	$(5,667)	$17,000

Year Ended December 31, 20X3

	Before-Tax Amount	Tax (Expense) or Benefit	Net-of-Tax Amount
Foreign currency translation adjustments	$ 7,333	$(1,833)	$ 5,500
Unrealized gains on securities:			
Unrealized holding gains arising during period	11,334	(2,834)	8,500
Less: Reclassification adjustment for gains included in net income	(26,667)	6,667	(20,000)
Net unrealized gains	(15,333)	3,833	(11,500)
Other comprehensive income	$ (8,000)	$ 2,000	$(6,000)

127. Statement 130 requires that the total of other comprehensive income for a period be transferred to a component of equity that is displayed separately from retained earnings and additional paid-in capital in a statement of financial position. Statement 130 also requires that an entity disclose accumulated balances for each classification in that separate component of equity on the face of a statement of financial position, in a statement of changes in equity, or in notes to the financial statements. The following provides an illustration of disclosure of that information in the notes to the financial statements.

Entity X
Notes to Financial Statements
Disclosure of Accumulated Other Comprehensive Income Balances
Year Ended December 31, 20X2

	Foreign Currency Items	Unrealized Gain on Securities	Minimum Pension Liability	Accumulated Other Comprehensive Income
Controlling interest:				
Beginning balance	$ (500)	$ —	$ —	$ (500)
Current-period change	6,400	9,200	(2,500)	13,100
Ending balance	$5,900	$9,200	$(2,500)	$12,600
Noncontrolling interest:				
Beginning balance	$ —	$ —	$ —	$ —
Current-period change	1,600	2,300	—	3,900
Ending balance	$1,600	$2,300	$ —	$3,900

Year Ended December 31, 20X3

	Foreign Currency Items	Unrealized Gain on Securities	Minimum Pension Liability	Accumulated Other Comprehensive Income
Controlling interest:				
Beginning balance	$ 5,900	$ 9,200	$(2,500)	$12,600
Current-period change	4,400	(9,200)	—	(4,800)
Ending balance	$10,300	$ —	$(2,500)	$7,800
Noncontrolling interest:				
Beginning balance	$1,600	$2,300	$ —	$3,900
Current-period change	1,100	(2,300)	—	(1,200)
Ending balance	$2,700	$ —	$ —	$2,700

.28. Statement 130 also permits information related to comprehensive income to be displayed in a statement of changes in equity. The following example uses that approach.

Entity X
Statement of Changes in Equity
Year Ended December 31, 20X2

			Controlling Interest					Noncontrolling Interest	
	Total	**Comprehensive Income**	**Retained Earnings**	**Accumulated Other Comprehensive Income**	**Common Stock**	**Preferred Stock**	**Paid-in Capital**	**Noncontrolling Interests**	**Accumulated Other Comprehensive Income**
Beginning balance	$538,000		$ 88,500	$ (500)	$150,000		$300,000		
Sale of subsidiary shares	60,000			100				$60,000	$ (100)
Comprehensive income:									
Net income (loss)	63,250	$ 63,250	67,650					(4,400)	
Other comprehensive income, net of tax:									
Unrealized gains on securities	11,500	11,500		9,200					2,300
Minimum pension liability adjustment	(2,500)	(2,500)		(2,500)					
Foreign currency translation adjustment	8,000	8,000		6,400					1,600
Other comprehensive income		17,000		13,100					3,900
Comprehensive income		$80,250							
Common stock issued	150,000				50,000		100,000		
Dividends declared on common stock	(10,000)		(10,000)						
Ending balance	$818,250		$146,150	$12,700	$200,000	$ 0	$400,000	$55,600	$3,800

Year Ended December 31, 20X3

			Controlling Interest					Noncontrolling Interest	
	Total	**Comprehensive Income**	**Retained Earnings**	**Accumulated Other Comprehensive Income**	**Common Stock**	**Preferred Stock**	**Paid-in Capital**	**Noncontrolling Interests**	**Accumulated Other Comprehensive Income**
Beginning balance	$818,250		$146,150	$12,700	$200,000		$400,000	$55,600	$ 3,800
Issuance of preferred stock	50,000					$50,000			
Comprehensive income:									
Net income (loss)	117,500	$117,500	116,000					1,500	
Other comprehensive income, net of tax:									
Unrealized gains on securities (net of reclassification adjustment)	(11,500)	(11,500)		(9,200)					(2,300)
Foreign currency translation adjustment	5,500	5,500		4,400					1,100
Other comprehensive income		(6,000)		(4,800)					(1,200)
Comprehensive income		$111,500							
Common stock issued									
Dividends declared on common stock	(10,000)		(10,000)						
Dividends declared on preferred stock	(5,000)		(5,000)						
Ending balance	$964,750		$247,150	$ 7,900	$200,000	$50,000	$400,000	$57,100	$ 2,600

Reclassification amount:

Unrealized holding gains arising during period	$ 8,500
Less: Reclassification adjustment for gains included in net income	(20,000)
Net unrealized gains on securities	$ (11,500)

Appendix C

BACKGROUND INFORMATION AND BASIS FOR CONCLUSIONS

Appendix C

BACKGROUND INFORMATION AND BASIS FOR CONCLUSIONS

Introduction

129. This appendix summarizes considerations that Board members deemed significant in reaching the conclusions in this Statement. It includes reasons for accepting certain views and rejecting others. Individual Board members gave greater weight to some factors than to others.

130. The Board undertook this project in response to concerns expressed by various parties related to classification in the statement of financial position of financial instruments that have characteristics of liabilities, equity, or both. Financial instruments that have characteristics of liabilities were being presented either entirely as equity or between the liabilities section and the equity section of the statement of financial position. Financial instruments that have characteristics of equity also were being presented between the liabilities section and the equity section of the statement of financial position. Additionally, certain financial instruments that have characteristics of both liabilities and equity were being classified entirely as liabilities or entirely as equity.

131. Another reason the Board undertook this project was to accelerate convergence of the accounting standards used in different nations. Other standard setters, namely the Canadian Institute of Chartered Accountants (CICA), the Australian Accounting Standards Board (AASB), and the International Accounting Standards Committee (IASC), have addressed the issue of accounting for financial instruments with characteristics of liabilities, equity, or both. Like this Statement, standards issued by those organizations

require that the components of a financial instrument be classified as liabilities or as equity based on their characteristics. Therefore, the Board believes that issuance of this Statement will enhance convergence of accounting standards toward similar high-quality solutions.

Benefits and Costs

132. One of the precepts of the Board's mission is to promulgate standards only if the expected benefits of the resulting information exceed the perceived costs. The Board strives to determine that a proposed Statement will fill a significant need and that the costs incurred to satisfy that need, as compared with other alternatives, are justified in relation to the overall benefits of the resulting information. The Board has concluded that the benefits that will result from application of this Statement will exceed the related costs.

Background Information

133. This Statement is issued as part of the Board's broad project on financial instruments. That project was added to the Board's agenda in 1986 to address financial reporting issues that were arising, or that were given a new sense of urgency, as a result of financial innovation. The project initially focused on disclosures and resulted in the issuance of FASB Statements No. 105, *Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk,* in March 1990, and No. 107, *Disclosures about Fair Value of Financial Instruments,* in December 1991.

134. In August 1990, the Board issued a Discussion Memorandum, *Distinguishing between Liability and Equity Instruments and Accounting for Instruments with*

Characteristics of Both. The issuance of that Discussion Memorandum, combined with the issuance of another Discussion Memorandum in November 1991, *Recognition and Measurement of Financial Instruments,* commenced the recognition phase of the financial instruments project. That phase of the project has resulted in the issuance of:

?? FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan,* May 1993
?? FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities,* May 1993
?? FASB Statement No. 118, *Accounting by Creditors for Impairment of a Loan—Income Recognition and Disclosures,* October 1994
?? FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities,* June 1998
?? FASB Statement No. 134, *Accounting for Mortgage-Backed Securities Retained after the Securitization of Mortgage Loans Held for Sale by a Mortgage Banking Enterprise,* October 1998
?? FASB Statement No. 137, *Accounting for Derivative Instruments and Hedging Activities—Deferral of the Effective Date of FASB Statement No. 133,* June 1999
?? FASB Statement No. 138, *Accounting for Certain Derivative Instruments and Certain Hedging Activities,* June 2000
?? FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities,* September 2000.

135. The liabilities and equity Discussion Memorandum elicited views on 12 broad issues. Four of those issues related to interpretation and application of the conceptual definitions of liabilities and equity in FASB Concepts Statement No. 6, *Elements of Financial Statements,* and whether the distinction between liabilities and equity should be changed in some manner. Two issues related to whether particular instruments should be classified as liabilities or as equity. Three issues related to whether the Board should make more far-reaching changes to the distinction between liabilities and equity, including whether equity should be defined independently of liabilities and assets, whether a third "capital" element should be added to include certain instruments with characteristics of both liabilities and equity, and whether the distinction between liabilities

and equity should be eliminated. One issue related to the measurement of issuances and repurchases of equity instruments. The two remaining issues addressed accounting by issuers for compound instruments with characteristics of both liabilities and equity. The Board received 104 comment letters in response to that Discussion Memorandum.

136. The Board held 2 days of public hearings on the Discussion Memorandum in March 1991, at which representatives from 13 organizations testified. Subsequent to the public hearings, the Board held two public meetings to discuss the conceptual distinctions between liabilities and equity that were pertinent to its project on accounting for stock compensation and whether the conceptual framework should be changed. At those meetings, the Board decided that it would not make fundamental changes to the definitions of liabilities and equity in the Concepts Statements. After the second of those meetings (held in March 1992), the Board reached a decision to temporarily suspend work on the liabilities and equity project to devote its resources to financial instrument issues that were deemed more urgent. The project was inactive until December 1996, at which time it was discussed by the Board's Financial Instruments Task Force. Based on the discussion at that task force meeting, the project was reactivated. Since that time, the Board has discussed issues related to the liabilities and equity project at 30 Board meetings, as well as 2 additional task force meetings.

Amendment to Concepts Statement 6

137. As part of its deliberations on this Statement, the Board discussed the accounting for financial instrument components that embody obligations that require (or permit at the issuer's discretion) settlement by issuance of the issuer's equity shares. Those obligations

do not meet the original definition of liabilities in Concepts Statement 6 because they do not require a transfer of assets. Therefore, they were classified as equity.

138. However, not all such obligations establish the type of relationship that usually exists between an entity and its owners. For example, if an entity issues a financial instrument that requires settlement by issuance of $100,000 worth of equity shares, some might question whether that obligation establishes an ownership relationship. Because of the fixed amount of value that must be conveyed to the holder, the relationship appears to be more akin to a debtor-creditor relationship than to an ownership relationship.

139. The Board considered and rejected an alternative to resolve the accounting issues raised by those financial instruments by applying the original definitions of liabilities and equity in Concepts Statement 6. The Board decided that it would be preferable to reconsider the distinction between liabilities and equity. Otherwise, classification of financial instruments that embody obligations would be driven exclusively by whether the obligation requires settlement by a transfer of assets or by an issuance of equity instruments. As a result, certain items would be classified as equity even if they do not establish the type of relationship generally considered to be that between an entity and its owners.

140. As a result of its decision to reconsider that distinction, the Board decided to revise the definition of liabilities in Concepts Statement 6. Concurrent with the issuance of this Statement, the Board has issued an amendment to Concepts Statement 6, *Amendment to FASB Concepts Statement No. 6 to Revise the Definition of Liabilities,* to incorporate the revised definition of liabilities that resulted from its deliberations on this project.

Scope

141. This Statement provides guidance for determining the classification and initial measurement of: (a) financial instruments that do not embody obligations of the issuing entity and (b) financial instruments that embody obligations of the issuing entity. The term obligation is used in this Statement to refer to a duty or responsibility on the part of the entity that issues a financial instrument (the issuer) to transfer assets or to issue shares of its own equity.

142. Although this Statement primarily addresses issues pertaining to initial classification and measurement, it also provides limited guidance on the accounting for certain items after initial recognition. For example, this Statement provides guidance on the application of APB Opinion No. 21, *Interest on Receivables and Payables,* to the differences between amounts allocated to liability components of compound instruments and their face amounts (debt discount).

143. This Statement also provides guidance on the accounting for repayments of convertible debt and conversions of convertible debt. The Board concluded that that guidance was necessary because of changes in the classification of convertible debt that result from application of the provisions of this Statement.

144. As part of its work on the consolidations project, the Board identified a number of issues related to the noncontrolling interest. Because the Board has postponed its consideration of consolidation procedures, it considered each of those issues to determine if they should be addressed as part of the labilities and equity project or as part of some other project. Because certain of those issues raise liability and equity classification

questions, the Board concluded that the issues of display of (a) the noncontrolling interest in consolidated statements of financial position, (b) the noncontrolling interest in consolidated income statements, and (c) comprehensive income by entities with less-than-wholly-owned subsidiaries should be addressed as part of the liabilities and equity project. The Board believes that those issues are directly related to its decision that the noncontrolling interest should be presented as a separate component of equity. Therefore, this Statement also provides guidance on certain issues related to reporting of the noncontrolling interest.

145. The Board also elected to address in this Statement the issue of accounting for sales of a subsidiary's shares to entities outside the consolidated group. As a result of the Board's conclusion that the noncontrolling interest makes up part of the equity of a consolidated group, it follows that sales of shares that represent the noncontrolling interest are sales of the consolidated entity's equity. Therefore, the Board concluded that no gain or loss should be recognized on those sales as long as the subsidiary remains consolidated.

146. The Board believes that the issue of accounting for sales of subsidiary shares that result in the subsidiary's no longer being consolidated would be better addressed as part of another project (either consolidations or business combinations). However, the Board decided that until those projects are completed, interim guidance is needed on accounting for those sales. The Board therefore concluded that accounting for sales of subsidiary shares that result in the subsidiary's no longer being consolidated should be addressed in this Statement.

147. The Board intends to address other issues related to the noncontrolling interest (including purchases of shares that make up the noncontrolling interest) as part of the Board's projects on consolidations and business combinations.

148. Additionally, the Board elected to provide guidance on the presentation of adjustments to net income or net loss (or to net income or net loss attributable to the controlling interest) to arrive at the numerator for basic earnings per share.

Initial Classification—Basic Principles

Separation into Components

149. This Statement requires that the issuer of a financial instrument that contains one or more components that, if freestanding, would be classified as equity and one or more components that, if freestanding, would be classified as liabilities identify and report those components separately. The provisions of a compound financial instrument may call for different forms of settlement. For example, debt that is convertible at the option of the holder into shares of the issuer's common stock consists of the following components: an obligation to repay the principal, an obligation to make periodic interest payments, and a written option (also an obligation) to convert the debt into equity shares of the issuer. The issuer is required to transfer assets to settle the obligations embodied in the payable components. However, if the holder exercises the written option, the issuer is instead required to settle the obligation by issuing shares of its own equity. Under APB Opinion No. 14, *Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants,* all three components generally were classified together as a liability. However, if the components were issued as separate, freestanding financial instruments, the written option was classified as equity.

150. The separation of compound financial instruments into components was originally discussed in the liabilities and equity Discussion Memorandum. Each component of a financial instrument is one of six fundamental financial instruments identified in Chapter 1 of that Discussion Memorandum. Fundamental financial instruments are distinguished by the characteristics of the obligations and rights they embody, specifically by the conditionality of the obligations and rights and by the nature of the future economic sacrifices and benefits they specify. The Discussion Memorandum distinguished fundamental financial instruments based on whether they entail transfers or exchanges, their conditionality, and the definitions of assets, liabilities, and equity. Those six fundamental financial instruments are:

a. Unconditional receivable-payable contracts
b. Conditional receivable-payable contracts
c. Financial option contracts
d. Financial guarantee or other conditional exchange contracts
e. Financial forward contracts
f. Equity instruments.

151. That set of fundamental financial instruments was further developed and refined in the recognition and measurement Discussion Memorandum. That Discussion Memorandum introduced the fundamental financial instrument approach, also known as the "building block" approach, as a method of analysis of financial instruments. The approach is based on the premise that all financial instruments are made from a set of only a few different building blocks—fundamental financial instruments—and that determining how to recognize and measure the fundamental instruments would lead to consistent solutions for the accounting issues raised by more complex instruments and by various relationships between instruments.

152. In its deliberations, the Board considered two alternatives identified in the Discussion Memorandums for accounting for compound instruments containing liability and equity characteristics:

a. Identify the so-called governing characteristic of the compound instrument and apply the accounting principles appropriate for instruments with that characteristic to the entire compound instrument.
b. Separate the compound instrument into fundamental components and apply the appropriate accounting principles to each component.

153. A majority of respondents to the liabilities and equity Discussion Memorandum favored the governing-characteristic approach. The majority of those respondents based their responses on practical concerns about estimating the value of the separate components rather than on conceptual reasons. Many respondents stated that the methods available for separately valuing the components were too complex, too costly, and too subjective. Many respondents also said that separate accounting would confuse or mislead users of financial statements.

154. The Board believes that respondents' concerns related to the ability to separate and value the individual components have been ameliorated as a result of an increased level of sophistication in the financial markets since the time the liabilities and equity Discussion Memorandum was issued. Given the developments in pricing models since that time, the Board believes that separately valuing components is more feasible than it might have been at the time that Discussion Memorandum was issued. In fact, other FASB Statements (for example, Statement 133) require separation of certain compound financial instruments into components.

155. Additionally, the Board identified the following concerns related to the governing-characteristic approach:

a. Basing the accounting for an entire instrument on one characteristic sometimes produces anomalous, potentially confusing results. For example, the conversion option embedded in convertible debt sometimes results in a stated interest rate that is below the risk-free rate.
b. In many instances, it may be difficult to determine the governing characteristic. That determination might be made based on which component has the highest value, which outcome is considered the most probable, or which outcome is the default position (that is, which outcome will occur unless an action is taken or a specified event occurs). Those potential issues give rise to additional issues. For example, if the governing characteristic is initially determined based on which outcome is most probable, and subsequently, another outcome becomes more probable, should the instrument be reclassified?
c. Classifying the entire instrument as equity or as a liability ignores the other characteristics embedded in the instrument.

156. Before this Statement was issued, many financial instruments were classified using a governing-characteristic approach. For example, Opinion 14 required that issuers of convertible debt classify convertible debt entirely as a liability. The Board considered retaining that treatment but decided that approach would inappropriately ignore the attributes of the written option and the potential for issuance of equity shares.

157. When Opinion 14 was issued in 1969, the Accounting Principles Board noted that the most important reason for accounting for convertible debt solely as debt is the inseparability of the debt and the conversion option. The Accounting Principles Board noted that the alternative choices embedded in convertible debt cannot exist independently of one another; that is, the two choices are mutually exclusive.

158. The Board disagrees with the Accounting Principles Board's conclusion that the mutually exclusive outcomes should preclude separation. In reaching the conclusion in this Statement to separate convertible debt into components, the Board gave more consideration to the rights and obligations of the counterparties than to the fact that the

two choices are mutually exclusive. The Board believes that the conversion option embodies a distinct obligation of the issuer that should be accounted for.

159. As mentioned previously, significant developments in the sophistication of financial markets in general and in the ability to separately identify and price options have occurred since the issuance of Opinion 14. The Board believes that the level of sophistication that now exists allows for identification of components and separation of financial instruments. For example, Statement 133 requires that the holder of a convertible debt instrument separate the option from the host component. The Board believes that if the holder of convertible debt is able to identify and value the option, it is reasonable to expect that the issuer of the debt would be able to do likewise.

160. The Board believes that the sophistication of today's markets and measurement technology permits components of compound financial instruments to be distinguished and permits the values of those components to be estimated with reasonable reliability, albeit at some cost. The Board believes, however, that the costs of valuing the separate components would not place undue hardship on issuers of compound financial instruments and would be outweighed by the benefits of improved reporting of the rights and obligations embedded in compound financial instruments. Therefore, the Board concluded that the liability components and equity components of a compound financial instrument should be separated and reported separately in the issuer's financial statements.

161. In addition, several other standard setters have considered the issue of whether a compound financial instrument should be separated into components. The CICA (Section 3860 of the *CICA Handbook,* "Financial Instruments—Disclosure and Presentation"), the

AASB (AASB Accounting Standard 1033, *Presentation and Disclosure of Financial Instruments*), and the IASC (IAS 32, *Financial Instruments: Disclosure and Presentation*) each concluded that an issuer of a compound financial instrument should present the liability components and equity components of that financial instrument separately. The Board concluded that because the fundamental components approach is consistent with the conclusions reached by those standard setters, adopting that approach would accelerate convergence of accounting standards used in different nations which, as discussed above, is a goal of the Board.

Presentation between the Liabilities Section and the Equity Section of the Statement of Financial Position

162. As indicated previously, certain financial instruments and other items were presented between the liabilities section and the equity section of the statement of financial position before the issuance of this Statement. Because the Concepts Statements do not accommodate classification of items outside the elements of assets, liabilities, and equity, developing a model that would permit that practice would require the Board to define a new element of financial statements. The Board elected not to pursue that course of action, in part because of concern that adding another element would set an undesirable precedent of adding elements whenever new instruments are created that are difficult to classify.

163. Rather than develop a new element, the Board elected to develop an approach that would address the issues related to determining the appropriate classification of financial instruments with characteristics of liabilities, equity, or both. Because the Board believes that the provisions of this Statement sufficiently address those issues, the Board concluded

that presentation of financial instruments (and components of financial instruments) and other items between the liabilities section and the equity section of the statement of financial position should be prohibited.

Distinguishing between Liability Components and Equity Components

164. Concepts Statement 6 provides definitions of the elements of financial statements, including liabilities and equity. Paragraph 35 of Concepts Statement 6 defines liabilities as follows:

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

Paragraph 36 of Concepts Statement 6 elaborates on that definition by describing three essential characteristics of liabilities:

> A liability has three essential characteristics: (a) it embodies a present duty or responsibility to one or more other entities that entails settlement by probable future transfer or use of assets at a specified or determinable date, on occurrence of a specified event, or on demand, (b) the duty or responsibility obligates a particular entity, leaving it little or no discretion to avoid the future sacrifice, and (c) the transaction or other event obligating the entity has already happened.

165. Paragraph 49 of Concepts Statement 6 defines equity as "the residual interest in the assets of an entity that remains after deducting its liabilities." Paragraph 60 discusses equity in more detail:

> In a business enterprise, the equity is the ownership interest. It stems from ownership rights (or the equivalent) and involves a relation between an enterprise and its owners *as owners* rather than as employees, suppliers, customers, lenders, or in some other nonowner role. Since equity ranks after liabilities as a claim to or interest in the assets of the enterprise, it is a residual interest: (a) equity is the same as net assets, the difference between

> the enterprise's assets and its liabilities, and (b) equity is enhanced or burdened by increases and decreases in net assets from nonowner sources as well as investments by owners and distributions to owners. [Footnote references omitted.]

166. In determining the classification of a component, an important factor to consider is the holder's rights to and expectations of a return on investment. Paragraph 51 of Concepts Statement 6 discusses an owner's expectations:

> Owners invest in a business enterprise with the expectation of obtaining a return on their investment as a result of the enterprise's providing goods or services to customers at a profit. Owners benefit if the enterprise is profitable but bear the risk that it may be unprofitable. [Paragraph references omitted.]

In contrast, the right of a holder of a liability to a return on its investment does not depend directly on the entity's success or failure in providing goods or services to customers at a profit. The Board concluded, therefore, that one issue to consider in determining whether a component establishes an ownership relationship is whether the holder's right to a return depends directly on the profitability of the issuer.

167. The Board's conclusions in this Statement about the initial classification of financial instrument components reflect its reconsideration of the distinction between liabilities and equity in Concepts Statement 6. The Board believes that a fundamental basis for determining whether a financial instrument component should be classified as a liability or as equity is the nature of the relationship that the component establishes between the issuer and the holder. For most common types of financial instruments issued by an entity, application of the definitions in Concepts Statement 6 appropriately reflects those relationships. However, the Board decided that for certain financial instrument components, it is necessary to look beyond the issue of whether the financial instrument

requires a transfer of assets or an issuance of equity shares and consider the nature of the relationship established by the financial instrument component.

168. The requirements of this Statement provide guidance to determine whether that relationship is an ownership relationship, particularly in circumstances in which a transfer of assets or provision of services is not required. The Board believes that determination can be made by examining three aspects of each component. The Board believes those aspects must be viewed in combination for each component to appropriately distinguish those components that are liabilities from those that are equity. Those aspects are:

a. The existence (or lack) of a present obligation to one or more other entities
b. Whether a reporting entity can or must settle the obligation by a transfer of assets or by an issuance of equity shares (and the degree of discretion the reporting entity has to determine how it will settle the obligation)
c. If settlement of the obligation involves the issuance of the issuer's own equity shares, the risks and benefits associated with the value of the holder's investment in the issuer.

169. By focusing on those three aspects, the Board was able to develop an approach that helps to clarify the distinction between liabilities and equity, particularly in circumstances in which a transfer of assets or provision of services is not required. One of the requirements for liability classification under the approach in this Statement is that a component embody a present obligation of some sort. That requirement is consistent with the original definition of liabilities in Concepts Statement 6 and, therefore, does not represent a change. The main difference between the classifications required in this Statement and those that would be required by a strict application of the definition in Concepts Statement 6 relates to obligations that do not require a transfer of the entity's assets. Concepts Statement 6 addresses how the issuer is required to settle the obligation. It requires that if a component is to be classified as a liability, the present obligation must

entail settlement by “probable future transfer or use of assets.” The approach in this Statement places less emphasis on form of settlement and looks to the definition and description of equity in Concepts Statement 6 to assist in determining classification.

170. Thus, the principal change to application of Concepts Statement 6 results from the Board’s consideration of the aspect listed in paragraph 168(c). That aspect is not addressed directly in Concepts Statement 6 because the definition of liabilities in Concepts Statement 6 requires that the entity be obligated to transfer assets. An obligation would not meet the original Concepts Statement 6 definition of a liability and would be classified as equity if the issuer was required or permitted to settle the obligation by issuing shares of its own equity. As discussed previously, however, the Board believes that certain obligations that require or permit settlement by issuance of equity shares should not be classified as equity because they do not establish an ownership relationship. The three aspects in paragraph 168 are discussed in more detail in paragraphs 171–194.

Obligations

171. Identifying whether a financial instrument component embodies an obligation is the starting point in determining the appropriate classification of that component. Both the definition of liabilities in paragraph 35 of Concepts Statement 6 and the essential characteristics listed in paragraph 36 include the notion of an obligation. Additionally, paragraph 200 of Concepts Statement 6 states clearly that “to have a liability, an entity must be *obligated* to sacrifice its assets in the future . . .” (emphasis added). Because an obligation is an essential characteristic of a liability, a financial instrument component that does not embody an obligation cannot qualify as a liability under the original Concepts Statement 6 definition.

Lack of an obligation

172. Paragraph 17(a) of this Statement requires that any component that is an outstanding share of stock of the issuer that does not embody an obligation on the part of the issuer be classified as equity. For example, shares of nonredeemable common stock are outstanding equity shares of the issuer and do not impose on the issuer an obligation to pay dividends or to reacquire the shares. Declaration of dividends is at the discretion of the issuer, as is a decision to reacquire the shares.

173. Similarly, preferred stock that is not mandatorily redeemable does not impose on the issuer an obligation either to repurchase the shares or to pay dividends, even though a failure to pay dividends may have adverse economic consequences for the issuer. Outstanding shares that do not embody obligations lack an essential characteristic of a liability and cannot be classified as one.

174. As discussed in paragraph 55, some types of preferred stock (referred to in this Statement as increasing-rate preferred stock) pay either no dividends or below-market-rate dividends during the first few years they are outstanding and then pay dividends at an increasing rate. Certain issuances of increasing-rate preferred stock may contain terms (most notably the increased dividend rate) that make it highly probable that the issuer will redeem the shares rather than pay the dividends. For example, the dividend rate could increase to a point at which, although the declaration of dividends remains at the discretion of the issuer, failure to pay those dividends could have an adverse economic effect on the issuer. (For example, the accumulation of unpaid dividends could depress the fair value of the entity's common shares and make it more difficult for the issuer to access capital markets.) Assuming that, if capable, issuers would likely redeem those

shares rather than pay the higher dividend rates, the Board considered whether an issuer of that type of preferred stock should be deemed to have an obligation to redeem the shares even though it is not legally obligated to do so.

175. The Board determined that to the extent that the shares are not mandatorily redeemable and no enforceable obligation to pay dividends exists, increasing-rate preferred stock does not embody an obligation on the part of the issuer and, therefore, should not be classified as a liability. Because holders of the shares cannot demand redemption, the issuer is not obligated to redeem the shares until it announces that it will do so. As with other types of preferred stock, the declaration of dividends remains within the control of the issuer. The issuer also has the discretion to avoid paying dividends until it declares them.

176. The Board believes that there is no conceptual distinction between increasing-rate preferred stock and "regular" cumulative preferred stock. The Board decided that in circumstances in which the terms of an issuance of increasing-rate preferred stock or regular preferred stock do not legally obligate the issuer to redeem the shares or to declare and pay dividends, neither type of preferred stock would qualify for liability classification. Therefore, the Board concluded that those issuances of increasing-rate preferred stock, like similar issuances of regular cumulative preferred stock, should be classified as equity. However, issuances of increasing-rate preferred stock that are mandatorily redeemable on (or not later than) a specified date, like other mandatorily redeemable preferred stock, embody obligations to transfer assets and, therefore, are classified as liabilities under the provisions of this Statement.

Existence of an obligation

177. Other financial instrument components do embody obligations on the part of the issuer. Because an obligation is an essential characteristic of a liability, financial instrument components that embody obligations are candidates for liability classification. As discussed previously, two additional aspects of an obligation must be considered to determine the appropriate classification of a component. They are (a) whether the obligation can be settled by a transfer of assets or by an issuance of the issuer's equity shares and (b) if settlement of the obligation involves issuance of the issuer's own equity shares, the risks and benefits associated with the value of the holder's investment in the issuer.

Whether an Obligation Can Be Settled by a Transfer of Assets or by an Issuance of Equity Shares

178. An issuer may be required to transfer assets (such as cash), provide services, or issue equity shares to settle an obligation. Instead of specifying how the obligation must be settled, the terms of a financial instrument may provide either the issuer or the holder with some degree of discretion to determine how the obligation will be settled, or the terms may specify different methods of settlement based on some condition.

Obligations That Specify a Method of Settlement

179. Obligations that require settlement by a transfer of assets or provision of services met the original definition of liabilities in Concepts Statement 6 before it was amended. Those obligations are probable future sacrifices of economic benefits arising from present obligations to transfer assets in the future as a result of past transactions or events. Obligations that meet that definition will continue to be classified as liabilities under this Statement.

180. Other obligations require that the issuer issue shares of its own equity. Those obligations were classified as equity under the original definitions in Concepts Statement 6. As has been discussed previously, however, the Board concluded that those obligations should not be classified as equity unless they establish an ownership relationship. In particular, the Board believes that the obligation must expose the holder to certain risks and benefits that are similar to those to which an owner (that is, a holder of an outstanding share of the entity's equity) is exposed.

181. As noted in paragraph 166 of this Statement, paragraph 51 of Concepts Statement 6 discusses an owner's expectation of realizing a return on investment. That return may result from two direct sources: dividends received and proceeds from sale of the ownership interest. Owners also benefit from (or bear the risk of) unrealized increases (or decreases) in the fair value of their ownership interests that occur while those interests are held. Those benefits are not always linked directly to an entity's profitability. For example, under certain circumstances, owners of an entity may not benefit despite the fact that the entity is profitable. Further, under other circumstances, owners of an entity may benefit even if the entity is unprofitable. To illustrate, consider the following examples:

a. An entity operates in an industry that is subject to government regulation. A new regulation is passed that will take effect in the following year. The regulation will result in a major change to the market in which the entity operates, and future profitability is expected to suffer. As a result, the fair value of the entity's equity shares decreases. However, the entity reports a profit in the current year. In that situation, the realizable value of an investor's ownership interest has declined even though the entity was profitable.
b. An entity makes a large research and development expenditure that causes it to report a net loss in the current year. As a result of the research, the entity's future performance is expected to be greatly enhanced, and the fair value of the entity's shares increases dramatically. In that situation, despite the lack of profitability in the current year, the value of an investor's ownership interest has increased.

182. For purposes of interpreting paragraph 51 of Concepts Statement 6, the Board concluded that in determining whether an owner benefits, it is more appropriate to consider whether the owner's investment increases in value rather than to consider whether the entity is profitable. The value of an owner's investment changes in response to changes in the fair value of the entity's equity shares. Therefore, the Board concluded that exposure to changes in the fair value of the issuer's equity shares provides an appropriate basis for determining the existence of an ownership relationship because the fair value reflects the realizable benefits of owners that are within their control. Therefore, for the purpose of classifying an obligation that requires settlement by issuance of the issuer's equity shares, the distinction between obligations that are liabilities and obligations that are equity should be based on the relationship between (a) the value that the holder is entitled to receive upon settlement of the obligation and (b) the value of the underlying equity shares. In particular, the Board concluded that in order for those obligations to be classified as equity, any benefits or risks of changes in the value of an obligation must stem directly from changes in the fair value of the issuer's equity shares and be similar[21] to those risks or benefits that would be realized by a holder of an outstanding equity share of the entity.

Monetary Value

183. To assist in determining whether the risks of changes in fair value of the issuer's equity shares to which a holder is exposed are similar to those to which a holder of

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[21]Because the approach in this Statement focuses on *changes* in monetary value, it is possible that the monetary value will not reflect all changes in the fair value of the equity shares. For example, for components with an exercise price, there would be no decrease in the monetary value of the obligation if the fair value of the equity shares decreased below that price. (However, to the extent that the monetary value of the obligation does change, that change must be in response to, equal to, and in the same direction as the change in the fair value of the underlying shares if the obligation is to be classified as equity.)

outstanding equity shares is exposed, the Board developed the notion of monetary value. This Statement uses the term monetary value to describe the amount of value measured in units of currency that must be conveyed to the holder upon settlement of an obligation at its maturity absent a change in current market conditions. Monetary value is not a fair value notion; that is, it is not a measurement of the price that the issuer would be required to pay to be released from the obligation currently. Instead, it is the amount of value that the issuer would have to convey to the holder at maturity under the contractual terms of the obligation presuming the fair value of the issuer's equity shares does not change.

184. The Board concluded that if changes in the monetary value of an obligation are caused by, equal to, and in the same direction as changes in the fair value of the issuer's equity shares throughout the period the obligation is outstanding, the holder of the component is exposed to risks and benefits that are similar to those to which a holder of that number of outstanding equity shares (an owner) is exposed. If that is the case, the component establishes an ownership relationship and should be classified as equity under this Statement.

185. In applying that basic principle, the Board concluded that a component embodying an obligation that requires settlement by issuance of a *fixed* number of the issuer's equity shares should be classified as equity. By the very nature of that type of component, changes in its monetary value arise from and are equal to changes in the fair value of that fixed number of shares. For example, consider a holder of 1,000 equity shares and a holder of a component embodying an obligation that requires settlement by issuance of 1,000 equity shares. If the current fair value of the issuer's equity shares is $10, the fair value of 1,000 equity shares owned by the holder of those shares is $10,000. Similarly,

the monetary value of the obligation to issue 1,000 equity shares is $10,000. If the fair value of the issuer's equity shares subsequently increases to $11, both (a) the change in fair value of the 1,000 outstanding shares and (b) the change in monetary value of the obligation to issue 10,000 shares equal $1,000. Consequently, the holder of the component and the holder of the outstanding shares are exposed to similar risks of changes in the fair value of the equity shares. As a result, the component establishes an ownership relationship and, therefore, should be classified as equity under this Statement.

186. Paragraph 17(c)(2) of this Statement addresses obligations that require settlement by issuance of a *variable* number of shares. The monetary values of many of those components are fixed and do not change regardless of changes in the fair value of the issuer's equity shares. For example, if an obligation requires settlement by issuance of shares worth $100,000 on the settlement date, the number of shares to be issued varies with the fair value of those shares. Regardless of changes in that fair value, however, the holder will receive $100,000 of value at settlement—that is, the monetary value of the obligation does not change. The holder of that component does not benefit if the fair value of the issuer's equity shares increases and does not bear the risk that the fair value of those shares might decrease. The component, therefore, is not considered to establish an ownership relationship. Thus, even though the issuer's equity shares will be issued in settlement of the obligation, the Board decided that that type of component should be classified as a liability because it does not establish an ownership relationship. That is, even though the obligation will be settled by issuance of equity shares, the component has more characteristics of a liability than of equity because the holder's return is not related to the fair value of the issuer's equity shares.

187. However, certain obligations that require settlement by issuance of a variable number of shares are considered to establish an ownership relationship under the provisions of this Statement. For certain obligations that can be settled by issuing a variable number of equity shares, any changes in monetary value result from, are equal to, and are in the same direction as changes in the fair value of the issuer's equity shares. For example, a financial instrument component might embody an obligation of the issuer to issue shares with a value equal to the appreciation in the fair value of 5,000 of the issuer's equity shares over some specified period of time. The number of shares that will be issued to settle that obligation would vary depending on the fair value of the issuer's equity shares. However, changes in the monetary value of that obligation would be in response to, equal to, and in the same direction as changes in the fair value of the issuer's equity shares. The realizable value of that component to the holder would increase if the fair value of the shares increased and decrease if the fair value of those shares decreased. Those types of obligations are classified as equity under this Statement.

Obligations That Provide the Issuer with Discretion to Determine How It Will Settle the Obligation

188. Certain financial instruments embody obligations that provide the issuer with the discretion to determine whether it will settle the obligation by transferring assets or by issuing equity shares. Because those obligations provide the issuer with discretion to avoid a transfer of assets, the Board concluded that they should be treated in a manner similar to obligations that require settlement by issuance of equity shares. That is, if the

conditions in paragraph 17(c) related to changes in monetary value are met,[22] obligations that provide the issuer with the discretion to determine how the obligations will be settled should be classified as equity.

Obligations That Provide the Holder with Discretion to Determine How the Issuer Will Settle the Obligation

189. Other obligations provide the holder with the discretion to determine whether the issuer will be required to transfer assets or issue equity shares to settle the obligation. For that type of obligation, the Board concluded that if the monetary values of the two settlement alternatives do not have the potential to differ, the obligation does not establish an ownership relationship, regardless of the settlement provision chosen. Consequently, the Board concluded that such an instrument does not establish an ownership relationship and should not be classified as equity. The obligation should be classified entirely as a liability.

190. To illustrate, assume an entity issues a financial instrument that provides the holder with the discretion to determine whether it will receive $1,000 cash or $1,000 worth of the issuer's equity shares in 1 year. Even though the obligation may potentially be settled by an issuance of shares, the monetary value of the obligation does not change. Therefore, the holder is not exposed to risks of changes in the fair value of the issuer's equity shares that are similar to those faced by a holder of outstanding equity shares.

[22]As discussed in paragraph 185, if an obligation requires settlement by issuance of a *fixed* number of shares, the monetary value conditions are inherently met; that is, any changes in the monetary value of the obligation must arise from, be equal to, and be in the same direction as changes in the fair value of the issuer's equity shares. The same holds true for an obligation that permits the issuer to settle by issuing a fixed number of shares.

191. Obligations that provide the holder with the discretion to choose between two settlement alternatives with equal monetary value are classified as liabilities even if changes in the monetary value are caused by, equal to, and in the same direction as changes in the fair value of the issuer's equity shares. For example, an entity may issue a financial instrument that provides the holder with the discretion to determine whether it will receive 1,000 equity shares of the issuer in 1 year or cash in an amount equal to the fair value of those 1,000 equity shares in 1 year. Although the obligation exposes the holder to risks of changes in the fair value of the issuer's equity shares that are similar to those faced by a holder of outstanding shares, the issuer must stand ready to transfer assets. The Board therefore concluded that the financial instrument should be classified entirely as a liability because the issuer has no discretion to avoid a transfer of assets if the holder exercises its option to receive assets.

192. If the monetary values of the two settlement alternatives have the potential to differ at the settlement date, the Board concluded that the instrument is a compound financial instrument and should be considered to comprise at least two components. Treating the instrument as a single liability component would ignore the potential equity item embedded in the instrument. Conversely, treating the instrument as a single equity component would ignore the potential for settlement of the obligation by transferring assets.

193. The individual components of compound financial instruments should be classified in accordance with paragraph 17. The component that provides for settlement of the obligation by transfer of assets is classified as a liability. The component that provides for

settlement of the obligation by issuance of equity shares is classified as equity if the conditions of paragraph 17(c) are met. Otherwise, it would also be classified as a liability.

194. For example, assume an entity issues a financial instrument that provides the holder with the discretion to determine whether it will receive $1,000 cash or 100 equity shares of the issuer. That instrument comprises (a) an obligation to transfer cash (a liability component) and (b) an obligation to issue a fixed number of equity shares. Because the monetary values of those two obligations have the potential to differ, the Board concluded that each settlement alternative should be treated as a separate component. The criteria in paragraph 17 should be applied to each component separately. As a result, the component that requires settlement by issuance of a fixed number of equity shares is classified as equity because it meets the criteria in paragraph 17(c). The component that requires settlement by transfer of assets is classified as a liability.

Identification of Components

195. Having reached a conclusion that instruments that have more than one settlement alternative should be separated into components if the monetary values of those alternatives have the potential to differ, the Board considered what guidance should be provided on how to identify the components. In many financial instruments, the components are easily distinguishable, and therefore identification of the components is relatively straightforward. For other financial instruments, however, identification of the separate components is not as straightforward.

196. To illustrate the potential difficulties in identifying components, consider the following three instruments:

a. Financial Instrument A requires settlement by transfer of $100,000 cash unless the holder elects to receive 10,000 of the issuer's equity shares (default settlement of assets).
b. Financial Instrument B requires settlement by issuance of 10,000 of the issuer's equity shares unless the holder elects to receive $100,000 cash (default settlement of shares).
c. Financial Instrument C states that at the settlement date, the holder will notify the issuer as to whether it wishes to receive $100,000 cash or 10,000 of the issuer's equity shares (no default settlement specified).

197. Each of those instruments conveys identical rights to the holder and imposes identical obligations on the issuer. However, the Board was concerned that, depending on the terms of the contract, different parties might identify the components of those instruments differently. For example, an issuer might separate Financial Instrument A into (a) an unconditional obligation to transfer $100,000 cash and (b) a written option that, if exercised by the holder, would require the issuer to issue 10,000 shares. However, because Financial Instrument B contains a default settlement provision of an issuance of equity shares, that same issuer might separate that instrument into (1) an unconditional obligation to issue 10,000 equity shares and (2) a conditional obligation to transfer $100,000 cash. Further, the lack of a default settlement provision in Financial Instrument C also could lead to inconsistent classification. Identical instruments issued by different issuers might be accounted for differently. The differing identification likely would result in differing allocations. Given the similarities of those three instruments, the Board believes they should be accounted for similarly.

198. Those concerns led the Board to develop the general guidance for identification of components in paragraph 24. The Board believes that all three instruments described in paragraph 196 are similar to convertible debt in that (a) the instruments provide the holder with the choice between receiving assets and receiving shares and (b) there is no

outstanding share of stock that should be accounted for. Consequently, in each instrument, the issuer has no discretion to avoid a transfer of assets to settle the obligation. Therefore, the Board decided that in each instance the obligation to transfer assets (the liability component) should be considered unconditional.

199. The method in paragraph 24 of identifying components is appropriate if (a) both of the components embody obligations, (b) the monetary values of the two obligations have the potential to differ, and (c) the holder has discretion to determine form of settlement. The Board decided, however, that that method of identifying components would not be appropriate if the instrument comprises an outstanding equity share and a written option that, if exercised, would require settlement by a transfer of assets. That method of identifying components would ignore the fact that an equity share that is not itself an obligation is outstanding.

200. For example, in accounting for puttable common stock, if the obligation to transfer assets were considered an unconditional obligation, puttable common stock would be accounted for in essentially the same manner as convertible debt. However, unlike puttable stock (which embodies one obligation), convertible debt embodies multiple obligations and does not contain an outstanding share of stock. More specifically, the Board believes that even though the cash flows of the two instruments are potentially the same, the contractual rights and obligations of the instruments are markedly different. For example,

a. In accounting for puttable common stock, the fact that a share of stock is outstanding must be taken into account. There is no outstanding share to consider with convertible debt.

b. Exercise of the option embedded in convertible debt would result in an issuance of equity shares. Exercise of the option embedded in puttable common stock would result in a transfer of assets.
c. If the option embedded in convertible debt is not exercised, the issuer is obligated to transfer assets. If the option embedded in puttable common stock is not exercised, the issuer is not required to transfer assets.

201. From a practical perspective, if puttable common stock were considered to contain an unconditional obligation to transfer assets, the conditional obligation would have to be described as an option exercisable by the holder to obtain shares that the holder already owns. Additionally, the amount allocated to that option component would bear no resemblance to the fair value of a separate put option.

202. Given the differences between puttable stock and convertible debt, the Board decided that it was appropriate that they be accounted for differently. The Board decided that puttable stock should not be considered to contain an unconditional obligation to transfer assets. Therefore, those instruments should be considered to comprise (a) an outstanding share of stock and (b) a written put option that, if exercised, would require the issuer to transfer assets.

Obligations That Require Settlement by Issuance of Equity Shares and That Are Subject to Minimum Limitations on Monetary Value

203. Other financial instruments contain obligations that require settlement by issuance of a fixed number of equity shares but also have monetary values that are subject to minimum limitations. The Board believes that even though the obligations embedded in that type of instrument require settlement by issuance of equity shares, the instrument should be considered a compound instrument because the potential exists for the monetary values of the two obligations to differ. For example, assume an entity issues a financial instrument that (a) requires settlement by issuance of 1,000 of its equity shares and (b)

contains a provision that the value conveyed to the holder at settlement cannot be less than $10,000. If the fair value of the entity's shares at settlement date is $10 or greater, the entity will settle by issuing 1,000 equity shares. The monetary value of that obligation is equal to the fair value of the entity's equity shares multiplied by 1,000. If the fair value of the entity's equity shares at settlement is less than $10, the entity will be required to issue more than 1,000 shares. The monetary value of that obligation is $10,000.

204. The Board concluded that that type of financial instrument should be considered to comprise (a) an unconditional obligation to issue equity shares worth a fixed amount (a liability component) and (b) a conditional obligation (similar to an SAR) to issue shares with a value equal to the appreciation of 1,000 equity shares above a fair value of $10 per share.

205. Some may believe that the instrument in paragraph 203 should be considered to comprise (a) an unconditional obligation to issue 1,000 equity shares and (b) a conditional obligation to issue additional shares to make up for any shortfall in value. That conditional obligation is similar to a written put option in that it represents a right exercisable by the holder to put the 1,000 equity shares to the issuer in return for shares worth $10,000. In most circumstances, if the instrument were separated in that manner, the majority of the proceeds would be allocated to the equity component. Proponents of that classification approach believe that that allocation is appropriate, noting the following equity-like characteristics of the instrument:

a. The obligation must be settled by issuance of equity shares.
b. Because the obligation cannot be settled by issuance of fewer than 1,000 shares, there is some element of settlement by issuance of a fixed number of equity shares.

206. The Board believes, however, that although the obligation requires settlement by issuance of equity shares, that fact by itself does not justify equity classification. The Board concluded that other obligations that require settlement by issuance of equity shares (namely, those obligations requiring settlement by issuance of equity shares worth a fixed value) should be classified as liabilities.

207. The Board also considered the issuer's lack of discretion to choose between the alternative settlement amounts contained in that financial instrument. In doing so, the Board considered its conclusions for classification of other types of financial instruments in which the issuer lacks discretion. In particular, the Board noted that when the issuer cannot choose whether it will settle an obligation by a transfer of assets or by the issuance of its equity shares, the obligation is classified as a liability even though the instrument may be settled by issuing equity shares.

208. The discretion to choose between forms of settlement is not at issue with respect to the instruments containing floors because those instruments require settlement by issuance of equity shares. However, the issuer's discretion also is relevant to the issuer's ability to choose the total amount of value required to be delivered to settle the obligation. For instruments that contain a floor, the issuer has no discretion to avoid the obligation that would be classified as a liability under the provisions of this Statement. The Board concluded that, for instruments that have a floor, a fixed minimum obligation exists that should be classified as a liability. Once it is determined that an obligation would be classified as a liability, the classification requirements should be indifferent as to form of settlement.

Initial Measurement

Method of Allocation

209. In determining how the proceeds received from issuing a compound financial instrument should be allocated to its components, the Board considered whether it should prescribe a specific method to be used and if so, what method. The Board noted that other standard-setting bodies (the CICA, the AASB, and the IASC) had issued standards requiring separate presentation of the liability components and the equity components of a compound financial instrument. None of the standards developed by those institutions prescribe a specific method of allocating the proceeds of issuance to the separately classified liability and equity components because the scope of each of those documents is limited to presentation and disclosure. Instead, each of the standards describes a fair value objective and describes two possible valuation methods. Although the methods are not referred to by name, the descriptions correspond to the relative-fair-value method and the with-and-without method described in this Statement. The following is an excerpt from paragraph 29 of Section 3860 of the *CICA Handbook*:[23]

> This Section does not deal with measurement of financial assets, financial liabilities and equity instruments and does not therefore prescribe any particular method for assigning a carrying amount to liability and equity elements contained in a single instrument. Approaches that might be followed include:
>
> (a) assigning to the less easily measurable component (often an equity instrument) the residual amount after deducting from the instrument as a whole the amount separately determined for the component that is more easily measurable; and
> (b) measuring the liability and equity components separately and, to the extent necessary, adjusting these amounts on a pro rata basis so that the sum of the components equals the amount of the instrument as a whole.

[23] AASB 1033 and IAS 32 contain similar language.

210. The Board noted that the absence of a prescribed approach in those standards could lead to a lack of comparability among entities applying those standards. That would be contrary to the Board's intent of maximizing the value of information provided by reporting liability components and equity components separately. Therefore, the Board concluded that a specific method should be prescribed.

211. Having concluded that a specific method should be prescribed, the Board then considered what that method should be. The liabilities and equity Discussion Memorandum and the recognition and measurement Discussion Memorandum identify two alternatives: the relative-fair-value method and the with-and-without method. Those two methods are summarized in the following paragraphs.

212. Paragraph 6.74(a) of the recognition and measurement Discussion Memorandum describes the relative-fair-value method as follows:

> This method necessitates measuring the whole heterogeneous compound instrument and each of its components and comparing the sum of the components' values with the value of the entire compound; any difference would be allocated on a pro rata basis among the components. For example, if the issuer of exchangeable debt measured the values of the unconditional payable contract and the option contract independently and the sum of the two does not equal the proceeds received from issuance of the exchangeable debt, the proceeds would be allocated to the two components in the ratio of the separately measured amounts. [Footnote reference omitted.]

213. Paragraph 6.74(b) of that Discussion Memorandum describes the with-and-without method as follows:

> This method necessitates valuing a specific component by deduction, after independently determining the market value of both the complete heterogeneous compound instrument and a hypothetical instrument that does not include that component. For example, to value the conversion

> feature in a callable convertible bond, the issuer would determine the market values of both the entire bond and a nonconvertible callable bond with otherwise identical terms; the difference between the two market values would be the market value of the barter option (conversion feature) under the with-and-without method. [Footnote reference omitted.]

214. The Board believes that neither method is universally superior. The predominant factor the Board considered is the availability of fair values. The Board believes that if the fair values of *all* of the components are available, the relative-fair-value method is preferable because that method treats all components comparably. When components are embedded in a compound financial instrument, the interaction of those components generally results in a total value for the instrument that differs from the sum of the values of freestanding components. The relative-fair-value method avoids attributing to a single component the entire effect of that interaction. That method also tends to dilute the effect of any inaccuracies in an estimate of a component's value. In addition, the relative-fair-value method preserves the relationship among the components in terms of the amount of value each contributes to the financial instrument in its entirety. For those reasons, the Board concluded that, with the exception of the circumstances discussed in paragraphs 215–218, the relative-fair-value method should be used to allocate the proceeds of issuance to the separately classified liability components and equity components.

215. The Board acknowledges, however, that the relative-fair-value method may not be practical in all circumstances. For example, fair values may not be available for all individual components of all compound instruments. Further, the relative-fair-value method would not be practical in circumstances in which the costs of obtaining a reliable measure of an individual component's fair value are excessive. This Statement, therefore, requires use of the with-and-without method in two circumstances. The first is when use

of the relative-fair-value method is not possible because the fair values of the components are not available.

216. The second circumstance in which the with-and-without method should be used is when the financial instrument contains one or more components that meet the definition of a derivative under Statement 133 (as discussed in paragraph 28 of this Statement). That conclusion was a pragmatic one based on the position reached in Statement 133 Implementation Issue No. B6, "Embedded Derivatives: Allocating the Basis of a Hybrid Instrument to the Host Contract and the Embedded Derivative." That Issue discusses allocation of proceeds to compound financial instruments containing derivative components.

217. If the relative-fair-value method were used, the issuer initially would record the component at its *relative* fair value. The issuer would then be required under Statement 133 to adjust the carrying amount of that component to its fair value as if it were freestanding, resulting in recognition of gain or loss if the fair value differed from the amount allocated. It is likely that, because of the allocation process inherent in the relative-fair-value method, the amount allocated to the "derivative" component would differ from its fair value. As stated in Implementation Issue B6:

> Because the "relative fair value" method involves an independent estimation of the fair value of each component, the sum of the fair values of those components may be greater or less than the initial basis of the hybrid instrument, resulting in an initial carrying amount for the embedded derivative that differs from its fair value. Similarly, the "with and without" method based on the fair value of the host contract may result in an initial carrying amount for the embedded derivative that differs from its fair value. Therefore, both of those methods may result in recognition of an immediate gain or loss upon reporting the embedded derivative at fair value. [References omitted.]

218. The Board concluded that an issuer should allocate the proceeds using the with-and-without method, based on the fair value of the derivative component, to avoid the recognition of gain or loss upon issuance. Therefore, the derivative component should be recorded at its fair value, and the residual amount of proceeds should be allocated to the other component or components. The Board agreed that in those circumstances the relative-fair-value method should not be used even if the fair value of each component can be determined and, therefore, provided an exception to the requirement to use that method for financial instruments that contain components that meet the definition of a derivative under Statement 133.

Compound Financial Instruments That Contain Components That Are neither Liabilities nor Equity

219. The primary purpose of this Statement is to provide guidance to assist issuers of compound financial instruments with classification of financial instruments that have characteristics of liabilities, equity, or both. The Board notes that it is sometimes difficult to distinguish between liabilities and equity. Similar problems do not arise in distinguishing either liabilities or equity from assets. Thus, assets are not included in the scope of this project.

220. As discussed in paragraph 16, however, certain financial instruments that have characteristics of liabilities, equity, or both also include components that, if freestanding, would be classified as assets. An example of that type of instrument is callable convertible debt (discussed in paragraph 30). The call option in callable convertible debt, if freestanding, would be an asset.

221. Because assets are not included in the scope of this project, this Statement does not require separation of those asset components. Rather, unless an asset is required to be presented separately under other authoritative accounting literature, the effect of an asset component should be reflected in determining the fair value of the liability or equity component. For example, because exercise of the call option in callable convertible debt would have the effect of calling both the obligation to repay principal and pay interest (liabilities) and the conversion option (equity component), the amount of proceeds allocated upon issuance to both of those components should take into account the effect of the call option. Thus, the proceeds of issuing a financial instrument such as callable convertible debt should be allocated to the liability and equity components using the relative-fair-value method (unless the financial instrument meets one of the exceptions described in paragraphs 215–218) based on the relative fair values of callable debt and a callable conversion option.

Repayments and Conversions of Convertible Debt

222. APB Opinion No. 26, *Early Extinguishment of Debt,* addresses the accounting for debt that is extinguished before its maturity date. Paragraph 21 of Opinion 26 states:

> *Convertible debt*. The extinguishment of convertible debt before maturity does not change the character of the security as between debt and equity at that time. Therefore, a difference between the cash acquisition price of the debt and its net carrying amount should be recognized currently in income in the period of extinguishment as losses or gains.

223. However, Opinion 26 was written in the context of Opinion 14, which did not permit separation of convertible debt into its liability and equity components. Consequently, the Board decided to amend paragraph 21 of Opinion 26 to require that an issuer of convertible debt account for the separate components of that instrument.

224. When convertible debt is extinguished, the consideration paid to extinguish the debt also extinguishes the conversion option. Consequently, the Board concluded that a portion of the consideration paid is attributable to the conversion option. For reasons discussed previously, the Board believes that, unless impracticable, the relative-fair-value method should be used to determine the portion of the consideration to be attributed to each of the components.

225. The Board believes that conversions of convertible debt are similar in nature to extinguishments by repayment and, therefore, should receive similar accounting treatment. For that reason, the Board concluded that upon conversion, the fair value of the convertible debt at the date of conversion should be attributed to the liability and equity components in the same manner as discussed in paragraph 224.

Entities with One or More Less-Than-Wholly-Owned Subsidiaries

226. For an entity with one or more less-than-wholly-owned subsidiaries, the Board concluded in this Statement that the noncontrolling interest in a consolidated subsidiary should be reported in the consolidated financial statements as equity. That conclusion is consistent with the discussion of minority interests in paragraph 254 of Concepts Statement 6:

> Minority interests in net assets of consolidated subsidiaries do not represent present obligations of the enterprise to pay cash or distribute other assets to minority stockholders. Rather, those stockholders have ownership or residual interests in components of a consolidated enterprise.

227. The Board previously addressed the issue of classification of the noncontrolling interest in the October 1995 Exposure Draft, *Consolidated Financial Statements: Policy and Procedures*. Paragraph 22 of that Exposure Draft stated:

> The aggregate amount of the noncontrolling interest in subsidiaries that are not wholly owned by the parent shall be reported in consolidated financial statements as a separate component of equity. [Footnote reference omitted.]

228. In response to that Exposure Draft, the Board received comments on its conclusions related to the noncontrolling interest. As part of its due process, the Board considered those comments and ultimately decided not to issue a final Statement on consolidation policy and procedures at that time.[24]

229. The Board decided, however, that resolving certain issues related to the noncontrolling interest was necessary before the requirements in this Statement could be implemented. In particular, one of the goals of this project was to eliminate classification of items between the liabilities section and the equity section of the statement of financial position. Consequently, the Board elected to address the following issues related to the noncontrolling interest:

a. Display of the noncontrolling interest in the consolidated statement of financial position
b. Display of the noncontrolling interest in the consolidated income statement
c. Accounting for sales of a subsidiary's shares if those sales do not result in the subsidiary's no longer being consolidated
d. Accounting for sales of a subsidiary's shares if those sales result in the subsidiary's no longer being consolidated.

Additionally, because classification of the noncontrolling interest as equity will give rise to changes in the way in which certain items are presented in the income statement and the way in which components of other comprehensive income are displayed, the Board elected to provide guidance on those issues as well.

[24]The FASB Exposure Draft, *Consolidated Financial Statements: Purpose and Policy,* was issued in February 1999. That Exposure Draft is a revision of the 1995 Exposure Draft. The 1999 Exposure Draft focuses on consolidation policy and does not address issues related to the noncontrolling interest.

230. Other issues related to the noncontrolling interests do not have a direct effect on the liabilities and equity project and, therefore, are not addressed in this Statement. The Board intends to address certain issues related to the noncontrolling interest as part of its projects on business combinations and consolidations.

231. The Board considered three possible methods of reporting the noncontrolling interest: as a liability, as equity, or as a separate item between the liabilities section and the equity section of the consolidated statement of financial position. The Board reached the same conclusion that it had reached in its 1995 consolidations Exposure Draft: the noncontrolling interest should be reported as a separate component of equity. The rationale underlying the Board's conclusion is similar to that included in the 1995 consolidations Exposure Draft and is summarized in paragraphs 232–236.

232. The display of the noncontrolling interest as a liability has no conceptual support because it does not meet the definition of a liability under Concepts Statement 6. None of the entities involved—the parent company, the subsidiary, or the consolidated entity—have an obligation. Therefore, the noncontrolling interest lacks a fundamental characteristic of a liability.

233. The Board also considered and rejected the alternative of requiring that the noncontrolling interest be reported as a separate item between the liabilities section and the equity section of the consolidated balance sheet. In the 1995 consolidations Exposure Draft, the rationale for rejecting that view was included in paragraph 106:

> Some who said that the noncontrolling interest is not a liability suggested, nonetheless, that it not be reported as equity because that interest has no ownership interest in the parent. That view suggests that a

> new element—noncontrolling interests in consolidated subsidiaries—be created specifically for consolidated financial statements. Concepts Statement 6 defines three elements of a statement of financial position: assets, liabilities, and equity (or net assets). The Board concluded that no compelling reasons exist to create a new element of financial statements to report the interests of stockholders that do not control the parent or its subsidiaries. The Board believes that appropriate labeling and disclosure of items and distinctions between items within the existing elements of financial statements will report financial information in consolidated financial statements that is representationally faithful, understandable, and relevant to owners of the parent as well as to creditors and other resource providers of the parent.

That rationale is consistent with other conclusions reached by the Board in this Statement.

234. Having reached a decision that the noncontrolling interest in a subsidiary constitutes part of the equity of a consolidated group, the Board concluded that sales of shares of that subsidiary are sales of the consolidated entity's equity and, therefore, should not result in gain or loss recognition as long as the subsidiary remains consolidated. The Board continues to support the rationale for that decision that was initially put forth in paragraph 128 of the 1995 consolidations Exposure Draft:

> . . . the Board believes that [sales of] the stock of a subsidiary by any of the affiliates, whether . . . by the parent or another subsidiary . . . are transactions in the equity of the reporting entity. The stock of the subsidiary is neither an asset nor a liability of the reporting entity comprising a parent and its subsidiaries. Rather, it is part of the residual interest remaining after subtracting consolidated liabilities from consolidated assets. Therefore, no gains or losses should be recognized on those transactions.

235. Some Board members believe that the issue of accounting for sales of subsidiary shares that result in the subsidiary's no longer being consolidated would be better addressed as part of another Board project. The Board decided, however, that until that project is completed, guidance is needed on how to account for those sales.

236. If the sale of shares results in the subsidiary's no longer being consolidated, the transaction is no longer a transaction in the entity's own equity. Therefore, the sale should result in gain or loss recognition. Under generally accepted accounting principles, a gain or loss on the sale of shares of stock is equal to the difference at the time of sale between the selling price and the carrying amount of the stock sold. The Board is aware that some have concerns about applying that requirement in this situation, but it concluded that reconsideration of that general requirement as it applies to the sale of subsidiary shares that results in the subsidiary's no longer being consolidated is beyond the scope of this Statement. Therefore, the Board decided that that requirement should continue to apply to those transactions.

Reporting Comprehensive Income and Its Components

237. The Board believes that only transactions related to financial instrument components that are classified as equity are transactions with owners in their role as owners. The effect of those transactions should be recognized directly in equity. Transactions with nonowners, as well as transactions with owners acting other than in their role as owners, should be included in the determination of comprehensive income. As a result of the Board's conclusions related to classification of components in the statement of financial position, transactions related to all components that are classified as liabilities are considered to be transactions with nonowners.

238. The Board's conclusion that the noncontrolling interest is part of the equity of an entity gives rise to issues of how to present individual line items in the income statement. Before issuance of this Statement, income attributable to the noncontrolling interest was deducted to arrive at consolidated net income in consolidated financial statements. That

practice was based on a view that the noncontrolling interest lacks characteristics of equity because the noncontrolling investors in a subsidiary do not have an ownership interest in the subsidiary's parent. The Board's perspective that both the controlling interest and the noncontrolling interest are part of the proprietary group of the consolidated entity led the Board to conclude that the noncontrolling interest is of the same nature and should be accounted for in essentially the same way as the controlling interest. Consequently, all items included in the income statement should include amounts attributable to both the controlling interest and the noncontrolling interest. That is consistent with paragraph 254 of Concepts Statement 6.

239. Similar to its decision on presentation of line items in the income statement, the Board's decision that components of other comprehensive income should include amounts attributable to both the controlling interest and the noncontrolling interest is a logical consequence of its decision that the noncontrolling interest is part of the equity of the consolidated entity.

Earnings per Share

240. In its deliberations related to the treatment of the noncontrolling interest, the Board discussed what impact, if any, the classification of the noncontrolling interest as equity should have on the computation of earnings-per-share amounts. The Board concluded that the presentation of earnings-per-share information is for the benefit of the controlling interest stockholders. Thus, although both the controlling interest and the noncontrolling interest amounts are reported in items of comprehensive income, the Board decided the calculation of earnings-per-share data in consolidated financial statements that include

subsidiaries that are not wholly owned should be based on amounts attributable to the controlling interest.

241. The Board also considered whether a difference between the proceeds and carrying amount of subsidiary shares sold in a sale that does not result in the subsidiary's no longer being consolidated should be viewed as a transfer of wealth between the controlling interest and the noncontrolling interest. Such a perspective might indicate the need to adjust the numerator of the basic earnings-per-share calculation to reflect amounts reported in paid-in capital for those transactions. The Board noted that such an approach would be inconsistent with the Board's conclusion that both the controlling interest and the noncontrolling interest are part of the same proprietary group of stockholders of the consolidated entity. Therefore, the Board concluded that amounts charged or credited to paid-in capital for those transactions should not be treated as adjustments to the numerator of the earnings-per-share calculation.

Disclosures

242. The Board believes that the existing disclosure requirements for liabilities and for equity instruments, most notably those requirements in FASB Statement No. 129, *Disclosure of Information about Capital Structure,* are sufficient to provide users of financial statements with adequate information to analyze an entity's liabilities and equity. Therefore, this Statement does not introduce new disclosure requirements for financial instruments classified in their entirety as either liabilities or equity. However, the Board concluded that, in order to continue to provide those users with adequate information after the adoption of this Statement, those existing disclosure requirements for financial

instruments classified in their entirety as liabilities or as equity also should apply to components of financial instruments that are separately classified as liabilities or equity.

243. As a result of this Statement, issuers of compound financial instruments may be required to separate those compound instruments into liability and equity components. Because it may not be readily apparent to readers of financial statements that those separately presented components are part of a single financial instrument, the Board concluded that the disclosure requirements of paragraph 45 of this Statement should be applied in the year that the compound financial instrument is issued.

244. The Board believes that disclosure of the nature of the instrument, a description of components into which the instrument was separated, and the allocation of proceeds at issuance will provide users of financial statements with information that will facilitate their understanding of an entity's capital structure.

245. The method used to allocate the proceeds of issuance and the assumptions used to allocate those proceeds to the components (including those used to determine the fair values used to apply the allocation method) may significantly affect the amounts at which the components are recorded in the financial statements. Therefore, disclosure of the method of allocation and those key assumptions will assist users of financial statements in understanding the information provided by entities in their financial statements.

246. The Board also concluded that an entity with one or more less-than-wholly-owned subsidiaries should be required to disclose certain information related to the controlling interest. FASB Statement No. 128, *Earnings per Share*, requires presentation of basic per-share amounts for income from continuing operations and net income on the face of

the income statement. It also requires that an entity that reports a discontinued operation, an extraordinary item, or a cumulative effect of an accounting change present basic and diluted per-share amounts for those line items either on the face of the income statement or in the notes to the financial statements. As discussed previously, because the noncontrolling interest is classified as equity, amounts displayed as line items in the income statement and amounts displayed as components of comprehensive income will include amounts attributable to both the controlling interest and the noncontrolling interest. However, earnings-per-share calculations should continue to be based on amounts attributable to the controlling interest. Therefore, the Board concluded that an entity should be required to disclose amounts attributable to the controlling interest for relevant per-share computations.

247. The Board also concluded that an entity with one or more less-than-wholly-owned subsidiaries should be required to disclose amounts attributable to the controlling interest for total comprehensive income and components of other comprehensive income. The Board believes that most users of the consolidated financial statements are interested in information pertaining to the controlling interest. Therefore, the Board elected not to require disclosure of amounts attributable to the noncontrolling interest for total comprehensive income and components of other comprehensive income. The Board noted that that information is available in the subsidiary's financial statements.

Effective Date and Transition

248. This Statement is effective for financial statements issued for fiscal years beginning after June 15, 2002. The Board concluded that the effective date provides entities with adequate time to accumulate and develop the information required by this Statement. The

Board also decided to permit entities to adopt the provisions of this Statement as of the beginning of any fiscal year that begins after issuance of this Statement.

249. In determining the appropriate transition method, the Board considered prospective application, cumulative-effect transition, and retroactive application. The Board concluded that prospective application (that is, application to financial instruments issued after the adoption of this Statement or some other specified date) would diminish both the comparability of financial statements among entities and consistency within an entity that had entered into similar transactions both before and after adoption of this Statement. Given the long lives of certain of the financial instruments within the scope of this Statement, the Board was concerned with the length of time that would elapse before comparability and consistency would be achieved.

250. In considering cumulative-effect transition, the Board noted that a number of recent standards issued by the Board as part of its comprehensive project on financial instruments have prohibited retroactive application. For example, Statement 115 and Statement 133 do not permit retroactive application. However, the Board's decisions not to permit retroactive application of those standards were based to some extent on the fact that both of those standards rely on the reporting entity's intent. For example, under Statement 115, classification of securities among the categories of trading, held-to-maturity, and available-for-sale is based on the entity's intent. The Board notes that the reporting entity's intent is not relevant in this Statement and, therefore, is not a factor that would prohibit restatement.

251. The Board also prohibited retroactive application of the provisions of Statement 140 because of the perceived costs of restatement. The Board believes that in order to determine the effect of adopting this Statement, an entity will be required to determine the fair values of a financial instrument and its components at the date the financial instrument was issued. That determination would be required regardless of whether the Board required cumulative-effect transition or restatement. The Board concluded, therefore, that requiring restatement (rather than cumulative-effect transition) would not result in significant additional costs to entities. The Board believes that retroactive application and restatement would maximize consistency and comparability. Given that, and the belief that the costs of restatement would not be materially greater than the costs of cumulative-effect transition, the Board concluded that restatement is the appropriate transition method.

252. The Board then considered those items for which restatement should be required. The Board considered the following alternatives:

a. Complete restatement
b. Restatement for items outstanding at any point during any period presented
c. Restatement for items outstanding at any point during the year of adoption.

253. The alternative of complete restatement (that is, restatement for all items within the scope of this Statement) was considered to be cost prohibitive. The Board concluded that the benefits of information provided by complete restatement would not outweigh the costs.

254. In comparing the remaining two alternatives, the Board concluded that restatement should only be required for those items outstanding at any point in the year of adoption. The Board's decision was based on practical considerations. Although the alternative in

paragraph 252(b) would result in more comparability, that increased comparability would come at an increased cost. The Board concluded that the alternative in paragraph 252(c) would result in a sufficient level of comparability at lower cost.

255. The Board believes, however, that some entities may wish to maximize comparability by restating for all items within the scope of this Statement that were outstanding at any time during any period presented. For that reason, the Board decided to permit restatement for those items. However, the Board wanted to ensure that users of financial statements were provided with meaningful and consistent information. The Board considered whether an entity should be able to restate for selected items but concluded that permitting that type of restatement would not achieve the desired comparability. Thus, the Board concluded that an entity that chooses to restate for items other than those outstanding in the year of adoption should restate for all items outstanding in any period presented.

Appendix D

AMENDMENTS TO EXISTING PRONOUNCEMENTS

256. This Statement supersedes APB Opinion No. 14, *Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants.*

257. APB Opinion No. 21, *Interest on Receivables and Payables,* is amended as follows:

a. In paragraph 4, the last sentence is replaced by the following:

> The accounting for convertible debt is prescribed in FASB Statement No. 1XX, *Accounting for Financial Instruments with Characteristics of Liabilities, Equity, or Both.*

b. In paragraph 16, the last sentence, as amended by FASB Statement No. 34, *Capitalization of Interest Cost,* is replaced by the following:

> In accordance with Statement 1XX, costs incurred to issue a financial instrument shall be accounted for as a reduction of proceeds of issuance. Issuance costs comprise only those incremental costs directly attributable to issuance that would have been avoided if the instrument had not been issued.

258. Paragraph 21 of APB Opinion No. 26, *Early Extinguishment of Debt,* is replaced by the following:

> *Convertible debt*. In accordance with FASB Statement No. 1XX, *Accounting for Financial Instruments with Characteristics of Liabilities, Equity, or Both,* if convertible debt is extinguished, a portion of the consideration paid on extinguishment shall be attributed to the liability component and the equity component based on their relative fair values at the date of extinguishment. Any difference between (a) the amount attributed to the liability component and (b) the carrying amount of the liability component shall be recognized in income. No gain or loss shall be recognized for the difference, if any, between (1) the amount attributed to the equity component and (2) the carrying amount of that component.

259. The last sentence of AICPA Accounting Interpretation 1, "Debt Tendered to Exercise Warrants," of Opinion 26 is replaced by the following:

In accordance with FASB Statement No. 1XX, *Accounting for Financial Instruments with Characteristics of Liabilities, Equity, or Both,* the fair value of the convertible debt at the date of conversion shall be attributed to its separately classified liability and equity components based on their relative fair values at the date of conversion. A gain or loss shall be recognized for the difference between the carrying amount of the liability component and its relative fair value.

260. The following is added to the end of paragraph 36 of FASB Statement No. 109, *Accounting for Income Taxes:*

h. Temporary differences arising from the separation of financial instruments into components in accordance with FASB Statement No. 1XX, *Accounting for Financial Instruments with Characteristics of Liabilities, Equity, or Both.*

261. FASB Statement No. 123, *Accounting for Stock-Based Compensation,* is amended as follows:

a. The following footnote is added to the end of the heading that precedes paragraph 18, *Awards that call for settlement by issuing equity instruments*:

*In accordance with FASB Statement No. 1XX, *Accounting for Financial Instruments with Characteristics of Liabilities, Equity, or Both,* certain obligations that require (or permit at the issuer's discretion) settlement by issuance of equity shares are classified as liabilities. Those obligations shall be accounted for in conformity with paragraph 25.

b. The following footnote is added to the end of the heading that precedes paragraph 25, *Awards that call for settlement in cash*:

[†]As discussed in footnote *, this section applies to certain obligations that require (or permit at the issuer's discretion) settlement by issuance of equity shares that are classified as liabilities pursuant to Statement 1XX.

262. FASB Statement No. 128, *Earnings per Share,* is amended as follows:

a. The following footnote is added to the end of the second sentence of paragraph 9:

*For entities with one or more less-than-wholly-owned subsidiaries, any deduction for preferred stock dividends declared or accumulated shall be from income from continuing operations attributable to the controlling interest and from net income attributable to the controlling interest. Similarly, any increase for preferred stock dividends shall be to loss from continuing operations attributable to the controlling interest and net loss attributable to the controlling interest.

b. The following is added to the end of footnote 4:

> Entities with one or more less-than-wholly-owned subsidiaries shall use that line item as it related to the controlling interest (for example, *income before extraordinary items attributable to the controlling interest* or *income before accounting change attributable to the controlling interest*).

c. The following footnote is added to the end of the first sentence of paragraph 15:

> *Entities with one or more less-than-wholly-owned subsidiaries shall use income from continuing operations attributable to the controlling interest (adjusted for preferred stock dividends) as the "control number" in determining whether those potential common shares are dilutive or antidilutive.

d. Footnote 15 is replaced by the following:

> The amount of preferred dividends added back will be the amount of preferred dividends for convertible preferred stock deducted from income from continuing operations and from net income (or, if applicable, income from continuing operations attributable to the controlling interest and net income attributable to the controlling interest) in computing income available to common stockholders pursuant to paragraph 9.

e. In the third sentence of paragraph 58, *(or, if applicable, income from continuing operations attributable to the controlling interest)* is inserted after *restatement of income from continuing operations*.

f. In paragraph 171, the following is added to the end of the definition of *Income available to common stockholders*:

> *(or, if applicable, income (or loss) from continuing operations attributable to the controlling interest or net income (or net loss) attributable to the controlling interest adjusted for preferred stock dividends*.

263. In paragraph 4 of FASB Statement No. 129, *Disclosure of Information about Capital Structure*, the phrase *(and components thereof)* is added to the end of the first sentence.

264. FASB Statement No. 130, *Reporting Comprehensive Income,* is amended as follows:

a. The following footnote is added to the end of paragraph 14:

> *As discussed in FASB Statement No. 1XX, *Accounting for Financial Instruments with Characteristics of Liabilities, Equity, or Both,* entities with one or more less-than-wholly-owned subsidiaries are required to disclose a total amount for comprehensive income attributable to the controlling interest.

b. The following footnote is added to the end of paragraph 22:

> *Statement 1XX provides illustrations of reporting comprehensive income for entities with one or more less-than-wholly-owned subsidiaries.

c. The following footnote is added to the end of the third sentence of paragraph 26:

> *Entities with one or more less-than-wholly-owned subsidiaries shall display separate totals for comprehensive income attributable to the controlling interest and comprehensive income attributable to the noncontrolling interest.

265. In FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities,* the phrase *in accordance with the requirements of FASB Statement No. 1XX, Accounting for Financial Instruments with Characteristics of Liabilities, Equity, or Both* is added to the end of paragraph 11(a).

Appendix E

GLOSSARY

266. This appendix contains definitions of terms as used in this Statement.

Fair value

The amount at which an asset (liability) could be bought (incurred) or sold (settled) in a current transaction between willing parties, that is, other than in a forced or liquidation sale. Additional guidance on determining fair value is provided in other FASB Statements and Concepts Statements.

Monetary value

The gross amount of value measured in units of currency that must be conveyed to the holder of a financial instrument upon settlement of an obligation at its maturity absent a change in current market conditions.

Net share settlement

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

Noncontrolling interest

The portion of the equity (residual interest) in a subsidiary attributable to the owners of the subsidiary other than the parent company and its affiliates.

Obligation

A duty or responsibility to transfer assets or issue equity shares.

Physical settlement

A form of settling a financial instrument under which (a) the party designated in the contract as the buyer delivers the full stated amount of cash to the seller and (b) the seller delivers the full stated number of shares to the buyer.

Relative-fair-value method

A method of allocating proceeds from issuance of a compound financial instrument to the instrument's various component parts. Under this method, the issuer of the compound financial instrument independently determines the fair value of each of the components and then allocates the proceeds to those components on a pro rata basis, based on those independently determined fair values.

With-and-without method

A method of allocating proceeds from issuance of a compound financial instrument to its various component parts. Under this method, the value attributed to one of the components is derived by deduction. Independent determinations are made of (a) the fair value of the entire compound financial instrument and (b) the fair value of a hypothetical instrument that does not contain the component being measured.

Appendix F

INDEX OF REFERENCES TO FINANCIAL INSTRUMENTS

267. The following is an index to the financial instruments discussed in the standards section and Appendix A of this Statement. Application of this Statement is not limited to the types of financial instruments listed below.

*Examples containing specific instruments are noted with “ex.” preceding the index paragraph number.