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Equity Method Investments and Joint Ventures
Equity Method Investees — SEC Reporting Considerations
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Contents

Preface xi

Contacts xiii

Chapter 1 — Overview 1

Chapter 2 — Scope 5
2.1 Entities 5
  2.1.1 Issuers 5
  2.1.2 Exempt Entities 6
2.2 Instruments 7
  2.2.1 Obligations of the Issuer 8
    2.2.1.1 The Concept of an Obligation 8
    2.2.1.2 Economic Compulsion 10
    2.2.1.3 Issuer Discretion to Avoid a Transfer of Assets or Equity Shares 11
    2.2.1.4 Asset-Classified Instruments Embodying Obligations 12
    2.2.1.5 Prepaid Obligations 13
  2.2.2 Financial Instruments 14
  2.2.3 Freestanding Financial Instruments 15
  2.2.4 Legal Form of Share or Involves Equity Shares 16
    2.2.4.1 Shares 17
    2.2.4.2 Equity Shares 17
    2.2.4.3 Issuer’s Equity Shares 18
2.3 Derivatives 19
  2.3.1 Interaction With Derivative Accounting Requirements in ASC 815-10 19
  2.3.2 Interaction With Embedded Derivative Requirements in ASC 815-15 20
  2.3.3 Interaction With Accounting Requirements for Own-Equity Contracts in ASC 815-40 20
  2.3.4 Application of ASC 480-10 to Freestanding Written Puts and Forward Purchase Contracts 21
2.4 Share-Based Payments 22
  2.4.1 Contracts Issued as Compensation for Employee Service 22
  2.4.2 Contracts to Acquire Goods or Services Other Than Employee Service 25
  2.4.3 Transition Related to ASU 2018-07 26
2.5 Convertible Preferred Shares With CCFs 27
2.6 Contingent Consideration in a Business Combination 29
2.7 Registration Payment Arrangements 30
2.8 Guarantee Obligations 32
# Chapter 3 — Contract Analysis

## 3.1 Identifying and Evaluating Contractual Terms

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>3.1.1 Overview</td>
<td>33</td>
</tr>
<tr>
<td>3.1.2 Examples</td>
<td>34</td>
</tr>
<tr>
<td>3.1.2.1 Mandatorily Redeemable Preferred Shares With a Nonsubstantive Conversion Option</td>
<td>35</td>
</tr>
<tr>
<td>3.1.2.2 Option to Redeem Shares Embedded in a Minimal Host</td>
<td>36</td>
</tr>
</tbody>
</table>

## 3.2 Nonsubstantive or Minimal Features

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>3.2.1 Overview</td>
<td>34</td>
</tr>
<tr>
<td>3.2.2 Examples</td>
<td>35</td>
</tr>
<tr>
<td>3.2.2.1 Mandatorily Redeemable Preferred Shares With a Nonsubstantive Conversion Option</td>
<td>35</td>
</tr>
<tr>
<td>3.2.2.2 Option to Redeem Shares Embedded in a Minimal Host</td>
<td>36</td>
</tr>
</tbody>
</table>

## 3.3 Unit of Account

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>3.3.1 Concept of a “Freestanding Financial Instrument”</td>
<td>37</td>
</tr>
<tr>
<td>3.3.2 Combination Guidance</td>
<td>40</td>
</tr>
<tr>
<td>3.3.3 Application Issues and Examples</td>
<td>42</td>
</tr>
<tr>
<td>3.3.3.1 Issuance of Warrants and Put Options</td>
<td>42</td>
</tr>
<tr>
<td>3.3.3.2 Put Option on Noncontrolling Interest</td>
<td>42</td>
</tr>
<tr>
<td>3.3.3.3 Issuance of Shares and Put Options</td>
<td>42</td>
</tr>
<tr>
<td>3.3.3.4 Put Right That Expires Upon Share Transfer</td>
<td>43</td>
</tr>
<tr>
<td>3.3.3.5 Tranche Preferred Stock Agreement</td>
<td>43</td>
</tr>
<tr>
<td>3.3.4 Allocation of Proceeds and Issuance Costs</td>
<td>44</td>
</tr>
<tr>
<td>3.3.4.1 Allocation of Proceeds</td>
<td>44</td>
</tr>
<tr>
<td>3.3.4.2 With-and-Without Method</td>
<td>44</td>
</tr>
<tr>
<td>3.3.4.3 Relative Fair Value Method</td>
<td>45</td>
</tr>
<tr>
<td>3.3.4.4 Allocation of Issuance Costs</td>
<td>46</td>
</tr>
<tr>
<td>3.3.5 Accelerated Share Repurchase Programs</td>
<td>47</td>
</tr>
</tbody>
</table>

# Chapter 4 — Mandatorily Redeemable Financial Instruments

## 4.1 Classification

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>4.1.1 Overview</td>
<td>51</td>
</tr>
<tr>
<td>4.1.2 Legal Form of a Share</td>
<td>52</td>
</tr>
<tr>
<td>4.1.3 Unconditional Redemption Obligation</td>
<td>53</td>
</tr>
<tr>
<td>4.1.4 Transfer of Cash or Other Assets</td>
<td>56</td>
</tr>
<tr>
<td>4.1.5 Exceptions</td>
<td>57</td>
</tr>
<tr>
<td>4.1.5.1 Overview</td>
<td>57</td>
</tr>
<tr>
<td>4.1.5.2 Only-Upon-Liquidation Exception</td>
<td>58</td>
</tr>
<tr>
<td>4.1.5.3 Noncontrolling Interest Exception</td>
<td>59</td>
</tr>
<tr>
<td>4.1.5.4 Exception for Certain Instruments of Certain Nonpublic Entities</td>
<td>60</td>
</tr>
</tbody>
</table>

## 4.2 Application Issues

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>4.2.1 Share That Is Both Puttable and Callable</td>
<td>62</td>
</tr>
<tr>
<td>4.2.2 Exchangeable Share</td>
<td>63</td>
</tr>
<tr>
<td>4.2.3 Redemption Requirement That Is Contingent on the Issuer’s Liquidity</td>
<td>64</td>
</tr>
<tr>
<td>4.2.4 Preferred Stock With CCFs</td>
<td>65</td>
</tr>
</tbody>
</table>
Chapter 6 — Certain Variable-Share Obligations

6.1 Classification

6.1.1 Overview

6.1.1.1 Obligation

6.1.1.2 Requires or May Require the Transfer of a Variable Number of Equity Shares

6.1.1.3 Monetary Value

6.1.2 Fixed Monetary Amount Known at Inception

6.1.3 Amount Indexed to Something Other Than Own Equity

6.1.4 Amount Inversely Related to Own Equity

6.2 Application Issues

6.2.1 Obligations to Deliver a Variable Number of Shares on the Basis of an Average Stock Price

6.2.2 Share-Settled Guarantee Obligations

6.2.3 Financial Instruments That Embody Dual-Indexed Obligations

6.2.3.1 Overview

6.2.3.2 Evaluating Predominance — Contract Indexed to Issuer's Stock Price and Foreign Exchange Rate

6.2.3.3 Evaluating Predominance — Dual-Indexed Guarantee Obligation

6.2.4 Financial Instruments That Embody Multiple Obligations

6.2.4.1 Overview

6.2.4.2 Warrant With Share-Settleable Put

6.2.4.3 Warrant With Share-Settleable Make-Whole Put

6.2.4.4 Variable-Share Forward Sales Contracts

6.2.5 Financial Instruments With Contingent Obligation

6.2.5.1 Outstanding Shares

6.2.5.2 Instruments Other Than Outstanding Shares

6.2.6 Obligations With Settlement Alternatives

6.2.6.1 Issuer Choice

6.2.6.2 Counterparty Choice

6.2.6.3 Summary

6.2.6.4 Illustration

6.2.7 Financial Instruments That Embody Both Rights and Obligations

6.3 Accounting

6.4 Reassessment

Chapter 7 — Certain Option Combinations

7.1 Certain Transactions Involving Noncontrolling Interests

7.1.1 Scenarios

7.1.2 "Derivative 2"

7.1.2.1 Options Embedded in Noncontrolling Interest

7.1.2.2 Freestanding Options

7.2 Illustrations of the Application of ASC 480-10 to Certain Option Combinations
Chapter 8 — Presentation and Disclosure

8.1 Presentation 132
8.2 Disclosure 132
8.3 Entities That Have No Equity-Classified Shares 135
  8.3.1 Separate Presentation and Disclosure 135
  8.3.2 Difference Between Redemption Price and Book Value 136
8.4 Earnings per Share 139
  8.4.1 Mandatorily Redeemable Financial Instruments and Physically Settled Forward Contracts to Repurchase Common Stock 139
  8.4.2 Other Forward Purchase Contracts and Written Put Options on Common Stock 141
  8.4.3 Certain Variable-Share Obligations 144

Chapter 9 — The SEC’s Guidance on Temporary Equity

9.1 Sources of Guidance 145
  9.1.1 Overview 145
  9.1.2 SEC Rules and Policies
    9.1.2.1 Regulation S-X 146
    9.1.2.2 ASR 268 146
    9.1.2.3 CFRP 211 147
  9.1.3 SABs
    9.1.3.1 SAB Topic 3.C 147
    9.1.3.2 SAB Topic 14.E 147
  9.1.4 SEC Announcements and Observer Comments Made at EITF Meetings
    9.1.4.1 SEC Staff Announcement: Classification and Measurement of Redeemable Securities 147
    9.1.4.2 SEC Observer Comments — Sponsor’s Balance Sheet Classification of Capital Stock With a Put Option Held by an Employee Stock Ownership Plan 148
9.2 Scope — Entities 148
  9.2.1 SEC Registrants 148
  9.2.2 Nonpublic Entities 148
9.3 Scope — Instruments 149
  9.3.1 Equity Instruments 149
  9.3.2 Assets and Liabilities 149
  9.3.3 Freestanding Equity-Classified Contracts (Other Than Outstanding Shares) 150
  9.3.4 Hybrid Equity Instruments and Embedded Derivatives 151
  9.3.5 Convertible Debt Instruments Separated Into Liability and Equity Components 151
  9.3.6 Equity Instruments Subject to Registration Payment Arrangements 153
  9.3.7 Noncontrolling Interests 155
  9.3.8 Securities Held by an Employee Stock Ownership Plan 156
  9.3.9 Share-Based Payment Arrangements With Employees 157
9.4 Classification 158
  9.4.1 Characteristics That Trigger Temporary-Equity Classification 158
  9.4.2 Evaluation of Whether an Event Is Under the Sole Control of the Issuer 161
  9.4.3 Redemption Features Triggered by Holder’s Death or Disability 164
  9.4.4 Special Considerations When the Holder Has the Ability to Control Issuer Decisions 164
9.4.5 Evaluation of Liquidation Provisions 167
  9.4.5.1 Overview 167
  9.4.5.2 Ordinary Liquidation Events 167
  9.4.5.3 Deemed Liquidation Events 168
  9.4.5.4 Limited Exception Applicable to Certain Deemed Liquidation Provisions 170
  9.4.5.5 Convertible Preferred Stock With a Liquidation Provision Upon a Change in Control 172

9.4.6 Features That the Issuer Must or May Settle in Its Equity Shares 173

9.4.7 Features That the Issuer Must or May Settle in Redeemable Instruments 174

9.4.8 Convertible Debt Instruments Separated Into Liability and Equity Components 175

9.4.9 Share-Based Payment Arrangements With Employees 176

9.4.10 Classification of ESOP Shares Within Temporary Equity 177
  9.4.10.1 Outstanding Shares 177
  9.4.10.2 Classification of Unearned ESOP Shares of Leveraged ESOP 179

9.5 Measurement 180
  9.5.1 Initial Measurement 180
  9.5.2 Subsequent Measurement 181
    9.5.2.1 Overview 181
    9.5.2.2 Current Redemption Value 183
    9.5.2.3 Accreted Redemption Value 184
    9.5.2.4 Multiple Redemption Features 186
    9.5.2.5 Limit on Reductions to the Carrying Amount 187
    9.5.2.6 Increasing Rate Preferred Stock 187
  9.5.3 Assessment of Whether an Instrument Is Currently Redeemable 188
  9.5.4 Assessing Whether It Is Probable That an Instrument Will Become Redeemable 188
    9.5.4.1 Overview 188
    9.5.4.2 Mutually Exclusive Holder Options 190
    9.5.4.3 Holder Option in Instrument With Mandatory Conversion Feature 191
    9.5.4.4 Issuer's Redemption Option 192
    9.5.4.5 Deemed Liquidation Features 193
  9.5.5 Recognition of Measurement Changes and Dividends 193
    9.5.5.1 Paid-in-Kind Dividends 195
  9.5.6 Bifurcated Embedded Derivatives 197
  9.5.7 Convertible Debt With a Separated Equity Component 199
  9.5.8 Convertible Preferred Stock With a Separated Equity Component 201
  9.5.9 Redeemable Equity Instruments Issued With Other Instruments 203
  9.5.10 Noncontrolling Interests 203
  9.5.11 Equity Securities Held by Employee Stock Ownership Plans 205
  9.5.12 Share-Based Payment Arrangements 206

9.6 EPS Considerations 208
  9.6.1 Preferred Stock 208
  9.6.2 Common Stock 209
9.6.3 Noncontrolling Interests
   9.6.3.1 Noncontrolling Interests in the Form of Preferred Stock 210
   9.6.3.2 Noncontrolling Interests in the Form of Common Stock 211

9.6.4 Convertible Debt With Separated Equity Component 212

9.7 Derecognition 213
   9.7.1 Extinguishments 213
   9.7.2 Conversions 215
      9.7.2.1 Conversions Pursuant to the Original Terms 215
      9.7.2.2 Induced Conversions 215
   9.7.3 Modifications and Exchanges 216
   9.7.4 Reclassifications 217
      9.7.4.1 Reclassifications From Temporary Equity Into Permanent Equity 218
      9.7.4.2 Reclassifications From Permanent Equity to Temporary Equity 220
      9.7.4.3 Reclassifications Out of Equity and Into a Liability 220
   9.7.5 Deconsolidation of a Subsidiary 220

9.8 Presentation and Disclosure 221
   9.8.1 Presentation 221
      9.8.1.1 Separate Presentation of Temporary Equity 221
      9.8.1.2 Liability Classification Prohibited 223
      9.8.1.3 Presentation of Shareholder Loans 224
   9.8.2 Disclosure 224

Chapter 10 — Comparison to IFRS Standards 229
10.1 Background 229
   10.1.1 Circumstances in Which an Understanding of IFRS Standards May Be Relevant 229
   10.1.2 IFRS Guidance 229
   10.1.3 Key Differences 230
10.2 Redeemable Equity Securities 231
10.3 Obligations to Repurchase Shares 232
   10.3.1 Forward Purchase Contracts on an Entity’s Own Equity 232
   10.3.2 Written Put Options on an Entity’s Own Equity 232
10.4 Obligations to Issue a Variable Number of Equity Shares 233

Appendix A — Overview of Classification Requirements in ASC 480-10 234
Appendix B — Legacy FASB Guidance Codified in ASC 480-10 235
Appendix C — Sources of SEC Guidance on Temporary Equity 236
Appendix D — Glossary of Selected Terms 238
Appendix E — Titles of Standards and Other Literature 242
Appendix F — Abbreviations 246
Appendix G — Changes Made in the 2019 Edition of This Publication 247
Preface

July 2019

To our clients, colleagues, and other friends:

We are pleased to present the 2019 edition of A Roadmap to Distinguishing Liabilities From Equity. This Roadmap provides an overview of the guidance in ASC 480-10 as well as insights into and interpretations of how to apply it in practice. ASC 480-10 requires (1) issuers to classify certain types of shares of stock and certain share-settled contracts as liabilities or, in some circumstances, as assets and (2) SEC registrants to classify certain types of redeemable equity instruments as temporary equity.

The 2019 edition of this Roadmap includes several new discussions as well as some modifications to previously expressed views to reflect our latest thinking and input from standard setters and regulators. Appendix G highlights all new content as well as any substantive revisions to previous content.

Subscribers to the Deloitte Accounting Research Tool (DART) may access any interim updates to this publication by selecting the document from the “Roadmaps” tab on DART's home page. If a “Summary of Changes Since Issuance” displays, subscribers can view those changes by clicking the related links or by opening the “active” version of the Roadmap.

We hope you will find this Roadmap to be a useful resource in determining the appropriate accounting for contracts within the scope of ASC 480-10, and we welcome your suggestions for future improvements to it. If you have questions about the guidance or would like assistance applying it, we encourage you to consider consulting our technical specialists and other professional advisers.

Sincerely,

Deloitte & Touche LLP

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1 For a list of abbreviations used in this publication, see Appendix F. For the full titles of standards, topics, and regulations used in this publication, see Appendix E.
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Chapter 1 — Overview

ASC 480-10 provides guidance on determining whether (1) certain financial instruments with both debt-like and equity-like characteristics should be accounted for “outside of equity” (i.e., as liabilities or, in some cases, assets) by the issuer and (2) SEC registrants should present certain redeemable equity instruments as temporary equity.

Examples of contracts and transactions that may require evaluation under ASC 480-10 include:

- Redeemable shares.
- Redeemable noncontrolling interests.
- Forward contracts to repurchase own shares.
- Forward contracts to sell redeemable shares.
- Written put options on own stock.
- Warrants (and written call options) on redeemable equity shares.
- Warrants on shares with deemed liquidation provisions.
- Puttable warrants on own stock.
- Equity collars.
- Share-settled debt (this term is used in this Roadmap to describe a share-settled obligation that is not in the legal form of debt but has the same economic payoff profile as debt).
- Preferred shares that are mandatorily convertible into a variable number of common shares.
- Unsettled treasury stock transactions.
- Accelerated share repurchase programs.
- Hybrid equity units.

However, ASC 480-10 does not apply to legal-form debt, which is always classified as a liability by the issuer (see Section 2.2.4).
ASC 480-10 requires an issuer to classify three classes of financial instruments (e.g., outstanding shares and contracts on the issuer’s shares) as assets or liabilities:

- **Mandatorily redeemable financial instruments** (see Chapter 4) — The issuer of a financial instrument that is in the form of a share must classify the share as a liability if it embodies an unconditional obligation requiring the issuer to redeem the share by transferring assets unless redemption would occur only upon the liquidation or termination of the reporting entity. Examples include those mandatorily redeemable shares and mandatorily redeemable noncontrolling interests that do not contain any substantive conversion features.

- **Obligations to repurchase the entity’s equity shares by transferring assets** (see Chapter 5) — A financial instrument other than an outstanding share is classified as an asset or a liability if it both (1) embodies an obligation to repurchase the issuer’s equity shares (or is indexed to such an obligation) and (2) requires (or may require) the issuer to settle the obligation by transferring assets. Examples include those forward purchase contracts and written put options on the entity’s own equity shares that are either physically settled or net cash settled.

- **Certain obligations to issue a variable number of equity shares** (see Chapter 6) — An outstanding share that embodies an unconditional obligation, or a financial instrument other than an outstanding share that embodies an obligation, is classified as an asset or a liability if the issuer must or may settle the obligation by issuing a variable number of its equity shares and the obligation’s monetary value is based solely or predominantly on one of the following: (1) a fixed monetary amount, (2) variations in something other than the fair value of the issuer's equity shares, or (3) variations inversely related to changes in the fair value of the issuer's equity shares. Examples include share-settled debt and those forward purchase contracts and written put options on the entity’s own equity shares that are net share settled.

Financial instruments that are accounted for as assets or liabilities under ASC 480 are initially recognized at fair value, with one exception (see Sections 4.3, 5.3, and 6.3). A forward contract that requires the entity to repurchase a fixed number of its equity shares for cash is initially measured at the fair value of the shares at inception (i.e., not the fair value of the forward contract), with certain adjustments, and the offsetting entry is presented in equity (i.e., the transaction is treated as if the repurchase had already occurred with borrowed funds).

In subsequent periods, financial instruments classified as assets or liabilities under ASC 480-10 are remeasured at their then-current fair value, and changes in fair value are recorded in earnings, with two exceptions (see Sections 4.3, 5.3, and 6.3). Physically settled forward contracts to repurchase "a fixed number of the issuer's equity shares [for] cash and mandatorily redeemable financial instruments [are] measured subsequently in either of the following ways," as applicable:

- If both the amount to be paid and the settlement date are fixed, such instruments are measured subsequently at the present value of the amount to be paid at settlement, and interest cost is accrued at the rate implicit at inception.

- If either the amount to be paid or the settlement date varies on the basis of specified conditions, such instruments are measured subsequently at the amount of cash that would be paid under the conditions specified in the contract if settlement were to occur as of the reporting date, and any change in that amount is recognized as interest cost.
Further, ASC 480-10 includes:

- Special guidance on the accounting for certain option combinations involving noncontrolling interests and illustrations of the application of its requirements to other option combinations (see Chapter 7).
- Presentation and disclosure requirements (see Chapter 8).

If ASC 480-10 does not require an instrument to be classified outside of equity, an issuer should consider whether such a requirement exists under other GAAP (e.g., ASC 815-40) or whether the SEC guidance in ASC 480-10-3A requires the instrument to be classified outside of permanent equity. Under the SEC’s guidance in ASC 480-10-3A, issuers of certain equity-classified instruments that are redeemable for cash or other assets in circumstances not under the sole control of the issuer must present such instruments in temporary equity and apply specific measurement and disclosure guidance to them (see Chapter 9).

Some entities are affected by both U.S. GAAP and IFRS® Standards. There are significant differences between the guidance in ASC 480-10 and the equivalent guidance under IFRS Standards (see Chapter 10).

The appendixes of this Roadmap include an overview of the classification requirements in ASC 480-10 (Appendix A), legacy FASB guidance codified in ASC 480-10 (Appendix B), a table with sources of SEC guidance on temporary equity (Appendix C), and glossary terms from ASC 480-10-20 (Appendix D).

Although they are doing so less frequently, some practitioners continue to refer to FASB Statement 150, EITF Issue 00-4, and EITF Topic D-98, which were superseded by ASC 480-10 in 2009 as a result of the FASB’s codification of U.S. GAAP (the “Codification”). While the guidance in those pronouncements has not changed significantly since being codified (see the table below for cross-references), they are no longer recognized as authoritative sources of accounting guidance. This Roadmap contains excerpts from FASB Statement 150’s Background Information and Basis for Conclusions, which describes the Board’s considerations in developing some of the guidance now contained in ASC 480-10.

<table>
<thead>
<tr>
<th>Subject</th>
<th>Pre-Codification Guidance</th>
<th>Codification Reference</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounting for certain financial instruments with characteristics of both liabilities and equity</td>
<td>FASB Statement 150</td>
<td>ASC 480-10</td>
</tr>
<tr>
<td>Majority owner’s accounting for a transaction in the shares of a consolidated subsidiary and a derivative indexed to the noncontrolling interest in that subsidiary</td>
<td>EITF Issue 00-4</td>
<td>ASC 480-10-55-53 through 55-62</td>
</tr>
<tr>
<td>Classification and measurement of redeemable securities</td>
<td>EITF Topic D-98</td>
<td>ASC 480-10-599-3A</td>
</tr>
</tbody>
</table>

The following ASUs have amended the guidance in ASC 480-10:

- ASU 2009-04 (issued in August 2009) updated the SEC’s guidance on the accounting for redeemable equity instruments in ASC 480-10-3A (see Chapter 9).
- ASU 2016-19 (issued in December 2016) introduced a scope exception for registration payment arrangements (see Section 2.7).
• ASU 2017-11 (issued in July 2017) recharacterizes certain indefinite effective-date deferrals as scope exceptions to improve the readability of the guidance in ASC 480-10 (see Sections 2.1.2 and 4.1.5).

• ASU 2018-07 (issued in June 2018) amends the ASC 480-10 scope exception for obligations under share-based payment arrangements (see Section 2.4).

• ASU 2018-09 (issued in July 2018) conforms the guidance on certain freestanding options involving noncontrolling interests in ASC 480-10-55 with the guidance in FASB Statement 150 and ASC 480-10-25-15 (see Section 7.1.2).

**Connecting the Dots**

When analyzing financial instruments with characteristics of both liabilities and equity, entities typically must consider multiple Codification subtopics in addition to ASC 480-10, including:

• ASC 260-10 (see Deloitte’s *A Roadmap to the Presentation and Disclosure of Earnings per Share*).

• ASC 470-20 (see Deloitte’s *A Roadmap to the Issuer’s Accounting for Convertible Debt*).

• ASC 815-10 and ASC 815-15 (on derivatives and hedging).

• ASC 815-40 (see Deloitte’s *A Roadmap to Accounting for Contracts on an Entity’s Own Equity*).
Chapter 2 — Scope

Before an issuer applies the accounting guidance in ASC 480-10 to a contract, it should evaluate whether the guidance applies to the contract. In this chapter, we discuss the types of entities and instruments that are subject to ASC 480-10 (see Sections 2.1 and 2.2). Further, we describe how the guidance in ASC 480-10 interacts with other GAAP that apply to derivatives (see Section 2.3), share-based payments (see Section 2.4), convertible preferred shares with cash conversion features (CCFs) (see Section 2.5), contingent consideration in a business combination (see Section 2.6), registration payment arrangements (see Section 2.7), and guarantee obligations (see Section 2.8).

Note that this chapter does not address the scope of the SEC's temporary-equity requirements in ASC 480-10-3A. For a discussion of the applicability of those requirements, see instead Sections 9.2 and 9.3.

2.1 Entities

2.1.1 Issuers

ASC 480-10

10-1 The objective of this Subtopic is to require issuers to classify as liabilities (or assets in some circumstances) three classes of freestanding financial instruments that embody obligations for the issuer.

15-2 The guidance in the Distinguishing Liabilities from Equity Topic applies to all entities.

ASC 480-10 — Glossary

Issuer
The entity that issued a financial instrument or may be required under the terms of a financial instrument to issue its equity shares.

ASC 480-10 applies to both public business entities (including SEC registrants) and private companies that are issuers of financial instruments within its scope. Under ASC 480-10-20, an issuer is defined as an entity that either “issued a financial instrument” (e.g., an outstanding common or preferred share) or “may be required under the terms of a financial instrument to issue its equity shares” (e.g., certain obligations to deliver a variable number of equity shares). An entity that enters into an obligation to repurchase its equity shares by transferring assets (e.g., an entity that writes a put option or enters into a forward purchase contract on its equity shares) is also considered an “issuer” under ASC 480-10 because it issued the shares underlying the contract. Conversely, ASC 480-10 does not apply to investors in the entity's equity shares or to the counterparty to a financial instrument on the entity's equity shares.
2.1.2 Exempt Entities

Some of the requirements in ASC 480-10 do not apply to certain mandatorily redeemable financial instruments that either represent noncontrolling interests or are issued by nonpublic entities that are not SEC registrants. The following table provides an overview of these exceptions:

<table>
<thead>
<tr>
<th>Affected Entities</th>
<th>Instruments for Which Some or All of the Guidance in ASC 480-10 Does Not Apply</th>
<th>Exempt Guidance</th>
<th>Scope Exception in ASC 480-10-15 (as added by ASU 2017-11)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Parents preparing consolidated financial statements (both public and nonpublic)</td>
<td>Mandatorily redeemable noncontrolling interests that do not have to be classified as liabilities by the subsidiary under the only-upon-liquidation exception in ASC 480-10-25-4 and 25-6</td>
<td>The classification and measurement provisions (but not the disclosure provisions) in ASC 480-10</td>
<td>7E(a)</td>
</tr>
<tr>
<td></td>
<td>Other mandatorily redeemable noncontrolling interests that were issued before November 5, 2003</td>
<td>The measurement provisions (but not the classification and disclosure provisions) in ASC 480-10</td>
<td>7E(b)</td>
</tr>
<tr>
<td>Subsidiaries (both public and nonpublic)</td>
<td>Mandatorily redeemable noncontrolling interests that were issued before November 5, 2003</td>
<td>The measurement provisions (but not the classification and disclosure provisions) in ASC 480-10</td>
<td>7E(b)</td>
</tr>
<tr>
<td>Nonpublic entities that are not SEC registrants</td>
<td>Mandatorily redeemable financial instruments other than those that are mandatorily redeemable on fixed dates for amounts that either are fixed or are determined by reference to an interest rate index, currency index, or another external index</td>
<td>The classification, measurement, and disclosure provisions in ASC 480-10</td>
<td>7A</td>
</tr>
</tbody>
</table>

These exceptions are described in more detail in Section 4.1.5.

**Connecting the Dots**

In 2003, the FASB indefinitely deferred the effective date of some of the requirements related to the classification, measurement, and disclosure of certain mandatorily redeemable financial instruments that either represent noncontrolling interests or are issued by nonpublic entities that are not SEC registrants, as summarized in the table above. While such requirements were labeled “pending content” in the Codification, there was no effective date for them. Accordingly, for affected entities and instruments, the deferrals effectively served as scope exceptions to some or all of the guidance in ASC 480-10. To improve the readability of the Codification, the FASB issued ASU 2017-11 in July 2017. ASU 2017-11 replaces the deferrals with scope exceptions by moving the related guidance from ASC 480-10-65-1 to ASC 480-10-15-7A through 15-7F. Those amendments do not change the required accounting for affected instruments and entities.
2.2 Instruments

ASC 480-10

10-1 The objective of this Subtopic is to require issuers to classify as liabilities (or assets in some circumstances) three classes of freestanding financial instruments that embody obligations for the issuer.

15-3 The guidance in the Distinguishing Liabilities from Equity Topic applies to any freestanding financial instrument, including one that has any of the following attributes:
   a. Comprises more than one option or forward contract
   b. Has characteristics of both a liability and equity and, in some circumstances, also has characteristics of an asset (for example, a forward contract to purchase the issuer’s equity shares that is to be net cash settled). Accordingly, this Topic does not address an instrument that has only characteristics of an asset.

15-4 For example, an instrument that consists of a written put option for an issuer’s equity shares and a purchased call option and nothing else is a freestanding financial instrument (paragraphs 480-10-55-18 through 55-20 provide examples of such instruments). That freestanding financial instrument embodies an obligation to repurchase the issuer’s equity shares and is subject to the requirements of this Topic.

ASC 480-10 applies only to items that have all of the following characteristics:

- They embody one or more obligations of the issuer (see Section 2.2.1).
- They meet the definition of a financial instrument (see Section 2.2.2).
- They meet the definition of a freestanding financial instrument (see Sections 2.2.3 and 3.3); that is, they are not features embedded in a freestanding financial instrument.
- Their legal form is that of a share, or they could result in the receipt or delivery of shares or are indexed to an obligation to repurchase shares (see Section 2.2.4).

ASC 480-10 requires an instrument that has all of the above characteristics to be classified outside of equity if it falls within one of the following classes of instruments:

- Mandatorily redeemable financial instruments (see Chapter 4).
- Obligations to repurchase the issuer’s shares (or indexed to such obligations) by transferring assets (see Chapter 5).
- Certain obligations to issue a variable number of shares (see Chapter 6).

The fact that an instrument is not required to be classified as an asset or a liability under ASC 480-10 does not necessarily mean that it qualifies for equity classification. To determine whether an instrument qualifies for classification in equity in whole or in part, an entity must also consider other GAAP (e.g., ASC 470-20, ASC 815-10, ASC 815-15, and ASC 815-40). Further, under ASC 480-10-599-3A, an entity that is subject to SEC guidance should consider whether an equity-classified instrument must be classified outside of permanent equity (see Chapter 9).
2.2.1 Obligations of the Issuer

2.2.1.1 The Concept of an Obligation

<table>
<thead>
<tr>
<th>ASC 480-10 — Glossary</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Obligation</strong></td>
</tr>
<tr>
<td>A conditional or unconditional duty or responsibility to transfer assets or to issue equity shares. Because Topic 480 relates only to financial instruments and not to contracts to provide services and other types of contracts, but includes duties or responsibilities to issue equity shares, this definition of obligation differs from the definition found in FASB Concepts Statement No. 6, Elements of Financial Statements, and is applicable only for items in the scope of that Topic.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>ASC 480-10</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>05-2</strong> All of the following are examples of an obligation:</td>
</tr>
<tr>
<td>a. An entity incurs a conditional obligation to transfer assets by issuing (writing) a put option that would, if exercised, require the entity to repurchase its equity shares by physical settlement. (Further, an instrument that requires the issuer to settle its obligation by issuing another instrument [for example, a note payable in cash] ultimately requires settlement by a transfer of assets.)</td>
</tr>
<tr>
<td>b. An entity incurs a conditional obligation to transfer assets by issuing a similar contract that requires or could require net cash settlement.</td>
</tr>
<tr>
<td>c. An entity incurs a conditional obligation to issue its equity shares by issuing a similar contract that requires net share settlement.</td>
</tr>
<tr>
<td><strong>05-3</strong> In contrast, by issuing shares of stock, an entity generally does not incur an obligation to redeem the shares, and, therefore, that entity does not incur an obligation to transfer assets or issue additional equity shares. However, some issuances of stock (for example, mandatorily redeemable preferred stock) do impose obligations requiring the issuer to transfer assets or issue its equity shares.</td>
</tr>
</tbody>
</table>

ASC 480-10 applies to a freestanding financial instrument only if it embodies one or more obligations of the issuer. Therefore, in evaluating whether the instrument must be classified outside of equity under ASC 480-10, the issuer should determine whether it contains at least one obligation. Paragraph B33 of the Background Information and Basis for Conclusions of FASB Statement 150 states, in part:

Identifying whether a financial instrument embodies an obligation is the starting point in determining the appropriate classification of that instrument. . . . A financial instrument that does not embody an obligation cannot be a liability under the current Concepts Statement 6 definition.

ASC 480-10 defines an obligation as a “conditional or unconditional duty or responsibility to transfer assets or to issue equity shares.” This definition is based in part on the definition of a liability in paragraphs 35 and 36 of FASB Concepts Statement 6. Those paragraphs state, in part:

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. . . . 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.

Chapter 4 discusses mandatorily redeemable financial instruments, which (as noted in Chapter 1) are one of the three classes of financial instruments that must be classified outside of equity under ASC 480-10. ASC 480-10-20 defines a mandatorily redeemable financial instrument as “[a]ny of various financial instruments issued in the form of shares that embody an unconditional obligation requiring the
issuer to redeem the instrument by transferring its assets at a specified or determinable date (or dates) or upon an event that is certain to occur.” The characteristics of such an instrument are consistent with those in the FASB’s definition of a liability in FASB Concepts Statement 6 because they (1) embody an obligation to transfer assets, (2) leave the issuer no discretion to avoid the future transfer of assets, and (3) result from a past event (the issuance of the instrument).

Chapter 5 discusses the second of the three classes: financial instruments, other than outstanding shares, that embody an obligation to repurchase shares (or an obligation that is indexed to such an obligation) in exchange for cash or other assets (e.g., a physically settled forward purchase or written put option on the issuer’s equity shares). These instruments embody obligations that have all the characteristics of a liability as defined in FASB Concepts Statement 6 because they conditionally or unconditionally require the issuer to transfer assets, they give the issuer no discretion to avoid the future transfer of assets, and they result from a past event (i.e., the issuance of the instrument).

Chapter 6 discusses the third of the three classes: certain obligations to deliver a variable number of equity shares. As noted in paragraph B17 of the Background Information and Basis for Conclusions of FASB Statement 150, the Board concluded that some financial instruments “that embody obligations to issue shares place the holder of the instrument in a position fundamentally different from the position of a holder of the issuer’s equity shares, that such obligations do not result in an ownership relationship, and that an instrument that embodies an obligation that does not establish an ownership relationship should be a liability.” For example, the economic payoff profile of an obligation to issue equity shares worth a fixed monetary amount resemble that of a debt obligation. Even though it is share settled, such an obligation could adversely affect the economic interests of current holders of the entity’s equity shares by diluting their ownership interest.

Under FASB Concepts Statement 6, an obligation to issue equity shares is not a liability. Nevertheless, an entity should apply ASC 480-10 in evaluating whether a share-settled obligation within the scope of ASC 480-10 should be classified as a liability since FASB concepts statements are not an authoritative source of U.S. GAAP (see ASC 105-10-05-3). When the FASB developed the requirements that are now in ASC 480-10, its plan was to amend the definition of a liability in Concepts Statement 6 to include certain share-settled obligations, but the Board has not yet done so.

An obligation can be either unconditional or conditional. An obligation is unconditional if no condition needs to be satisfied (other than the passage of time) to trigger a duty or responsibility for the obligated party to perform. Examples of unconditional obligations include:

- Mandatorily redeemable financial instruments (as defined in ASC 480-10-20; see Chapter 4).
- Physically settled forward contracts that require the issuer to repurchase equity shares by transferring assets (see Chapter 5) or a variable number of shares (see Chapter 6).
- Preferred stock that mandatorily converts into a variable number of common shares (see Chapter 6).

An obligation is conditional if the obligated party only has a duty or responsibility to perform if a specified condition is met (e.g., the occurrence or nonoccurrence of an uncertain future event or the counterparty’s election to exercise an option). Examples of conditional obligations include:

- Physically settled written put options that, if exercised, could require the issuer to purchase equity shares and transfer assets (see Chapter 5).
- Physically settled forward contracts that require the issuer to purchase equity shares upon the occurrence or nonoccurrence of an event that is outside the issuer’s control (see Chapter 5).
• Net-settled forward contracts to purchase equity shares that could require the issuer to transfer cash or a variable number of equity shares to settle the contracts’ fair value if they are in a loss position (see Sections 5.2.3 and 6.2.5).

• Net-settled written options that require the issuer to transfer assets or shares if the counterparty elects to exercise the options (see Sections 5.2.3 and 6.2.6).

ASC 480-10 does not address the accounting for financial instruments that do not embody any obligation of the issuer. Examples of such instruments include:

• Outstanding equity shares that do not have any redemption or conversion provisions.

• Purchased call options that permit but do not require the issuer to purchase equity shares for cash (see ASC 480-10-55-35).

• Purchased put options that permit but do not require the issuer to sell equity shares for cash.

An obligation to provide services does not meet the definition of a financial instrument and is therefore outside the scope of ASC 480-10 (see Section 2.2.2).

2.2.1.2 Economic Compulsion

An instrument would not necessarily be classified outside of equity even if its terms have been designed to economically compel the issuer to redeem it. For example, a perpetual preferred share without any contractual redemption requirements may have an increasing, discretionary dividend designed to incentivize the issuer to redeem the instrument by a certain date. That instrument would not be within the scope of ASC 480-10 because it embodies no obligation.

In developing the guidance in ASC 480-10, the FASB considered whether an instrument in the form of a share should be viewed to embody an obligation to redeem the share if the issuer could be economically compelled to redeem the share but is not legally required to do so. However, the Board decided not to establish any such requirement. Paragraph B24 of the Background Information and Basis for Conclusions of FASB Statement 150 states, in part:

Some types of preferred stock pay no, or low, dividends during the first few years they are outstanding and then pay dividends at an increasing rate. The Board considered whether an issuer of such “increasing-rate preferred stock” should be deemed to have an obligation to redeem the shares even though it is not legally obligated to do so. The Exposure Draft proposed that to the extent 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. Some commentators proposed that increasing-rate preferred stock be classified as a liability on the grounds that the increasing rate made redemption economically compelling or created an implied mandatory redemption date. The Board reconsidered that issue during its redeliberations but did not resolve it. The Board deferred until the next phase of the project a decision about whether an increasing-rate dividend provision, as well as other forms of economic compulsion, imposes an obligation on the issuer that causes the instrument to be a liability.

While the existence of economic compulsion itself is not sufficient to cause an instrument to be classified as a liability under ASC 480-10, it may be a factor in the evaluation of whether a feature is substantive. Further, note that the SEC staff has issued guidance on the accounting for increasing-rate preferred stock (see ASC 505-10-S99-7).
Example 2-1

A perpetual preferred share has the following terms:

- A fixed par amount ($100).
- A stated dividend rate (5 percent per annum) for an initial period (five years).
- An increasing dividend-rate. As of a specified date in the future, the dividend rate will have increased to an interest rate that is likely to be significantly in excess of market rates (20 percent per annum).
- Discretionary dividends. The issuer has discretion over whether to declare a dividend (i.e., the issuer has no legally enforceable obligation to pay the dividend).
- A call option. The issuer has the right to repurchase the preferred share at its par amount if it also pays all unpaid and accumulated dividends on the preferred share.
- A dividend stopper. The issuer is not permitted to declare and pay any dividends on common shares before it pays all accumulated and unpaid dividends on the preferred share.

In these circumstances, the issuer may be expected to have a strong economic incentive to call the preferred stock before the cumulative undeclared dividends become too large. If it does not call the instrument, the issuer will either pay significantly above-market dividends to the preferred shareholders or be unable to pay dividends on common stock (potentially resulting in the loss of much of the value of its common stock). Nevertheless, the preferred stock is outside the scope of ASC 480-10 because it does not meet the definition of a mandatorily redeemable financial instrument and does not contain an unconditional obligation to deliver a variable number of shares. (Note also that the issuer's incentive to redeem the instrument would weaken if the market's required return on similar instruments approached or exceeded 20 percent per annum, for example, because the issuer's financial situation deteriorated sufficiently or market interest rates increased.)

2.2.1.3 Issuer Discretion to Avoid a Transfer of Assets or Equity Shares

We believe that in a manner consistent with the FASB's definition of a liability in Concepts Statement 6, an issuer does not have an obligation under ASC 480-10 if it has complete discretion to avoid the transfer of assets or equity shares. ASC 480-10 does not address the accounting for a financial instrument that does not embody any obligation of the issuer. Therefore, the following are examples of instruments that are outside the scope of ASC 480-10:

- An agreement to repurchase an entity's own stock by transferring assets, or to issue equity shares, that permits the issuer to cancel the agreement at any time at its sole discretion without penalty.
- An agreement that requires the issuer to transfer assets or issue equity shares upon the occurrence of an event that is solely within its control. In this case, the entity has no obligation before the event occurs since the entity could not be forced to transfer assets or issue shares unless it decides to proceed with the event or allows it to occur.

The table in Section 9.4.2 lists examples of events and circumstances that may be considered solely and not solely within the issuer's control when their occurrence triggers a duty or responsibility for the issuer to transfer assets or issue shares. Note, however, that the determination of whether a specific event is within the issuer's control could differ depending on the specific facts and circumstances. For example, an event that would ordinarily be considered to be solely within the issuer's control may not qualify as such if either (1) the counterparty controls the issuer's decision to cause the event to occur through board representation or other rights or (2) the issuer is firmly committed to undertake an action that will cause the event to occur.
Example 2-2

A warrant:

- Permits Holder H to purchase a fixed number of Entity E's perpetual common shares for a fixed amount of cash.
- Contains:
  - A call option that permits E to repurchase the warrant for a fixed price in cash at any time.
  - A put option that permits H to put the warrant to E for a fixed price in cash 30 days after giving notice of its intent to exercise the put. If H gives notice of its intent to exercise the put, E has the right to exercise its call option before the put option becomes exercisable. Accordingly, E can prevent the put option from ever becoming exercised.

In evaluating whether the warrant embodies one or more obligations that cause it to fall within the scope of ASC 480-10, E must consider all of the warrant’s terms and features.

The warrant contains two conditional requirements: (1) delivery of a fixed number of shares for cash if H elects to exercise the warrant and (2) delivery of a fixed amount of cash if H elects to put the warrant.

The first conditional requirement represents an obligation of E, because E has no discretion to avoid it. To be within the scope of ASC 480-10, however, an obligation to deliver shares must be for the delivery of a variable number of shares (see Chapter 6). Since this conditional obligation is to deliver a fixed number of equity shares, it does not cause the instrument to be classified as an asset or a liability under ASC 480-10.

In assessing the second conditional requirement, E notes that it is able to prevent the exercise of the put option by exercising its call option after the counterparty has notified E of its intent to exercise the put in 30 days.

Despite E's ability to prevent exercise of the put option, we believe that E has a conditional obligation to transfer assets (pay cash) since it (1) it cannot prevent H from giving notice of its intent to exercise the put option and (2) is required to pay cash irrespective of whether it exercises its call option or allows the put option to be exercised (i.e., it has no discretion to avoid the requirement to pay cash). Under ASC 480-10-25-8, E classifies the warrant as a liability because it (1) is not an outstanding share, (2) embodies an obligation that is indexed to an obligation to repurchase E’s equity shares, and (3) may require E to settle the obligation by transferring assets; that is, it contains a conditional obligation to deliver cash (see Section 5.1). If the put option was removed, however, ASC 480-10 would not require E to classify the warrant as an asset or a liability because the conditional obligation to deliver a fixed number of equity shares is not within the scope of ASC 480-10 and the call option does not represent an obligation. Instead, E would apply other GAAP (e.g., ASC 815-40) to determine how to account for the warrant.

2.2.1.4 Asset-Classified Instruments Embodying Obligations

ASC 480-10

25-12 Certain financial instruments that embody obligations that are liabilities within the scope of this Subtopic also may contain characteristics of assets but be reported as single items. Some examples include the following:

a. Net-cash-settled or net-share-settled forward purchase contracts
b. Certain combined options to repurchase the issuer's shares.

Those instruments are classified as assets or liabilities initially or subsequently depending on the instrument's fair value on the reporting date.

Although ASC 480-10 applies only to instruments that embody obligations of the issuer, not all instruments within its scope are liabilities. For example, an issuer may pay a net premium to purchase a single freestanding financial instrument, such as a collar that includes both a purchased call option and a written put option on the issuer’s shares. Because of the written option component, that instrument
embodies an obligation that is within the scope of ASC 480-10. If the fair value of the purchased option component (a valuable right) exceeds the fair value of the written option component, however, the collar is an asset rather than a liability. Similarly, a net-settled forward contract to purchase the entity’s equity shares embodies a conditional obligation to transfer assets or equity shares if the stock price is less than the contracted forward price on the forward settlement date, but it is an asset if the contract is in a gain position for the issuer on that date.

2.2.1.5 Prepaid Obligations

ASC 480-10 does not apply to a contract that embodies an obligation to repurchase equity shares (or a contract indexed to such an obligation) if the issuer prepays its obligation and therefore has no remaining obligation to transfer assets or issue equity shares. For example, a prepaid written put option does not meet the criteria to be accounted for as an asset or a liability under ASC 480-10-25-8 or ASC 480-10-25-14 because it does not represent an obligation of the issuing entity (i.e., the option writer) to transfer assets or issue equity shares. (Prepaid written put option strategies and economically equivalent arrangements have been marketed under names such as Dragons, Caesars, or ZCalls.)

Although such an instrument is not within the scope of ASC 480-10, the issuing entity (i.e., the option writer) will need to consider the applicability of other relevant GAAP. For example, the issuing entity should consider whether the prepaid contract represents a derivative within the scope of ASC 815-10 or includes an embedded derivative that should be bifurcated in accordance with ASC 815-15-25-1. The issuing entity should also consider the guidance in ASC 815-40 on contracts related to an entity’s own equity (see Deloitte’s A Roadmap to Accounting for Contracts on an Entity’s Own Equity) and in ASC 505-10-45-2 on receivables for the issuance of equity.

In accordance with a 2004 speech by Scott Taub, then deputy chief accountant in the SEC’s Office of the Chief Accountant, the issuing entity should also provide transparent disclosures about the transaction and the related accounting considerations.

**Example 2-3**

As part of its share repurchase strategy, Entity Y issues a prepaid written put option on its own common shares to Bank B. The relevant facts and circumstances are as follows:

- The notional amount of the option is 100,000 common shares of Y.
- The strike price of the option is $20 per share, which also represents the fair value of Y’s common shares on the option issuance date.
- The option premium is $4 per share.
- On the option issuance date, Y pays B $16 per share (or $1.6 million = $16 per share × 100,000), which represents the prepayment of the option strike price less the amount of the option premium due from B ($16 = $20 – $4).
- The prepaid written put option is a European-style option; it can be exercised (and will also expire) one year after the option issuance date (the exercise date).
- If the fair value of Y’s common shares on the exercise date is equal to or greater than the option strike price, B will pay Y $20 per share (or $2 million = $20 per share × 100,000).
- If the fair value of Y’s common shares on the exercise date is less than the option strike price, B will deliver 100,000 of Y’s common shares to Y.
Example 2-3 (continued)

The effect of Y's issuance of the prepaid written put option to B is as follows:

<table>
<thead>
<tr>
<th>Possible Outcome</th>
<th>Economic Result</th>
</tr>
</thead>
<tbody>
<tr>
<td>The fair value of Y's common shares on the exercise date is greater than the option strike price.</td>
<td>Entity Y receives a return on the written option equal to the difference between the strike price ($2 million = $20 per share × 100,000 shares) and the prepayment amount ($1.6 million = $16 per share × 100,000 shares), or $400,000: an annual return of 25 percent.</td>
</tr>
<tr>
<td>The fair value of Y's common shares on the exercise date is equal to or less than the option strike price.</td>
<td>Entity Y reacquires 100,000 of its common shares for $16 per share (the prepayment amount) under more favorable terms than the fair value of the shares on the option issuance date ($20 per share).</td>
</tr>
</tbody>
</table>

As an alternative to the written put option strategy, Y and B could have entered into an economically equivalent arrangement (i.e., one that has the same payoff profile) involving a purchased call option with a strike price of $0 per share and a written call option with a strike price of $20 per share. Under this alternative approach, the prepayment amount of $16 per share represents the premium due on the in-the-money purchased call option ($20), reduced by the premium received from the written call option ($4).

Under either approach, Y would not apply ASC 480-10-25-8 through 25-13 to the contract. It would, however, consider other relevant GAAP to determine the appropriate accounting for its share repurchase strategy.

2.2.2 Financial Instruments

ASC 480-10 — Glossary

**Financial Instrument**

Cash, evidence of an ownership interest in an entity, or a contract that both:

a. Imposes on one entity a contractual obligation either:
   1. To deliver cash or another financial instrument to a second entity
   2. To exchange other financial instruments on potentially unfavorable terms with the second entity.

b. Conveys to that second entity a contractual right either:
   1. To receive cash or another financial instrument from the first entity
   2. To exchange other financial instruments on potentially favorable terms with the first entity.

The use of the term financial instrument in this definition is recursive (because the term financial instrument is included in it), though it is not circular. The definition requires a chain of contractual obligations that ends with the delivery of cash or an ownership interest in an entity. Any number of obligations to deliver financial instruments can be links in a chain that qualifies a particular contract as a financial instrument.

Contractual rights and contractual obligations encompass both those that are conditioned on the occurrence of a specified event and those that are not. All contractual rights (contractual obligations) that are financial instruments meet the definition of asset (liability) set forth in FASB Concepts Statement No. 6, Elements of Financial Statements, although some may not be recognized as assets (liabilities) in financial statements — that is, they may be off-balance-sheet — because they fail to meet some other criterion for recognition.

For some financial instruments, the right is held by or the obligation is due from (or the obligation is owed to or by) a group of entities rather than a single entity.
The scope of ASC 480-10 is limited to financial instruments, which include:

- Ownership interests (e.g., common or preferred shares or interests in a partnership or limited liability company).
- Contracts to deliver cash (e.g., net-cash-settled options or forward contracts).
- Contracts to deliver shares (e.g., share-settled debt or net-share-settled options or forward contracts).
- Contracts to exchange financial instruments (e.g., physically settled written options or forward contracts that involve the exchange of equity shares for cash or another financial asset).

An obligation to provide services does not meet the definition of a financial instrument and is thus outside the scope of ASC 480-10. In paragraph B34 of the Background Information and Basis for Conclusions of FASB Statement 150, the Board notes that the “to provide services” language in the description of a liability in FASB Concepts Statement 6 was omitted from the definition of an obligation now in ASC 480-10-20:

This Statement [i.e., the guidance that is now in ASC 480-10] omits the Concepts Statement’s phrase to provide services, because this Statement [i.e., ASC 480-10] applies only to financial instruments.

Note, however, that a financial instrument (e.g., an outstanding share) may contain embedded features (e.g., an obligation to deliver gold) that would not have met the definition of a financial instrument on a stand-alone basis. ASC 480-10 applies to such a hybrid financial instrument. ASC 815-15-55-110 through 55-111 contain an example of “mandatorily redeemable preferred stock whose preferred dividends are payable in cash but that requires redemption at the end of 1 year for a payment of 312 ounces of gold.” That example implies that ASC 480 applies to the preferred stock and further suggests that the preferred stock contains an embedded derivative whose underlying is the price of gold, which is not clearly and closely related to the host preferred stock contract.

### 2.2.3 Freestanding Financial Instruments

**ASC 480-10 — Glossary**

<table>
<thead>
<tr>
<th>Freestanding Financial Instrument</th>
</tr>
</thead>
<tbody>
<tr>
<td>A financial instrument that meets either of the following conditions:</td>
</tr>
<tr>
<td>a. It is entered into separately and apart from any of the entity’s other financial instruments or equity transactions.</td>
</tr>
<tr>
<td>b. It is entered into in conjunction with some other transaction and is legally detachable and separately exercisable.</td>
</tr>
</tbody>
</table>

**ASC 480-10**

25-1 The guidance in this Section shall be applied to a freestanding financial instrument in its entirety.

ASC 480-10 applies only to financial instruments that are freestanding in accordance with the definition of a freestanding financial instrument in ASC 480-10-20. Accordingly, an entity does not apply ASC 480-10 separately to a feature that is embedded in a financial instrument (see Section 2.3.2).

For example, if an outstanding share that is not mandatorily redeemable contains an embedded put option feature that permits the holder to require the issuer to repurchase the share for a fixed amount of cash, that option would not be analyzed separately from the share under ASC 480-10 unless the
The definition of a freestanding financial instrument helps not only in the identification of whether an item is within the scope of ASC 480-10 but also in the determination of the appropriate units of account; that is, whether an item should be aggregated or disaggregated for accounting purposes (see Section 3.3).

### 2.2.4 Legal Form of Share or Involves Equity Shares

<table>
<thead>
<tr>
<th>ASC 480-10</th>
</tr>
</thead>
<tbody>
<tr>
<td>05-6 For purposes of this Subtopic, three related terms — shares, equity shares, and issuer’s equity shares — are used in the particular ways defined in the glossary.</td>
</tr>
</tbody>
</table>

The instruments in each of the three classes of freestanding financial instruments that must be classified outside of equity under ASC 480-10 either (1) have the legal form of a share (see Section 2.2.4.1) or could result in the receipt or delivery of the issuer’s equity shares (see Sections 2.2.4.2 and 2.2.4.3) or (2) are indexed to an obligation to repurchase its equity shares:

- **Mandatorily redeemable financial instruments** (the first class; see Chapter 4) applies only to “instruments issued in the form of shares” (emphasis added).
- **The second class** (see Chapter 5) applies only to financial instruments that embody “an obligation to repurchase the issuer’s equity shares, or is indexed to such an obligation” (emphasis added).
- **The third class** (see Chapter 6) applies only to obligations that “the issuer must or may settle by issuing a variable number of its equity shares” (emphasis added).

If a contract is not in the legal form of a share and does not involve the potential receipt or delivery of the issuer’s equity shares or is not indexed to an obligation to repurchase the issuer’s equity shares, it would be outside the scope of ASC 480-10.

Accordingly, financial instruments that are in the legal form of debt are outside the scope of ASC 480-10. For example, a note in the legal form of debt that has a stated maturity, stated coupon rate, and creditor rights is outside the scope of ASC 480-10 even if it is mandatorily exchangeable into a specified number of common shares on a future date (e.g., certain premium income-exchangeable securities). The issuer should present such a security as a liability on the basis of its legal form.

An instrument that represents a legal-form debt obligation should be classified as a liability even if it has certain economic characteristics that are similar to an equity instrument. For example, we believe that an instrument that represents a legal-form debt obligation in the jurisdiction in which it is issued and carries creditor rights (e.g., an ability to seek recourse in a bankruptcy court) should be classified as a liability even if the issuer only has a de minimis amount of common equity capital and the instrument is described as an “equity certificate,” has a long maturity (e.g., 40 years), is subordinated to all other creditors, contains conversion rights into common equity, and provides dividend rights that are similar to those of a holder of common equity (e.g., payable only if declared). If it is not readily apparent whether a claim on the entity legally represents debt or equity, an entity may need to seek an opinion from legal counsel.

In this Roadmap, the term “share-settled debt” is used to describe a share-settled obligation that is not in the legal form of debt but has the same economic payoff profile as debt (see Chapter 6).
2.2.4.1 Shares

ASC 480-10 — Glossary

Shares
Shares includes various forms of ownership that may not take the legal form of securities (for example, partnership interests), as well as other interests, including those that are liabilities in substance but not in form. (Business entities have interest holders that are commonly known by specialized names, such as stockholders, partners, and proprietors, and by more general names, such as investors, but all are encompassed by the descriptive term owners. Equity of business entities is, thus, commonly known by several names, such as owners’ equity, stockholders’ equity, ownership, equity capital, partners’ capital, and proprietorship. Some entities [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.)

In ASC 480-10, the term “share” is not limited to a financial instrument in the form of equity securities but broadly applies to any financial instrument that takes the form of an ownership interest. For example, shares include common and preferred shares, partnership interests (e.g., participating securities in the form of preferred limited partnership interests issued by investment funds licensed as SBICs), membership interests in limited liability companies or cooperative entities, and policyholder interests in mutual insurance companies.

The following table lists examples of instruments that, unless a legal analysis of their form suggests otherwise, would and would not be considered shares under ASC 480-10:

<table>
<thead>
<tr>
<th>Share</th>
<th>Not a Share</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Common shares of stock</td>
<td>• Debt securities</td>
</tr>
<tr>
<td>• Preferred shares of stock</td>
<td>• Convertible debt securities</td>
</tr>
<tr>
<td>• Partnership interests</td>
<td>• Debentures</td>
</tr>
<tr>
<td>• Membership interests (or units) in limited liability companies</td>
<td>• Notes payable</td>
</tr>
<tr>
<td>• Membership interests in cooperative entities</td>
<td></td>
</tr>
<tr>
<td>• Policyholder interests in mutual insurance companies</td>
<td></td>
</tr>
</tbody>
</table>

Under U.S. GAAP, instruments that are in the legal form of shares (i.e., instruments that evidence a claim to the net assets of the issuer and do not provide the holder with creditor rights) generally are classified in the stockholders’ equity section of the balance sheet (either permanent or temporary equity) unless they meet the criteria for liability classification in ASC 480-10. Thus, a preferred stock instrument that is not classified as a liability under ASC 480-10 generally would be presented in equity even if it has a stated liquidation preference, a stated dividend, redemption features, and a claim to net assets that is senior to that of common stockholders.

2.2.4.2 Equity Shares

ASC 480-10 — Glossary

Equity Shares
Equity shares refers only to shares that are accounted for as equity.
ASC 480-10-20 suggests that the term “equity share” is limited to shares that qualify, and are classified, as equity (including both permanent and temporary equity) in the reporting entity's financial statements. The term does not apply to shares that are classified as liabilities. Nevertheless, we believe that ASC 480-10-25-8 applies to financial instruments, such as warrants, options, or forwards, that involve the issuance of mandatorily redeemable shares that would be accounted for as liabilities when they are issued; see ASC 480-10-25-13(b) and ASC 480-10-55-33 and Sections 5.1.3 and 5.2.1.

Surplus notes, which are defined in ASC 944-470-20 as “financial instruments issued by insurance entities that are includable in surplus for statutory accounting purposes as prescribed or permitted by state laws and regulations,” do not qualify as equity shares under ASC 944-470-25-1 but are reported as debt instruments. ASC 944-470-05-1 indicates that such notes are also known as “certificates of contribution, surplus debentures, or capital notes.”

### 2.2.4.3 Issuer's Equity Shares

<table>
<thead>
<tr>
<th>ASC 480-10 — Glossary</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Issuer's Equity Shares</strong></td>
</tr>
<tr>
<td>The equity shares of any entity whose financial statements are included in the consolidated financial statements.</td>
</tr>
<tr>
<td><strong>Noncontrolling Interest</strong></td>
</tr>
<tr>
<td>The portion of equity (net assets) in a subsidiary not attributable, directly or indirectly, to a parent. A noncontrolling interest is sometimes called a minority interest.</td>
</tr>
</tbody>
</table>

References in ASC 480-10 to the “issuer's equity shares” include equity shares issued by any consolidated subsidiary. For example, if a parent writes a freestanding put option on a noncontrolling interest in a subsidiary, the put option might fall within the scope of ASC 480-10 in the parent's consolidated financial statements even if it is not recognized in the subsidiary's financial statements. Similarly, an entity should evaluate a put option written by a subsidiary on its own or its parent's equity shares to determine whether the option falls within the scope of ASC 480-10 in the consolidated financial statements. ASC 480-10-55-53 through 55-58 contain special accounting guidance on transactions involving noncontrolling interests (see Section 7.1).

Conversely, shares issued by entities that are not consolidated in the reporting entity's financial statements are not the issuer's equity shares. For example, if a subsidiary enters into a contract to purchase the parent's equity shares for cash, that contract would be within the scope of ASC 480-10 in the parent's consolidated financial statements but not in the subsidiary's separate financial statements. Further, shares issued by an equity-method investee or a third party are not considered the issuer's equity shares and are therefore outside the scope of ASC 480-10. Accordingly, an entity that enters into a contract to purchase or deliver shares of an equity-method investee or a third party would apply other GAAP in accounting for the contract (e.g., ASC 815-10, ASC 320, ASC 321, ASC 323, or ASC 325-20).
2.3  Derivatives

2.3.1 Interaction With Derivative Accounting Requirements in ASC 815-10

ASC 480-10

35-1 Financial instruments within the scope of Topic 815 shall be measured subsequently as required by the provisions of that Topic.

ASC 815-10

15-74 Notwithstanding the conditions of paragraphs 815-10-15-13 through 15-139, the reporting entity shall not consider the following contracts to be derivative instruments for purposes of this Subtopic: . . .

d. Forward contracts that require settlement by the reporting entity's delivery of cash in exchange for the acquisition of a fixed number of its equity shares (forward purchase contracts for the reporting entity's shares that require physical settlement) that are accounted for under paragraphs 480-10-30-3 through 30-5, 480-10-35-3, and 480-10-45-3.

15-83 A derivative instrument is a financial instrument or other contract with all of the following characteristics:

a. Underlying, notional amount, payment provision. The contract has both of the following terms, which determine the amount of the settlement or settlements, and, in some cases, whether or not a settlement is required:
   1. One or more underlyings
   2. One or more notional amounts or payment provisions or both.

b. Initial net investment. The contract requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors.

c. Net settlement. The contract can be settled net by any of the following means:
   1. Its terms implicitly or explicitly require or permit net settlement.
   2. It can readily be settled net by a means outside the contract.
   3. It provides for delivery of an asset that puts the recipient in a position not substantially different from net settlement.

Some instruments that must be classified as assets or liabilities under ASC 480-10 have all of the characteristics of a derivative instrument in ASC 815-10-15-83. In accordance with ASC 815-10-15-74(d), if such instruments are physically settled forward contracts to repurchase equity shares for cash, they are exempt from the scope of the derivative accounting requirements in ASC 815-10. Instead, the accounting guidance in ASC 480-10 applies (see Chapter 5). Other instruments within the scope of ASC 480-10 that have all the characteristics of derivative instruments fall within the scope of both ASC 480-10 and ASC 815-10 unless one of the scope exceptions in ASC 815 applies. Practically, this means that an entity may be required to apply the disclosure requirements of both ASC 480 and ASC 815 to such instruments. Further, in accordance with ASC 815-10, such instruments are measured subsequently at fair value, with changes in fair value recognized in earnings, unless they qualify as hedging instruments in a cash flow or net investment hedge, in which case all or a portion of the change in fair value is recognized in other comprehensive income.

Note that an option or forward that is outside the scope of the derivative accounting requirements in ASC 815-10 (e.g., because it does not meet the net settlement characteristic in the FASB’s definition of a derivative) would nevertheless be accounted for at fair value, with changes in fair value recognized in earnings, if it is within the scope of ASC 480-10.
2.3.2 Interaction With Embedded Derivative Requirements in ASC 815-15

ASC 480-10 does not apply in an entity's evaluation of whether an embedded feature should be bifurcated as an embedded derivative under ASC 815-15. For example, in determining whether an embedded feature qualifies for the scope exception in ASC 815-10-15-74(a) for certain contracts that are both indexed to, and classified in, stockholders' equity (e.g., a written put option embedded in a share), an entity disregards the classification guidance in ASC 480-10. Instead, the entity assesses whether the feature qualifies for that scope exception by applying the indexation and classification guidance in ASC 815-40 (see Section 2.3.3) and any other relevant guidance other than ASC 480-10 to the embedded put feature.

A financial instrument within the scope of ASC 480-10 could potentially contain a feature that must be bifurcated as an embedded derivative under ASC 815-15-25-1. For example, the redemption amount of a mandatorily redeemable financial instrument that is classified as a liability under ASC 480-10 might be indexed to the price of gold. If so, the issuer should assess whether the indexation to gold must be separated as an embedded derivative under ASC 815-15. The guidance in ASC 815-15-55-110 through 55-113 illustrates the application of the “clearly and closely related” criterion in an entity's bifurcation analysis to mandatorily redeemable preferred stock for which the redemption amount is indexed to the price of gold or a fixed amount of a specified foreign currency. The host contract that remains after an embedded feature has been bifurcated as an embedded derivative under ASC 815-15 should be analyzed separately from the embedded derivative in the measurement under ASC 480-10-35 (see Section 4.2.1).

2.3.3 Interaction With Accounting Requirements for Own-Equity Contracts in ASC 815-40

ASC 815-40 addresses the accounting for contracts indexed to, and potentially settled in, the issuer's equity shares (e.g., purchased put or call options, written call options, and forward sale contracts). ASC 815-40-15-3(e) specifies that freestanding financial instruments within the scope of ASC 480-10 are exempt from ASC 815-40. Accordingly, ASC 815-40 does not apply to freestanding contracts indexed to, and potentially settled in, the issuer's equity shares if they are required to be classified as assets or liabilities.
liabilities under ASC 480-10 (e.g., freestanding written put options and freestanding forward purchase contracts on own equity). This implies that an entity needs to assess whether a contract is within the scope of ASC 480-10 before it can determine whether to apply ASC 815-40 to the contract. See Deloitte’s *A Roadmap to Accounting for Contracts on an Entity's Own Equity* for a comprehensive discussion of the application of ASC 815-40.

### 2.3.4 Application of ASC 480-10 to Freestanding Written Puts and Forward Purchase Contracts

<table>
<thead>
<tr>
<th>One Settlement Method</th>
<th>Entity Choice</th>
<th>Counterparty Choice</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Net Share</td>
<td>Net Share</td>
</tr>
<tr>
<td>Physical(a)</td>
<td>Net Share</td>
<td>Net Cash</td>
</tr>
<tr>
<td>Net Share</td>
<td>Net Cash or</td>
<td>Physical(a)</td>
</tr>
<tr>
<td></td>
<td>Physical(a)</td>
<td></td>
</tr>
<tr>
<td>Net Cash</td>
<td>Net Share</td>
<td>Net Cash</td>
</tr>
<tr>
<td></td>
<td>or Net Cash</td>
<td></td>
</tr>
<tr>
<td></td>
<td>or Physical(a)</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Initial and Subsequent Classification and Measurement:

<table>
<thead>
<tr>
<th>Equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Asset/Liability</td>
</tr>
</tbody>
</table>

(a) Physical settlement of the contract requires that the entity deliver cash to the holder in exchange for the shares.

(b) Initial measurement of certain forward purchase contracts is at the present value of the redemption amount, adjusted for any consideration or unstated rights or privileges, with equity reduced by the fair value of the shares. Subsequent measurement of those forward purchase contracts is at the present value of the share redemption amount with accretion and any amounts paid to holders (including dividends) reflected as interest cost. Measurement of a written put option, or of a forward purchase contract that is not for a fixed number of shares in exchange for cash, is at fair value with subsequent changes in fair value recorded in earnings.

(c) Initial and subsequent measurement is at fair value with subsequent changes in fair value recorded in earnings.

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

The table in ASC 480-10-55-63 illustrates how an entity would classify, in accordance with ASC 480-10, freestanding written put options and forward purchase contracts under which the issuer has agreed to buy shares at a specified price on a future date. Irrespective of whether such an instrument requires physical settlement, net cash settlement, or net share settlement, or whether it gives the issuer or the counterparty a choice of settlement methods, the instrument is classified as an asset or a liability under ASC 480-10.

If a forward contract requires physical settlement by repurchase of a fixed number of the issuer’s equity shares for cash, it is classified as a liability under ASC 480-10-25-8 and accounted for in accordance with ASC 480-10-30-3 and ASC 480-10-35-3 in a manner similar to a treasury stock repurchase with borrowed funds (see Section 5.3.1). Other forward purchase contracts and written put options that require or may require the issuer to settle its obligation under the contract by transferring assets are classified as assets or liabilities under ASC 480-10-25-8 and accounted for at fair value under ASC 480-10-30-7, ASC 480-10-35-1, ASC 480-10-35-4A, or ASC 480-10-35-5 (see Sections 5.1 and 5.3.2). Such contracts include those that require net cash settlement, permit the issuer to choose between net cash or physical settlement (but not net share settlement), and give the counterparty a settlement choice if
at least one of the options is physical settlement or net cash settlement. Forward purchase contracts and written put options that require or permit the issuer to settle its obligation under the contract net in shares are classified as assets or liabilities under ASC 480-10-25-14(c) and accounted for at fair value in accordance with ASC 480-10-30-7 as well as ASC 480-10-35-1, ASC 480-10-35-4A, or ASC 480-10-35-5 (see Sections 6.1.4 and 6.3).

2.4 Share-Based Payments

ASC 480-10

15-8 The guidance in the Distinguishing Liabilities from Equity Topic does not apply to an obligation under share-based compensation arrangements if that obligation is accounted for under Topic 718 or Subtopic 505-50. For example, employee stock ownership plan shares or freestanding agreements to repurchase those shares are not within the scope of this Topic because those shares are accounted for under Subtopic 718-40 through the point of redemption. However, this Topic does apply to a freestanding financial instrument that was issued under a share-based compensation arrangement but is no longer subject to Topic 718 or Subtopic 505-50. For example, this Topic applies to a mandatorily redeemable share issued upon an employee’s exercise of an employee share option. (Topic 718 and Subtopic 505-50 provide accounting guidance for dividends on allocated shares, redemption of shares, recognition of expense, and computing earnings per share [EPS].) However, employee stock ownership plan shares that are mandatorily redeemable or freestanding agreements to repurchase those shares continue to be subject to other applicable guidance related to Subtopic 718-40.

Pending Content (Transition Guidance: ASC 718-10-65-11)

15-8 The guidance in the Distinguishing Liabilities from Equity Topic does not apply to an obligation under share-based compensation arrangements if that obligation is accounted for under Topic 718. For example, employee stock ownership plan shares or freestanding agreements to repurchase those shares are not within the scope of this Topic because those shares are accounted for under Subtopic 718-40 through the point of redemption. However, this Topic does apply to a freestanding financial instrument that was issued under a share-based compensation arrangement but is no longer subject to Topic 718. For example, this Topic applies to a mandatorily redeemable share issued upon a grantee’s exercise of a share option. (Topic 718 provides accounting guidance for dividends on allocated shares, redemption of shares, recognition of expense, and computing earnings per share [EPS].) However, employee stock ownership plan shares that are mandatorily redeemable or freestanding agreements to repurchase those shares continue to be subject to other applicable guidance related to Subtopic 718-40.

ASC 480-10 does not apply to a contract issued as compensation for employee service or to acquire goods or services other than employee service if the contract is subject to ASC 718 or, before the adoption of ASU 2018-07, ASC 505-50. In June 2018, the FASB issued ASU 2018-07, which (1) updates the scope of ASC 718 to include share-based payment transactions for acquiring goods or services from nonemployees and (2) supersedes ASC 505-50.

2.4.1 Contracts Issued as Compensation for Employee Service

ASC 480-10 — Glossary

Employee Stock Ownership Plan
An employee stock ownership plan is an employee benefit plan that is described by the Employee Retirement Income Security Act of 1974 and the Internal Revenue Code of 1986 as a stock bonus plan, or combination stock bonus and money purchase pension plan, designed to invest primarily in employer stock. Also called an employee share ownership plan.
ASC 718-10

25-7 Topic 480 excludes from its scope instruments that are accounted for under this Topic. Nevertheless, unless paragraphs 718-10-25-8 through 25-19 require otherwise, an entity shall apply the classification criteria in Section 480-10-25 and paragraphs 480-10-15-3 through 15-4, as they are effective at the reporting date, in determining whether to classify as a liability a freestanding financial instrument given to an employee in a share-based payment transaction. Paragraphs 718-10-35-9 through 35-14 provide criteria for determining when instruments subject to this Topic subsequently become subject to Topic 480 or to other applicable GAAP.

Pending Content (Transition Guidance: ASC 718-10-65-11)

25-7 Topic 480 excludes from its scope instruments that are accounted for under this Topic. Nevertheless, unless paragraphs 718-10-25-8 through 25-19A require otherwise, an entity shall apply the classification criteria in Section 480-10-25 and paragraphs 480-10-15-3 through 15-4 in determining whether to classify as a liability a freestanding financial instrument given to a grantee in a share-based payment transaction. Paragraphs 718-10-35-9 through 35-14 provide criteria for determining when instruments subject to this Topic subsequently become subject to Topic 480 or to other applicable GAAP.

25-8 In determining the classification of an instrument, an entity shall take into account the classification requirements that are effective for that specific entity at the reporting date as established by Topic 480. In addition, a call option written on an instrument that is not classified as a liability under those classification requirements (for example, a call option on a mandatorily redeemable share for which liability classification is not required for the specific entity under the requirements effective at the reporting date) also shall be classified as equity so long as those equity classification requirements for the entity continue to be met, unless liability classification is required under the provisions of paragraphs 718-10-25-11 through 25-12.

Pending Content (Transition Guidance: ASC 718-10-65-11)

25-8 In determining the classification of an instrument, an entity shall take into account the classification requirements as established by Topic 480. In addition, a call option written on an instrument that is not classified as a liability under those classification requirements (for example, a call option on a mandatorily redeemable share for which liability classification is not required for the specific entity under the requirements) also shall be classified as equity so long as those equity classification requirements for the entity continue to be met, unless liability classification is required under the provisions of paragraphs 718-10-25-11 through 25-12.

35-10 A freestanding financial instrument issued to an employee in exchange for past or future employee services that is subject to initial recognition and measurement guidance within this Topic shall continue to be subject to the recognition and measurement provisions of this Topic throughout the life of the instrument, unless its terms are modified when the holder is no longer an employee. Only for purposes of this paragraph, a modification does not include a change to the terms of an award if that change is made solely to reflect an equity restructuring provided that both of the following conditions are met:

a. There is no increase in fair value of the award (or the ratio of intrinsic value to the exercise price of the award is preserved, that is, the holder is made whole) or the antidilution provision is not added to the terms of the award in contemplation of an equity restructuring.

b. All holders of the same class of equity instruments (for example, stock options) are treated in the same manner.
35-10 A freestanding financial instrument issued to a grantee in exchange for goods or services received (or to be received) that is subject to initial recognition and measurement guidance within this Topic shall continue to be subject to the recognition and measurement provisions of this Topic throughout the life of the instrument, unless its terms are modified after a nonemployee vests in the award and is no longer providing goods or services, or a grantee is no longer an employee. Only for purposes of this paragraph, a modification does not include a change to the terms of an award if that change is made solely to reflect an equity restructuring provided that both of the following conditions are met:

a. There is no increase in fair value of the award (or the ratio of intrinsic value to the exercise price of the award is preserved, that is, the holder is made whole) or the antidilution provision is not added to the terms of the award in contemplation of an equity restructuring.

b. All holders of the same class of equity instruments (for example, stock options) are treated in the same manner.

35-12 Once the classification of an instrument is determined, the recognition and measurement provisions of this Topic shall be applied until the instrument ceases to be subject to the requirements discussed in paragraph 718-10-35-10. Topic 480 or other applicable GAAP, such as Topic 815, applies to a freestanding financial instrument that was issued under a share-based payment arrangement but that is no longer subject to this Topic. This guidance is not intended to suggest that all freestanding financial instruments shall be accounted for as liabilities pursuant to Topic 480, but rather that freestanding financial instruments issued in share-based payment transactions may become subject to that Topic or other applicable GAAP depending on their substantive characteristics and when certain criteria are met.

35-14 An entity may modify (including cancel and replace) or settle a fully vested, freestanding financial instrument after it becomes subject to Topic 480 or other applicable GAAP. Such a modification or settlement shall be accounted for under the provisions of this Topic unless it applies equally to all financial instruments of the same class regardless of whether the holder is (or was) an employee (or an employee's beneficiary). Following the modification, the instrument continues to be accounted for under that Topic or other applicable GAAP. A modification or settlement of a class of financial instrument that is designed exclusively for and held only by current or former employees (or their beneficiaries) may stem from the employment relationship depending on the terms of the modification or settlement. Thus, such a modification or settlement may be subject to the requirements of this Topic. See paragraph 718-10-35-10 for a discussion of changes to awards made solely to reflect an equity restructuring.
ASC 718 applies to share-based payment contracts that are issued as compensation for employee service and include, but are not limited to, employee stock appreciation rights and employee stock options. An entity applies ASC 718 in determining (1) whether such contracts should be classified as equity or as liabilities or assets and (2) how to account for them. For example, ASC 718 applies to puttable employee stock options and shares of employee stock ownership plans (ESOPs).

ESOP shares and freestanding contracts to repurchase such shares are accounted for under ASC 718-40. FASB Staff Position FAS 150-4 (superseded as a result of the Codification) contains the following commentary:

By law, employers with ESOPs must provide the employee with a put option or other redemption feature if the shares are not readily tradable; often, the plan requires that upon death, retirement, or the employee's reaching a certain age the shares must be sold back to the employer at fair value. If the employer must redeem, then the shares meet the definition of mandatorily redeemable shares under [ASC 480-10. However,] ESOP shares or freestanding agreements to repurchase those shares are not within the scope of [ASC 480-10], because those shares are accounted for under [ASC 718-40] through the point of redemption.

Although share-based payment awards subject to ASC 718 are outside the scope of ASC 480, ASC 718-10-25-7 requires entities to apply the classification criteria in ASC 480-10-25 and in ASC 480-10-15-3 and 15-4 unless ASC 718-10-25 requires otherwise. For detailed guidance on the application of these requirements, see Chapter 5 of Deloitte's A Roadmap to Accounting for Share-Based Payment Awards.

A contract originally issued as compensation for employee services may become subject to ASC 480-10 subsequent to its issuance if its terms are modified and the holder is no longer an employee. If the terms are modified and the holder is no longer an employee, ASC 718 ceases to apply unless the modification is made solely to reflect an equity restructuring that meets the criteria in ASC 718-10-35-10. That is, “[t]here is no increase in fair value of the award (or the ratio of intrinsic value to the exercise price of the award is preserved, that is, the holder is made whole) or the antidilution provision is not added to the terms of the award in contemplation of an equity restructuring” and “all holders of the same class of equity instruments . . . are treated in the same manner.” If a contract originally issued as compensation for employee service becomes subject to ASC 480-10, the classification of the contract as equity or as an asset or a liability may change as a result of the application of ASC 480-10.

ASC 480-10-15-8 indicates that if an employee exercises a stock option within the scope of ASC 718 and receives mandatorily redeemable shares, those shares would not be within the scope of ASC 718 but would need to be evaluated under ASC 480.

2.4.2 Contracts to Acquire Goods or Services Other Than Employee Service

Before the adoption of ASU 2018-07, ASC 505-50 applies to share-based payment contracts to acquire goods or services other than employee service. After the adoption of ASU 2018-07, such transactions are subject to the guidance in ASC 718.

In addition, before ASU 2018-07’s adoption, awards issued in whole or in part as consideration for goods or services other than employee services generally become subject to other applicable GAAP once performance is complete and the awards are no longer subject to ASC 505-50. Therefore, ASC 480-10 may apply to contracts on an entity’s own equity that represent share-based payments to acquire goods or services from nonemployees once performance has occurred. After the adoption of ASU 2018-07, such contracts generally are subject to ASC 718 unless modified after the goods have been delivered, the services have been rendered, any other conditions related to earning the right to benefit from the contracts have been satisfied, and the nonemployee is no longer providing goods or services (see Section 2.4.1 for a discussion of ASC 718-10-35-10 as amended by ASU 2018-07).
Both ASC 505-50-15-3(c) (before the adoption of ASU 2018-07) and ASC 718-10-15-5(b) (after the adoption of ASU 2018-07) contain a scope exception for transactions involving equity instruments granted to a lender or investor that provides financing to the issuer. For example, if an entity obtains a loan in exchange for issuing a contract on own equity, that contract would not be within the scope of ASC 505-50 or ASC 718 but would be evaluated under ASC 480-10 along with any other applicable literature (e.g., ASC 815-10 and ASC 815-40).

2.4.3 Transition Related to ASU 2018-07

<table>
<thead>
<tr>
<th>ASC 718-10</th>
</tr>
</thead>
</table>
| 65-11 | The following represents the transition and effective date information related to Accounting Standards Update No. 2018-07, Compensation — Stock Compensation (Topic 718): Improvements to Nonemployee Share-Based Payment Accounting:

   a. The pending content that links to this paragraph shall be effective for public business entities for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years.

   b. The pending content that links to this paragraph shall be effective for all other entities for fiscal years beginning after December 15, 2019, and interim periods within fiscal years beginning after December 15, 2020.

   c. Early adoption, including adoption in an interim period, of the pending content that links to this paragraph is permitted for:

      1. Public business entities for which financial statements have not yet been issued, but no earlier than the adoption of the pending content that links to paragraph 606-10-65-1

      2. All other entities for which financial statements have not yet been made available for issuance, but no earlier than the adoption of the pending content that links to paragraph 606-10-65-1.

   If an entity early adopts the pending content that links to this paragraph in an interim period, any adjustments shall be reflected as of the beginning of the fiscal year that includes that interim period.

   d. An entity shall apply the pending content that links to this paragraph in the same period in which it applies the pending content that links to paragraphs 718-10-65-12 through 65-14.

   e. An entity shall apply the pending content that links to this paragraph on a modified retrospective basis through a cumulative-effect adjustment to retained earnings as of the beginning of the fiscal year in which the pending content that links to this paragraph is adopted. For purposes of determining the cumulative-effect adjustment, an entity shall:

      1. Assess only liability-classified awards that have not been settled by the date of adoption and equity-classified awards for which a measurement date has not been established

      2. Remeasure awards as defined in (e)(1) at fair value as of the adoption date rather than grant-date fair value

      3. Not remeasure assets that are completed. For example, finished goods inventory or equipment that has begun amortization would not be remeasured upon transition.

   f. In the first interim period and fiscal year of adoption, an entity shall disclose both of the following:

      1. The nature of and reason for the change in accounting principle

      2. The cumulative effect of the change on retained earnings or other components of equity or net assets in the statement of financial position as of the beginning of the period of adoption. |
Chapter 2 — Scope

ASC 718-10 (continued)

65-12 The following represents the transition and effective date information related to Accounting Standards Update No. 2018-07, Compensation — Stock Compensation (Topic 718): Improvements to Nonemployee Share-Based Payment Accounting:

a. An entity shall apply the pending content that links to this paragraph in the same period in which it applies the pending content that links to paragraphs 718-10-65-11 and 718-10-65-13 through 65-14.

b. An entity shall apply the pending content that links to this paragraph on a modified retrospective basis through a cumulative-effect adjustment to retained earnings as of the beginning of the fiscal year in which the pending content that links to this paragraph is adopted. Upon adoption, an entity shall reevaluate the classification of nonemployee awards initially classified as equity before completion of performance and subsequently reclassified to liabilities upon completion of performance because of other guidance (for example, Topic 815 on derivatives and hedging).

c. For purposes of determining the cumulative-effect adjustment, an entity shall assess unsettled liability-classified awards that were previously classified as equity awards as of the adoption date. If a liability-classified award would have remained equity classified because of the application of the pending content that links to this paragraph, the guidance on the modification of an award from liability classification to equity classification in paragraphs 718-20-55-135 through 55-138 shall be applied.

d. In the first interim period and fiscal year of adoption, an entity shall disclose both of the following:
   1. The nature of and reason for the change in accounting principle
   2. The cumulative effect of the change on retained earnings or other components of equity or net assets in the statement of financial position as of the beginning of the period of adoption.

For public business entities, ASU 2018-07 is effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. For all other entities, the ASU is effective for fiscal years beginning after December 15, 2019, and interim periods within fiscal years beginning after December 15, 2020. Early adoption is permitted if financial statements have not yet been issued (for public business entities) or have not yet been made available for issuance (for all other entities), but no earlier than an entity’s adoption date of ASC 606.

For more information about the transition to ASU 2018-07, see Section 9.10 of Deloitte’s A Roadmap to Accounting for Share-Based Payment Awards.

2.5 Convertible Preferred Shares With CCFs

ASC 470-20

15-4 The guidance in this Section shall be considered after consideration of the guidance in Subtopic 815-15 on bifurcation of embedded derivatives, as applicable (see paragraph 815-15-55-76A). The guidance in the Cash Conversion Subsections applies only to convertible debt instruments that, by their stated terms, may be settled in cash (or other assets) upon conversion, including partial cash settlement, unless the embedded conversion option is required to be separately accounted for as a derivative instrument under Subtopic 815-15. The guidance in the Cash Conversion Subsections does not affect an issuer’s determination under Subtopic 815-15 of whether an embedded feature shall be separately accounted for as a derivative instrument.

15-6 For purposes of determining whether an instrument is within the scope of the Cash Conversion Subsections, a convertible preferred share shall be considered a convertible debt instrument if it has both of the following characteristics:
   a. It is a mandatorily redeemable financial instrument.
   b. It is classified as a liability under Subtopic 480-10.

For related implementation guidance, see paragraph 470-20-55-70.
An example of a convertible preferred share that paragraph 470-20-15-6 requires an entity consider as a convertible debt instrument for purposes of the scope application of the Cash Conversion Subsections is a convertible preferred share that has a stated redemption date and also would require the issuer to settle the face amount of the instrument in cash upon exercise of the conversion option. Such a convertible preferred share is a mandatorily redeemable financial instrument and is classified as a liability under Subtopic 480-10 because it embodies an unconditional obligation to redeem the instrument by transferring assets at a specified or determinable date (or dates).

An instrument that is within the scope of ASC 480-10 because it meets the definition of a mandatorily redeemable financial instrument in ASC 480-10-20 (see Chapter 4) may be subject also to the cash conversion guidance in ASC 470-20. For example, the terms of a redeemable convertible preferred share with a stated redemption date might state that, upon conversion of the instrument by the holder, the issuer must settle the face value of the instrument in cash but may choose to settle the conversion spread in either shares or cash. Such an issuer should consider whether it is required to separate the instrument into liability and equity components in accordance with the cash conversion guidance in ASC 470-20 (see Sections 4.2.4 and 4.3.1.4).

While more traditional forms of convertible debt instruments must be physically settled in the issuer’s equity shares upon conversion, an instrument with a CCF requires or permits settlement of all or part of the instrument’s conversion value by the transfer of cash or other assets. In Issue 90-19, the EITF identified three variants of convertible bonds with CCFs (Instruments A, B, and C); and in his remarks at the 2003 AICPA Conference on Current SEC Developments, then SEC Professional Accounting Fellow Robert Comerford identified a fourth variant (Instrument X):

<table>
<thead>
<tr>
<th>Settlement Provision</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Instrument A</td>
<td>Cash settlement</td>
</tr>
<tr>
<td></td>
<td>“Upon conversion, the issuer must satisfy the obligation entirely in cash based on the fixed number of shares multiplied by the stock price on the date of conversion (the conversion value).”</td>
</tr>
<tr>
<td>Instrument B</td>
<td>Issuer option to elect either cash or physical share settlement</td>
</tr>
<tr>
<td></td>
<td>“Upon conversion, the issuer may satisfy the entire obligation in either stock or cash equivalent to the conversion value.”</td>
</tr>
<tr>
<td>Instrument C</td>
<td>Cash settlement of accreted value and issuer option to elect either net cash or net share settlement of conversion spread</td>
</tr>
<tr>
<td></td>
<td>“Upon conversion, the issuer must satisfy the accreted value of the obligation (the amount accrued to the benefit of the holder exclusive of the conversion spread) in cash and may satisfy the conversion spread (the excess conversion value over the accreted value) in either cash or stock.”</td>
</tr>
<tr>
<td>Instrument X</td>
<td>Combination settlement</td>
</tr>
<tr>
<td></td>
<td>“Instrument X provides the issuer with the ability to settle investor conversions in any combination of shares or cash.”</td>
</tr>
</tbody>
</table>
The CCF guidance in ASC 470-20 applies to the issuer's accounting for convertible preferred stock that meets all of the following four conditions:

1. Upon conversion, it may be settled either fully or partially in cash or other assets in accordance with its stated terms.
2. It meets the definition of a mandatorily redeemable financial instrument in ASC 480-10 (see Section 4.1.1).
3. It is classified as a liability under ASC 480-10 (i.e., it is a mandatorily redeemable financial instrument that is not exempt from the scope of ASC 480-10; see Section 4.1.5).
4. The CCF is not required to be separately accounted for as a derivative instrument under ASC 815-15 (see Section 2.3 of Deloitte’s A Roadmap to the Issuer’s Accounting for Convertible Debt).

In the application of the CCF guidance in ASC 470-20, such convertible preferred stock is treated as convertible debt.

The requirements in ASC 470-20 (e.g., the CCF guidance) do not apply if the conversion feature must be bifurcated and accounted for as a derivative instrument under ASC 815. Therefore, an issuer needs to determine whether ASC 815-15 requires bifurcation of the CCF before it can assess whether the CCF guidance in ASC 470-20 applies to the instrument.

For further discussion of the cash conversion guidance in ASC 470-20, see Chapter 6 of Deloitte’s A Roadmap to the Issuer’s Accounting for Convertible Debt.

2.6 Contingent Consideration in a Business Combination

<table>
<thead>
<tr>
<th>ASC 480-10</th>
</tr>
</thead>
<tbody>
<tr>
<td>15-9 Subtopic 805-30 provides guidance on the recognition and initial measurement of consideration issued in a business combination, including contingent consideration.</td>
</tr>
<tr>
<td>15-10 However, when recognized, a financial instrument within the scope of this Topic that is issued as consideration (whether contingent or noncontingent) in a business combination shall be classified pursuant to the requirements of this Topic.</td>
</tr>
<tr>
<td>35-4A Contingent consideration issued in a business combination that is classified as a liability in accordance with the requirements of this Topic shall be subsequently measured at fair value in accordance with 805-30-35-1.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>ASC 805-30 — Glossary</th>
</tr>
</thead>
<tbody>
<tr>
<td>Contingent Consideration</td>
</tr>
<tr>
<td>Usually an obligation of the acquirer to transfer additional assets or equity interests to the former owners of an acquiree as part of the exchange for control of the acquiree if specified future events occur or conditions are met. However, contingent consideration also may give the acquirer the right to the return of previously transferred consideration if specified conditions are met.</td>
</tr>
</tbody>
</table>

In business combinations, the parties often agree to contingent consideration (i.e., consideration that depends on future events or conditions). Contingent consideration arrangements permit the parties to proceed with a business combination without agreeing on the final purchase price. For example, the acquirer may agree to deliver a specified number of its own equity shares if the acquiree's earnings exceed a specified target in the year after the combination. Other examples of events that may trigger
Contingent consideration payments include reaching a specified stock price or achieving a milestone in a research and development project.

In determining the appropriate classification of a contingent consideration arrangement, the acquirer considers the classification guidance in ASC 480-10 and any other applicable guidance (e.g., ASC 815-40). To measure the arrangement, however, the acquirer applies ASC 805-30 instead of ASC 480-10. Contingent consideration is part of the total consideration transferred for the acquiree and must therefore be measured and recognized at fair value as of the acquisition date under ASC 805-30. ASC 805-30-35-1 provides guidance on how to recognize changes in the fair value of contingent consideration other than measurement-period adjustments. Contingent consideration classified as equity is not remeasured, and its settlement is recognized in equity. Contingent consideration classified as an asset or liability is remeasured to fair value in each reporting period, with changes in fair value recognized in earnings, unless it qualifies for recognition in other comprehensive income under the hedge accounting guidance in ASC 815.

Under ASC 805, the acquirer recognizes as revisions to goodwill those adjustments made during the measurement period that pertain to facts and circumstances that existed as of the acquisition date. The acquirer must consider all pertinent factors in determining whether information obtained after the acquisition date should result in an adjustment to the provisional amounts recognized or whether that information stems from events that occurred after the acquisition date. For example, if earnings targets are met, share prices change, or FDA approvals are obtained after the acquisition date, resulting changes in fair value are recognized in earnings and not as adjustments to goodwill.

### 2.7 Registration Payment Arrangements

<table>
<thead>
<tr>
<th>ASC 480-10</th>
</tr>
</thead>
<tbody>
<tr>
<td>15-8A The guidance in this Topic does not apply to the following instruments:</td>
</tr>
<tr>
<td>a. Registration payment arrangements within the scope of Subtopic 825-20.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>ASC Master Glossary</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Registration Payment Arrangement</strong></td>
</tr>
<tr>
<td>An arrangement with both of the following characteristics:</td>
</tr>
<tr>
<td>a. It specifies that the issuer will endeavor to do either of the following:</td>
</tr>
<tr>
<td>1. File a registration statement for the resale of specified financial instruments and/or for the resale of equity shares that are issuable upon exercise or conversion of specified financial instruments and for that registration statement to be declared effective by the U.S. Securities and Exchange Commission (SEC) (or other applicable securities regulator if the registration statement will be filed in a foreign jurisdiction) within a specified grace period</td>
</tr>
<tr>
<td>2. Maintain the effectiveness of the registration statement for a specified period of time (or in perpetuity).</td>
</tr>
<tr>
<td>b. It requires the issuer to transfer consideration to the counterparty if the registration statement for the resale of the financial instrument or instruments subject to the arrangement is not declared effective or if effectiveness of the registration statement is not maintained. That consideration may be payable in a lump sum or it may be payable periodically, and the form of the consideration may vary. For example, the consideration may be in the form of cash, equity instruments, or adjustments to the terms of the financial instrument or instruments that are subject to the registration payment arrangement (such as an increased interest rate on a debt instrument).</td>
</tr>
</tbody>
</table>
The guidance in this Subtopic does not apply to any of the following:

a. Arrangements that require registration or listing of convertible debt instruments or convertible preferred stock if the form of consideration that would be transferred to the counterparty is an adjustment to the conversion ratio. (Subtopic 470-20 provides guidance on accounting for convertible instruments with contingently adjustable conversion ratios.)

b. Arrangements in which the amount of consideration transferred is determined by reference to either of the following:
   1. An observable market other than the market for the issuer's stock
   2. An observable index.

For example, if the consideration to be transferred if the issuer is unable to obtain an effective registration statement is determined by reference to the price of a commodity. See Subtopic 815-15 for related guidance.

c. Arrangements in which the financial instrument or instruments subject to the arrangement are settled when the consideration is transferred (for example, a warrant that is contingently puttable if an effective registration statement for the resale of the equity shares that are issuable upon exercise of the warrant is not declared effective by the SEC within a specified grace period).

An entity shall recognize a registration payment arrangement as a separate unit of account from the financial instrument(s) subject to that arrangement.

The financial instrument(s) subject to the registration payment arrangement shall be recognized in accordance with other applicable generally accepted accounting principles (GAAP) (for example, Subtopics 815-10; 815-40; and 835-30) without regard to the contingent obligation to transfer consideration pursuant to the registration payment arrangement.

An entity shall measure a registration payment arrangement as a separate unit of account from the financial instrument(s) subject to that arrangement.

The financial instrument(s) subject to the registration payment arrangement shall be measured in accordance with other applicable generally accepted accounting principles (GAAP) (for example, Subtopics 815-10; 815-40; and 835-30) without regard to the contingent obligation to transfer consideration pursuant to the registration payment arrangement.

In connection with issuances of equity shares, convertible instruments, and equity-linked contracts, an issuer may agree to pay amounts if it is unable to deliver registered shares or maintain an effective registration. For example, a warrant or other equity-linked contract may require the issuer to:

- Use its “best efforts” to file a registration statement for the resale of shares and have the registration statement declared effective by the end of a specified grace period (e.g., within 90 to 180 days).
- Maintain the effectiveness of a registration statement for a specified period.

If the issuer fails to meet the conditions, the contract may require it to make cash payments to the counterparty unless or until a registration statement is declared effective. For example, the contract may require the entity to pay the investor 2 percent of the contract purchase price in each month after the end of a 180-day grace period during which there is no registration statement in effect covering the shares that will be delivered under the contract.

ASC 480-10 does not apply to registration payment arrangements within the scope of ASC 825-20. Such arrangements are accounted for separately from any related financial instrument (such as a share or contract on own equity) even if they are included in the contractual terms of that instrument (see ASC 825-20-25-1 as well as ASC 825-20-30-1 and 30-2).
ASC 825-20-15-4 implies that an arrangement does not qualify for the scope exception in ASC 480-10 for registration payment arrangements if any of the following criteria apply:

- The form of consideration transferred is a contingently adjustable conversion ratio in a convertible instrument.
- The payment is adjusted by reference to either an observable market other than the issuer’s stock (e.g., a commodity price) or an observable index.
- The payment is made when the contract subject to the arrangement is settled (e.g., a payment that is made upon the exercise of an option on own stock that is subject to the arrangement).

Accordingly, provisions of the types contemplated in ASC 825-20-15-4 would be considered in the analysis under ASC 480-10 of the financial instrument that contains them.

### 2.8 Guarantee Obligations

**ASC 480-10**

**55-23** An entity’s guarantee of the value of an asset, liability, or equity security of another entity may require or permit settlement in the entity’s equity shares. For example, an entity may guarantee that the value of a counterparty’s equity investment in another entity will not fall below a specified level. The guarantee contract requires that the guarantor stand ready to issue a variable number of its shares whose fair value equals the deficiency, if any, on a specified date between the guaranteed value of the investment and its current fair value. Upon issuance, unless the guarantee is accounted for as a derivative instrument, the obligation to stand ready to perform is a liability addressed by Topic 460. If, during the period the contract is outstanding, the fair value of the guaranteed investment falls below the specified level, absent an increase in value, the guarantor will be required to issue its equity shares. At that point in time, the liability recognized in accordance with that Topic would be subject to the requirements of Topic 450. This Subtopic establishes that, even though the loss contingency is settleable in equity shares, the obligation under that Topic is a liability under paragraph 480-10-25-14(b) until the guarantor settles the obligation by issuing its shares. That is because the guarantor’s conditional obligation to issue shares is based on the value of the counterparty’s equity investment in another entity and not on changes in the fair value of the guarantor’s equity instruments.

A guarantee obligation within the scope of ASC 460-10 might be subject to ASC 480-10 if it requires or permits the guarantor to settle its obligation in a variable number of its equity shares (e.g., the contract is a liability under ASC 480-10-25-14(b); see Sections 6.1.3, 6.2.2, and 6.2.3). For such a contract, an entity should consider the requirements of both ASC 480-10 and ASC 460-10 (e.g., the disclosure requirements in ASC 460-10-50).

ASC 460-10-15-4 states that ASC 460-10 applies, with certain exceptions, to the following types of guarantee contracts:

a. Contracts that contingently require a guarantor to make payments [including cash, financial instruments, other assets, shares of its stock, or provision of services] to a guaranteed party based on changes in an underlying that is related to an asset, a liability, or an equity security of the guaranteed party.

b. Contracts that contingently require a guarantor to make payments to a guaranteed party based on another entity’s failure to perform under an obligating agreement (performance guarantees).

c. Indemnification agreements (contracts) that contingently require an indemnifying party (guarantor) to make payments to an indemnified party (guaranteed party) based on changes in an underlying that is related to an asset, a liability, or an equity security of the indemnified party.

d. Indirect guarantees of the indebtedness of others, even though the payment to the guaranteed party may not be based on changes in an underlying that is related to an asset, a liability, or an equity security of the guaranteed party.
Chapter 3 — Contract Analysis

As part of its accounting analysis under ASC 480-10, an issuer must carefully evaluate an instrument's contractual terms (see Section 3.1). Any feature that is nonsubstantive or minimal is ignored (see Section 3.2). Further, the issuer must consider how to appropriately identify units of account (see Section 3.3).

3.1 Identifying and Evaluating Contractual Terms

In determining the appropriate accounting for a contract or transaction under ASC 480-10, an entity is well advised to devote adequate time to reading the underlying legal documents. Terms that are significant to the accounting analysis may be buried deep within the fine print of the contract. All of the contractual terms as well as the legal and regulatory framework and surrounding facts and circumstances need to be carefully evaluated in light of the applicable accounting requirements.

In forming a view on the appropriate accounting, an entity cannot necessarily rely on the name given to a transaction (e.g., mandatorily redeemable equity security, convertible preferred equity certificate, hybrid equity unit, warrant, or equity option) or how it is described in summary term sheets, slideshow presentations, and marketing materials. Products with similar economics and legal characteristics sometimes go by different names in the marketplace (e.g., products marketed by different banks), while products subject to different accounting may go by the same or similar names (e.g., the accounting analysis for a warrant on an entity’s own stock might depend on whether it includes redemption requirements, and for a convertible preferred equity certificate, such analysis might depend on whether the certificate is in the legal form of debt or equity). Furthermore, the names given to contractual provisions in legal documents (e.g., conversion features or share settlement provisions) do not necessarily reflect how they would be identified and analyzed for accounting purposes. Minor variations in how contractual terms are defined can have major accounting implications.

For example, a share described contractually as “redeemable” or “mandatorily redeemable” does not necessarily meet the definition of a mandatorily redeemable financial instrument under ASC 480-10. If a share with a mandatory redemption date contains, for instance, a substantive conversion feature that permits the investor to convert the share into a fixed number of common shares before the mandatory redemption date, the share would not be considered mandatorily redeemable under ASC 480-10 (see Section 4.1).

An individual contract may consist of multiple legal documents (e.g., a trade confirmation that refers to a master agreement). The issuer should consider all such documents in identifying the terms of the contract. To determine the appropriate accounting for a contract that involves the receipt or delivery of equity shares, the issuer should also consider whether the terms of the underlying shares could affect the accounting analysis of the contract. For example, if an entity writes a call option or warrant on its equity shares, and the shares that would be delivered upon exercise of the option are redeemable by the shareholder, that redemption provision may affect the classification of the warrant even if the warrant contract does not mention any redemption requirement (see Section 5.2.1.1).
3.2 Nonsubstantive or Minimal Features

3.2.1 Overview

In its evaluation of whether a freestanding financial instrument should be classified outside of equity under ASC 480-10, an entity is required to disregard any nonsubstantive or minimal features contained in the instrument. For example, if a conversion option in an otherwise mandatorily redeemable preferred equity security is nonsubstantive, the entity ignores that conversion option in determining whether the share should be classified as a liability or equity under ASC 480-10. Thus, as long as redemption is judged certain to occur because the conversion option is nonsubstantive, a preferred equity security with a stated redemption date might meet the definition of a mandatorily financial instrument in ASC 480-10-20 (see Section 4.1) even if it contains an equity conversion option.

To determine whether a feature is nonsubstantive or minimal, an entity applies judgment and considers “all the terms of [the] instrument and other relevant facts and circumstances.” The examples in ASC 480-10-55’s application guidance imply that it may be relevant for an entity to consider (1) whether the feature is very deeply out-of-the-money and (2) the value of the feature in relation to the other components of the instrument (e.g., whether its fair value is trivial relative to the fair value of the entire instrument):

- ASC 480-10-55-12 states that a conversion option embedded in a mandatorily redeemable preferred equity security would be judged nonsubstantive if the conversion price is “extremely high in relation to the current share price” (i.e., the conversion option is very deeply out-of-the-money; see Section 3.2.2.1). For classification purposes, such a security is analyzed as a mandatorily redeemable equity security without an embedded conversion option. (In the absence of the requirement to disregard nonsubstantive or minimal features, the entity could have circumvented the requirement to classify the preferred equity security as a liability by embedding the nonsubstantive conversion option in the security.)

- In accordance with ASC 480-10-55-41, an outstanding share of preferred stock with a par amount of $100 and paying a small dividend would be judged minimal if the share contains an embedded written option that permits the counterparty to put both (1) the share and (2) 100,000 shares of common stock for an aggregate exercise price of $4.5 million when the current stock market value of those shares is $5 million (see Section 3.2.2.2). For classification purposes, such a financial instrument is analyzed as a freestanding written put option on common stock without a preferred stock host. (In the absence of the requirement to disregard nonsubstantive or minimal features, the entity could have circumvented the requirement to classify the written put as a liability by embedding it in the minimal preferred stock host.)

A feature may be substantive or nonminimal irrespective of whether it is expected or not expected to be exercised or triggered. ASC 480-10-55-40 suggests that a share that contains mirror-image put and call options that permit the issuer to call the instrument and the holder to put the instrument on the same exercise date and at the same strike price is not a mandatorily redeemable financial instrument. Even though there may be a significant likelihood that either the put option or the call option will be exercised, the share is not a mandatorily redeemable financial instrument since there is a reasonable possibility...
that both options will expire at-the-money. Accordingly, the instrument is analyzed as a share with a conditional redemption requirement rather than as a share that is certain to be redeemed (see Section 4.2.1). However, we believe that if the mirror price is set at a level that makes it virtually impossible for one option to expire unexercised (e.g., the exercise price of the put option is set so high that the option is virtually certain to be exercised), the share should be considered mandatorily redeemable.

In the evaluation of whether a feature is nonsubstantive or minimal, it may be relevant to consider whether it was designed to avoid the classification requirements in ASC 480-10. The FASB's purpose in developing the requirements related to nonsubstantive or minimal features was to prevent entities from incorporating such features into instruments to circumvent the classification requirements in ASC 480-10. Paragraph B54 of the Background Information and Basis for Conclusions of FASB Statement 150 states, in part:

In reaching its conclusion to limit this Statement's classification requirements only to certain freestanding financial instruments, the Board became concerned that a nonsubstantive or minimal feature might be inserted into a financial instrument, which otherwise would be a freestanding financial instrument subject to this Statement, to circumvent the provisions of this Statement. The Board decided to prevent that possibility by providing that any nonsubstantive or minimal features should be disregarded in applying the classification provisions of this Statement.

If a feature was included in a contract in good faith, and the parties believed at the inception of the contract that it was reasonably possible that the feature either would or would not be triggered, we believe that the feature should not be considered nonsubstantive. Conversely, the feature may lack substance if the outcome of a condition in the contract's terms is predetermined. For instance, an obligation that is conditional in form may, in substance, be unconditional if the condition is certain to be met in the absence of a violation of other legal obligations (e.g., if the holder of an embedded redemption option is legally required to exercise it under the terms of the same contract, a separate agreement, or its articles of incorporation).

We believe that the assessment of whether a feature is nonsubstantive or minimal should be made at contract inception only. That is, an issuer does not reassess its conclusion regarding whether a feature is nonsubstantive or minimal even if circumstances change so that the feature becomes substantive, nonsubstantive, minimal, or nonminimal. This view is supported by the guidance in ASC 480-10-55-12, which suggests that an entity does not subsequently reassess its determination that a conversion feature embedded in a preferred share with a stated redemption date is nonsubstantive. In addition, this view is consistent with paragraph B54 of the Background Information and Basis for Conclusions of FASB Statement 150 (quoted above), which implies that the purpose of the guidance is to prevent entities from circumventing the classification provisions of ASC 480-10 by inserting a nonsubstantive or minimal feature into a contract at its inception.

### 3.2.2 Examples

#### 3.2.2.1 Mandatorily Redeemable Preferred Shares With a Nonsubstantive Conversion Option

<table>
<thead>
<tr>
<th>ASC 480-10 55-11</th>
<th>For another example of a conditionally redeemable instrument, an entity may issue preferred shares with a stated redemption date 30 years hence that also are convertible at the option of the holders into a fixed number of common shares during the first 10 years. Those instruments are not mandatorily redeemable for the first 10 years because the redemption is conditional, contingent upon the holder's not exercising its option to convert into common shares. However, when the conversion option (the condition) expires, the shares would become mandatorily redeemable and would be reclassified as liabilities, measured initially at fair value.</th>
</tr>
</thead>
</table>
If the conversion option were nonsubstantive, for example, because the conversion price is extremely high in relation to the current share price, it would be disregarded as provided in paragraph 480-10-25-1. If that were the case at inception, those preferred shares would be considered mandatorily redeemable and classified as liabilities with no subsequent reassessment of the nonsubstantive feature.

Usually, an instrument that contains both a mandatory redemption requirement and an equity conversion option does not meet the definition in ASC 480-10 of a mandatorily redeemable financial instrument. The possibility of a conversion into equity shares suggests that redemption in cash or other assets is not certain to occur (see Section 4.1). If the conversion option is nonsubstantive, however, it would be disregarded in the evaluation of whether the instrument is a mandatorily redeemable financial instrument. A conversion option is nonsubstantive if the conversion price is “extremely high” relative to the share price (i.e., significantly deep out-of-the-money) at inception. That a conversion option is contingent (e.g., upon the payment of a dividend or the sale of a subsidiary) does not necessarily make it nonsubstantive as long as it is reasonably possible that the contingency will be met.

### 3.2.2.2 Option to Redeem Shares Embedded in a Minimal Host

An entity issues one share of preferred stock (with a par amount of $100), paying a small dividend, and embeds in it an option allowing the holder to put the preferred share along with 100,000 shares of the issuer's common stock (currently trading at $50) for a fixed price of $45 per share in cash. The preferred stock host is judged at inception to be minimal and would be disregarded under paragraph 480-10-25-1 in applying the classification provisions of this Subtopic. Therefore, under either paragraphs 480-10-25-8 through 25-12 or 480-10-25-14(c) (depending on the form of settlement), that instrument would be analyzed as a written put option in its entirety, classified as a liability, and measured at fair value.

### 3.3 Unit of Account

The level at which an asset or a liability is aggregated or disaggregated in a Topic for recognition purposes.

In applying ASC 480-10, an issuer should consider how to appropriately identify units of account (i.e., “the level at which an asset or a liability is aggregated or disaggregated” for accounting purposes). Determining the appropriate units of account is important because the application of ASC 480-10 and other GAAP depend on how units of account are identified. For example, if an issuer writes a freestanding put option on an equity share, the put option is analyzed as a unit of account that is separate from the share. Under ASC 480-10, the written put option would be classified as a liability and measured at fair value, with changes in fair value recognized in earnings. If the issuer instead were
to embed the same put option in the equity share, however, the put option would not be separately evaluated under ASC 480-10 because the scope of ASC 480-10 is limited to freestanding financial instruments (see Sections 2.2.3 and 2.3.2). In this circumstance, the combination of the share and the embedded put option potentially would represent a single unit of account that qualifies for equity classification depending on the application of other GAAP (including ASC 815-10 and ASC 815-15).

3.3.1 Concept of a “Freestanding Financial Instrument”

<table>
<thead>
<tr>
<th>ASC 480-10 — Glossary</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Freestanding Financial Instrument</strong></td>
</tr>
<tr>
<td>A financial instrument that meets either of the following conditions:</td>
</tr>
<tr>
<td>a. It is entered into separately and apart from any of the entity's other financial instruments or equity transactions.</td>
</tr>
<tr>
<td>b. It is entered into in conjunction with some other transaction and is legally detachable and separately exercisable.</td>
</tr>
</tbody>
</table>

Because ASC 480-10 applies only to freestanding financial instruments and not to features embedded in such instruments, the definition of a freestanding financial instrument helps an issuer determine whether an item is within the scope of ASC 480-10 (see Section 2.2.3). A single contract often represents a freestanding financial instrument. However, sometimes a single legal agreement consists of more than one component that individually meets the definition of a freestanding financial instrument, such as components that are legally detachable and separately exercisable (e.g., debt with a detachable warrant). Conversely, two separate agreements might, for accounting purposes, have to be combined and treated as a single freestanding financial instrument (e.g., debt issued with a warrant that is not legally detachable and separately exercisable).

ASC 480-10-20 defines a freestanding financial instrument as one that is entered into either “separately and apart from any of the entity's other financial instruments or equity transactions” or “in conjunction with some other transaction and is legally detachable and separately exercisable.” Therefore, we believe that an entity should consider the following questions in identifying freestanding financial instruments:

1. **Was the transaction entered into contemporaneously with and in contemplation of another transaction, or was it entered into separately and apart from other transactions?**

The fact that a transaction was entered into separately and apart from any other transaction suggests that it is a freestanding financial instrument that is separate from any other transaction. If the transaction was entered into contemporaneously and in contemplation of another transaction, the entity should assess whether the two transactions represent a single freestanding financial instrument. For example, if warrants are issued in conjunction with a debt issuance of the same issuer, the issuer should consider whether to treat them as being embedded in the debt even if they are subject to a separate contractual agreement.

A transaction's having been entered into contemporaneously or in conjunction with some other transaction, however, would not necessarily result in a conclusion that the two transactions should be viewed on a combined basis as a single freestanding financial instrument. The entity should also consider whether the transactions are legally detachable and separately exercisable (see below) and whether the combination guidance in ASC 815-10 applies (see Section 3.3.2).
A one-week period between transactions may be good evidence that the transactions are not contemporaneous if the entity is exposed to market fluctuations during this time. Even when transactions occur at different times, however, entities should consider all available evidence to ensure that no side agreements or other contracts were entered into that suggest the transactions were entered into in contemplation of one another.

Options written by the acquired entity on its stock as of the date of a business combination are often viewed as effectively modifying previously existing shares. Such options are not considered to have been entered into separately and apart from the shares.

2. Is the item legally detachable?

Neither ASC 480 nor other GAAP provide guidance on the meaning of “legally detachable.” We believe that a presumption exists that to be legally detachable from another item, the item must be separately transferable from that item. If an item is separately exercisable but not considered legally detachable, it would not be a separate freestanding financial instrument under item (b) of the definition of a freestanding financial instrument.

An item is considered “legally detachable” if it can be transferred separately from another item in a single contractual agreement (or from another item in multiple contracts entered into at the same time) at the holder’s discretion (i.e., without limitations imposed by the counterparty). The fact that an item can be transferred independently from another item indicates that it is a separate unit of account even if the two items were entered into contemporaneously and have the same counterparty. This view is supported by the guidance in ASC 815-10-25-9, which states, in part:

Derivative instruments that are transferable are, by their nature, separate and distinct contracts.

Similarly, ASC 815-10-15-5 states, in part:

The notion of an embedded derivative . . . does not contemplate features that may be sold or traded separately from the contract in which those rights and obligations are embedded. Assuming they meet [the] definition of a derivative instrument, such features shall be considered attached freestanding derivative instruments rather than embedded derivatives by both the writer and the current holder.

However, a scenario in which two items cannot be transferred independently of one another suggests that each item is not a freestanding financial instrument under (b) in the definition of a freestanding financial instrument in ASC 480-10-20. For example, if a warrant “travels with” a bond and cannot be transferred separately from the bond, it may be an embedded feature in the bond.

A contract may be entered into in conjunction with some other item. For such a contract to be considered a freestanding instrument, an assessment must be performed of both the form and substance of the transaction, including the substance of the independent transferability of the item. In some circumstances, an item is unconditionally separately transferable by the holder but would have no economic value if the related item were not held, which would suggest that the separate transferability has no substance and the item is embedded in the related item (see further discussion in question 3). Similarly, the holder of shares not readily obtainable in the market may have a separately transferable put option that it can exercise only by delivering the same specific shares. In this case, the shares and the put option may represent a single, combined unit of account on the basis of an assessment of the substance of the transaction.

In other circumstances, an item may be separately transferred only with the consent of the counterparty. If an item may be separated from a related contract without any modification to the contractual terms (e.g., the contract specifically permits the item to be transferred if the issuer gives its consent and such consent cannot be unreasonably withheld), the legally detachable condition is, in substance, generally met since the counterparty has agreed to not
withhold its consent. If, however, the counterparty can always prevent the separate transfer of the item at its discretion, the legally detachable condition is, in substance, most likely not met and therefore the item is not a freestanding financial instrument.

The SEC staff has indicated in informal discussions that it is possible, although not common, for two items that have been entered into contemporaneously with the same counterparty to be considered freestanding financial instruments solely on the basis of the items’ ability to be separately exercised (i.e., even though the contractual terms prevent the items from being transferred separately). This would generally be the case when a reasonable conclusion can be reached that the separate exercisability of one item is sufficient to establish that it is legally detachable from the related item (see Example 3-6). However, when determining whether an item can be transferred separately, an entity must use significant judgment and consider the transaction’s form and substance. We therefore strongly recommend that an entity consult with its independent accounting advisers when performing this assessment.

3. **Can the item be exercised separately, or does exercise result in the termination, redemption, or automatic exercise of a specifically identified item?**

If an item can be freely exercised without terminating the other item (e.g., through redemption, automatic exercise, or expiration), it is considered to be “separately exercisable.” The fact that a warrant remains outstanding if a bond to which it is attached is redeemed, for example, suggests that the warrant is a freestanding financial instrument that is separate from the bond. Similarly, if a bond may remain outstanding after a net-share-settled conversion feature included in the bond is exercised, the conversion feature may be a freestanding financial instrument.

Conversely, if the exercise of an item results in the termination of a specifically identified item, the first item would not be considered separately exercisable from the other item. For example, if a warrant can be exercised only by the tendering of a specific bond in a physical settlement, it may be a feature embedded in the bond rather than a freestanding financial instrument. ASC 470-20-25-3 states, in part:

> [I]f stock purchase warrants are not detachable from [a] debt instrument and the debt instrument must be surrendered to exercise the warrant, the two instruments taken together are substantially equivalent to a convertible debt instrument.

Similarly, if a specifically identified share is subject to a redemption requirement, the share and the redemption requirement may represent one single freestanding financial instrument even if they are documented in separate agreements. ASC 480-10-15-7C (as added by ASU 2017-11) states, in part:

> Some entities have issued shares that are required to be redeemed under related agreements. If the shares are issued with the redemption agreement and the required redemption relates to those specific underlying shares, the shares are mandatorily redeemable.

4. **Does the transaction involve multiple counterparties?**

Contracts with different counterparties are treated as separate freestanding financial instruments even if they were issued contemporaneously or are transacted as a package. Thus, ASC 815-10-15-6 suggests that an option added or attached to an existing debt instrument by another party is not an embedded derivative because it does not have the same counterparty. Similarly, ASC 815-15-25-2 indicates that the notion of an embedded derivative in a hybrid instrument does not refer to provisions in separate contracts between separate counterparties.
Example 3-1

An entity delivers a bond and a warrant on its own equity to an underwriter for cash. The underwriter is a party to the warrant but holds the bond merely as an agent for a third-party investor. The terms and pricing of the bond sold to the third-party investor are not affected by the sale of the warrant to the underwriter. Because they involve different counterparties, the bond and the warrant are two separate freestanding financial instruments.

Under ASC 815-10-25-10, transactions that are entered into with a single party are treated as having the same counterparty even if some of them are structured through an intermediary. In consolidated financial statements, the reporting entity is the consolidated group. Therefore, the parent and its subsidiary would not be considered different parties in the consolidated financial statements. For example, if a parent entity writes a put option on subsidiary shares to the holder of those shares, it may be acceptable to view the option as being embedded in the shares in the consolidated financial statements even though the subsidiary technically is not a party to the option.

3.3.2 Combination Guidance

<table>
<thead>
<tr>
<th>ASC 480-10</th>
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| **25-15** A freestanding financial instrument that is within the scope of this Subtopic shall not be combined with another freestanding financial instrument in applying paragraphs 480-10-25-4 through 25-14 unless combination is required under the provisions of Topic 815. For example, a freestanding written put option that is classified as a liability under this Subtopic shall not be combined with an outstanding equity share.

ASC 480-10 precludes an entity from treating two or more freestanding financial instruments as a single unit of account unless combination is required under the derivative accounting requirements in ASC 815. Thus, the entity is prevented from circumventing the requirements of ASC 480-10 by analyzing freestanding instruments on a combined basis as a synthetic instrument. For example, the entity could not combine a written put option on the entity's shares with an outstanding share and analyze them in combination as a puttable share if the option and the share are separate freestanding financial instruments. If the entity had been permitted to combine the option and the share, it might have been able to avoid the liability classification requirements in ASC 480-10 for the option since those requirements do not apply to (1) puttable shares that are not certain to be redeemed or (2) embedded put features.

Paragraph B51 of the Background Information and Basis for Conclusions of FASB Statement 150 explains the Board's reasoning and states, in part:

> [T]he Board prohibited the combining of instruments within the scope of [ASC 480-10] to avoid comparability and representational faithfulness problems from inadvertent or planned circumvention of [its] requirements . . . . The Board saw no justification for combining an instrument that in itself is a liability within the scope of this Statement with another freestanding instrument, because that combination might (a) cause a freestanding instrument to be considered to be outside the scope of this Statement, (b) change the reported amount of the liability, or (c) change the required measurement method.

Under a narrow exception in ASC 480-10, two or more items must be combined if combination would be required in accordance with the derivative accounting requirements in ASC 815. Paragraph B50 of the Background Information and Basis for Conclusions of FASB Statement 150 states, in part:

The Board noted that there are certain circumstances in which [ASC 815] and related guidance require separate transactions to be viewed in combination. Those circumstances arise if it is determined that one or more transactions were entered into separately to circumvent the requirements of [ASC 815]. The Board decided that, in those circumstances, it would be appropriate to retain that guidance.
Accordingly:

- If two or more transactions are required to be combined under ASC 815-10, they would be combined under ASC 480-10 as well.
- If two or more transactions are not required to be combined under ASC 815-10, they would not be combined under ASC 480-10 either.

ASC 815-10-15-8 states, in part:

In some circumstances, an entity could enter into two or more legally separate transactions that, if combined, would generate a result that is economically similar to entering into a single transaction that would be accounted for as a derivative instrument under this Subtopic.

Nevertheless, ASC 815 ordinarily does not permit an entity to treat two or more freestanding financial instruments as a single combined unit of account. Derivatives Implementation Group Issue F6 (not codified) notes the following:

[ASC 815] is a transaction-based standard.

Similarly, ASC 815-10-25-6 states, in part:

This Subtopic generally does not provide for the combination of separate financial instruments to be evaluated as a unit.

However, if two or more freestanding financial instruments have characteristics suggesting that they were structured to circumvent GAAP, they may need to be combined and treated as a single unit of account. Specifically, ASC 815-10 requires two or more separate transactions to be combined and viewed in combination as a single unit of account for accounting purposes if they were entered into in an attempt to circumvent that subtopic's accounting requirements for derivatives (i.e., measured at fair value, with subsequent changes in fair value recognized in earnings except for qualifying hedging instruments in cash flow or net investment hedges). ASC 815-10-15-9 states that such combination is required if the transactions have all of the following characteristics:

- They “were entered into contemporaneously and in contemplation of one another.”
- They “were executed with the same counterparty (or structured through an intermediary).”
- They “relate to the same risk” (e.g., the fair value of the issuer’s equity shares).
- “There is no apparent economic need or substantive business purpose for structuring the transactions separately that could not also have been accomplished in a single transaction.”

ASC 815-10-25-6 identifies characteristics similar to those listed above from ASC 815-10-15-9 and adds the following commentary:

If separate derivative instruments have all of [these] characteristics, judgment shall be applied to determine whether the separate derivative instruments have been entered into in lieu of a structured transaction in an effort to circumvent GAAP: . . . If such a determination is made, the derivative instruments shall be viewed as a unit.

Note that the SEC staff has indicated that it will challenge the accounting for transactions that have been structured to circumvent GAAP. EITF Issue 02-2 (not codified) states, in part:

The SEC Observer encouraged the [FASB] to examine the broader issue of when to combine transactions and noted that, in the interim, the SEC staff will continue to challenge the accounting for transactions for which it appears that multiple contracts have been used to circumvent generally accepted accounting principles.
3.3.3 Application Issues and Examples

3.3.3.1 Issuance of Warrants and Put Options

Example 3-2

An entity issues stock purchase warrants on its stock to third-party investors. In conjunction with that transaction, the entity enters into a warrant-holder rights agreement with each warrant holder giving it a put right that allows it to require the entity to purchase for cash any or all of the shares issued or issuable to the holders under the warrants. The put right cannot be sold separately from the shares issued or issuable, and those shares cannot be sold separately from the put rights. In other words, the put rights are directly linked to the shares that are issued or issuable under each warrant and accompany the shares if sold or transferred to another party. The put rights cannot be used to put back shares other than those issued or issuable under the warrants.

In this scenario, the warrants and put rights are combined and viewed as one single freestanding financial instrument (unit of account) even though they are documented in two separate legal documents. The combined instrument would be classified as a liability under ASC 480-10 because it is not an outstanding share, it embodies an obligation of the issuer (see Section 2.2.1), and the entity could be required under the put option to repurchase shares by transferring assets (see Chapter 5). If the warrants are exercised, the put rights would be considered embedded in the shares. As a result, those redeemable shares would be outside the scope of ASC 480-10 because they do not meet the definition of a mandatorily redeemable financial instrument (see Chapter 4), they represent outstanding shares (see Chapter 5), and they do not embody an unconditional obligation to issue a variable number of shares (see Chapter 6).

3.3.3.2 Put Option on Noncontrolling Interest

Example 3-3

An entity holds 70 percent of the equity shares of another entity and consolidates that entity (i.e., the entities have a parent-subsidiary relationship). The remaining 30 percent of the shares (the noncontrolling interest) are held by a third party. After the parent acquires its 70 percent of the shares and the third party acquires its 30 percent, the parent entity writes a put option that permits the third party to sell all of its shares to the parent for a fixed price on or before a specified date. Unlike the put option, the shares have no expiration date. Upon exercise, the put option is physically settled. There is no mechanism to net cash or net share settle the option. Given the nature of its terms, the put option cannot be transferred separately from the noncontrolling interest, and the exercise of the put option results in the termination of the noncontrolling interest.

We believe that because it is not legally detachable and separately exercisable, the put option should be considered embedded in the noncontrolling interest rather than a freestanding financial instrument. Because redemption is not certain to occur, the entity would not classify the instrument (the combination of the noncontrolling interest and the put option) as a liability under ASC 480-10 (see Chapter 4). In the parent’s consolidated financial statements, the put option may be considered embedded in the noncontrolling interest irrespective of whether the option issuer is the parent or the subsidiary.

3.3.3.3 Issuance of Shares and Put Options

Example 3-4

An entity issues equity shares along with put options that give the counterparty the right to require the entity to redeem the same number of shares for cash. The options can only be physically settled through the exchange of shares for cash. The put options do not require delivery of any specifically identified shares, and because the shares issued with the put options are publicly traded, they are not the only shares available to settle the put option. Therefore, the put options would not be considered embedded in the shares. Instead, they would be classified as liabilities under ASC 480-10 (see Chapter 5).
3.3.3.4 **Put Right That Expires Upon Share Transfer**

**Example 3-5**

An entity enters into an agreement to sell a share along with a put right to a specific investor. The put right is solely for the benefit of that specific investor with regard to the specific share it has purchased. If the investor transfers the share to a third party, the put right irrevocably terminates upon the transfer. Even if the investor subsequently repurchases the share, it cannot regain its put right.

In these circumstances, the agreement effectively prohibits separation of the put right from the share. Therefore, the put right would not be considered legally detachable from the share and would not be a freestanding financial instrument. Instead, the entity would analyze the share and the put right on a combined basis in determining whether ASC 480-10 applies. The redeemable shares would be outside the scope of ASC 480-10 because they do not meet the definition of a mandatorily redeemable financial instrument (see Chapter 4), they represent outstanding shares (see Chapter 5), and they do not embody an unconditional obligation to issue a variable number of shares (see Chapter 6).

3.3.3.5 **Tranche Preferred Stock Agreement**

**Example 3-6**

Entity X enters into a preferred stock purchase agreement with unrelated investors to sell two tranches of convertible redeemable preferred stock (the “preferred stock”). The purchase agreement stipulates the following:

- On the first closing date, which is the date of the purchase agreement, the investors will acquire 50,000 shares of preferred stock for $50 million.
- On the second closing date, the investors will acquire 25,000 additional shares of preferred stock for $25 million subject to a specified condition. The second closing will occur only if (1) a specific milestone related to X’s operations is achieved two years from the first closing date or (2) the specific milestone related to X’s operations is not achieved two years from the first closing date but the holders waive the milestone requirement and elect to purchase the additional shares of preferred stock (the “contingent purchase option”).

The purchase agreement stipulates that the holders of preferred stock issued in the first closing cannot transfer their contingent purchase options separately from the preferred shares acquired in the first closing (or vice versa). However, such holders have the right to convert those preferred shares into common stock before the date that is two years from the first closing date. The purchase agreement does not restrict the holders that convert preferred shares into common stock from selling those common shares. The only restrictions on selling common stock stem from restrictions under U.S. securities laws.

In this example, the contingent purchase option would be considered a freestanding financial instrument because it meets the “legally detachable and separately exercisable” condition. While the contingent purchase option cannot be legally detached from the preferred stock, the holders can, in substance, “detach” the two instruments because they can convert the preferred stock into common stock and sell those shares while retaining the contingent purchase option. This would be the case even if the contingent purchase option may not be separately transferred after the conversion into common stock of the preferred shares obtained in the first closing. It would not be appropriate to consider the preferred shares and the contingent purchase option a single combined financial instrument, because the contingent purchase option would not become embedded in the common shares received upon conversion of the preferred stock purchased in the first closing.
3.3.4 Allocation of Proceeds and Issuance Costs

3.3.4.1 Allocation of Proceeds

The amount of proceeds attributable to a financial instrument affects the determination of its initial carrying amount. Generally, one of the following two approaches applies to the issuer’s allocation of proceeds received among freestanding financial instruments that are part of the same transaction:

- A with-and-without method (also known as a residual method; see Section 3.3.4.2).
- A relative fair value method (see Section 3.3.4.3).

The appropriate allocation method depends on the accounting that applies to each freestanding financial instrument issued as part of the transaction. The issuer should also consider whether it is necessary to allocate an amount to any other rights or privileges included in the transaction (see, for example, ASC 470-20-25-24 and ASC 835-30-25-6).

3.3.4.2 With-and-Without Method

If one or more, but not all, of the freestanding financial instruments issued as part of a single transaction must be recognized as assets or liabilities measured at fair value on a recurring basis (e.g., one of the instruments is accounted for at fair value on a recurring basis under ASC 480-10, as a derivative instrument under ASC 815, or at fair value under the fair value option in ASC 825-10), the with-and-without method should be applied in the allocation of proceeds among the freestanding financial instruments. This approach is analogous to the allocation method for bifurcated embedded derivatives in ASC 815-15-30-2 through 30-3.

Under the with-and-without method, a portion of the proceeds equal to the fair value of the instrument (or instruments) measured at fair value on a recurring basis is first allocated to that instrument (or instruments) on the basis of its fair value as of the initial measurement date. The remaining proceeds are then allocated to the other instrument (or instruments) issued in the same transaction either on a residual basis, if there is only one remaining instrument, or by using a relative fair value approach, if there are multiple remaining instruments. The with-and-without allocation approach avoids the recognition of a “day 1” gain or loss in earnings that is not associated with a change in the fair value of the instrument (or instruments) that is subsequently measured at its fair value. Under this approach, if there is only one freestanding financial instrument to which the residual proceeds are allocated, the issuer is not required to estimate that instrument’s fair value.

Example 3-6A

Debt Issued With Liability-Classified Warrants

Company C issues debt to Company B, together with a detachable and separately transferable warrant, for total proceeds of $10,000, which is also the par amount of the debt. The warrant gives the holder the right to purchase shares issued by C, which are redeemable for cash at the holder's option. Company C determines that the debt and the warrant represent separate freestanding financial instruments.

Rather than electing to account for the debt by using the fair value option in ASC 825-10, C will account for it by using the interest method in ASC 835-30. In evaluating whether the warrant is within the scope of ASC 480-10, C determines that the warrant is a freestanding financial instrument that embodies an obligation to repurchase the issuer's equity shares and may require the issuer to settle the obligation by transferring assets. In a manner consistent with the guidance in ASC 480-10, C will account for the warrant as a liability that is measured both initially and subsequently at fair value, with changes in fair value recognized in earnings (see Chapter 5). Company C estimates that the initial fair value of the warrant is $2,000.
Example 3-6A (continued)

In determining the initial carrying amounts, C allocates the proceeds received between the debt and the warrant. Because the warrant, but not the debt, will be measured at fair value, with changes in fair value recognized in earnings, C should first measure the fair value of the warrant ($2,000) and allocate that amount to the warrant liability. The amount of proceeds allocated to the debt is the difference between the total proceeds received ($10,000) and the fair value of the warrant ($2,000). The resulting discount from the par amount of the debt ($2,000) is accreted to par by using the effective-interest method in ASC 835-30.

3.3.4.2.1 Estimated Fair Values Exceed Proceeds Received

In some circumstances, the initial fair value of the items that must be subsequently measured at fair value exceeds the proceeds received. At the 2014 AICPA Conference on Current SEC and PCAOB Developments, then SEC Professional Accounting Fellow Hillary Salo addressed the allocation of proceeds related to the issuance of a hybrid instrument in situations in which the initial fair value of the financial liabilities that must be measured at fair value (such as embedded derivatives) exceeds the net proceeds received. We believe that her remarks are applicable by analogy to freestanding financial instruments (e.g., debt issued with detachable warrants) when (1) one or both are measured at fair value with changes in fair value recognized in earnings and (2) the initial fair value of items that must be remeasured at fair value exceeds the amount of the proceeds received. Ms. Salo made the following remarks:

[T]he staff believes that when reporting entities analyze these types of unique fact patterns, they should first, and most importantly, verify that the fair values of the financial liabilities required to be measured at fair value are appropriate under Topic 820. [Footnote omitted] If appropriate, then the reporting entity should evaluate whether the transaction was conducted on an arm's length basis, including an assessment as to whether the parties involved are related parties under Topic 850. [Footnote omitted] Lastly, if at arm's length between unrelated parties, a reporting entity should evaluate all elements of the transaction to determine if there are any other rights or privileges received that meet the definition of an asset under other applicable guidance.

In the fact patterns analyzed by the staff, we concluded that if no other rights or privileges that require separate accounting recognition as an asset could be identified, the financial liabilities that are required to be measured at fair value (for example, embedded derivatives) should be recorded at fair value with the excess of the fair value over the net proceeds received recognized as a loss in earnings. Furthermore, given the unique nature of these transactions, we would expect reporting entities to provide clear and robust disclosure of the nature of the transaction, including reasons why the entity entered into the transaction and the benefits received.

Additionally, some people may wonder whether the staff would reach a similar conclusion if a transaction was into with a related party. We believe those fact patterns require significant judgment; therefore, we would encourage consultation with OCA in those circumstances.

3.3.4.3 Relative Fair Value Method

The relative fair value method is appropriate if either of the following applies: (1) none of the freestanding financial instruments issued as part of a single transaction are measured at fair value, with changes in fair value recognized in earnings on a recurring basis, or (2) after the entity measures freestanding financial instruments at fair value under the with-and-without method, more than one freestanding financial instrument is not subsequently measured at fair value on a recurring basis. To apply this method, the entity allocates the proceeds (or remaining proceeds after application of the with-and-without method) on the basis of the fair values of each freestanding financial instrument at the time of issuance. ASC 470-20-25-2 requires an entity to use the relative fair value allocation approach to allocate proceeds in certain transactions involving debt and detachable warrants (see Section 3.5.2.3.1 of Deloitte’s A Roadmap to the Issuer’s Accounting for Convertible Debt). The approach is also appropriate for other transactions that involve freestanding financial instruments that are not measured at fair value on a recurring basis.
Under the relative fair value method, the issuer makes separate estimates of the fair value of each freestanding financial instrument and then allocates the proceeds in proportion to those fair value amounts (e.g., if the estimated fair value of one of the instruments is 20 percent of the sum of the estimated fair values of each of the instruments issued in the transaction, 20 percent of the proceeds would be allocated to that instrument). Because an issuer needs to independently measure each freestanding financial instrument issued as part of the transaction, more fair value estimates are required under the relative fair value method than under the with-and-without method.

In some transactions involving the issuance of more than two freestanding financial instruments, both the with-and-without method and the relative fair value method will apply. For example, if one freestanding financial instrument is measured at fair value on a recurring basis and others are not, the freestanding financial instrument that is subsequently measured at fair value on a recurring basis should be initially measured at its fair value, and the remaining amount of proceeds should be allocated among the freestanding financial instruments not subsequently measured at fair value on the basis of their relative fair values.

### 3.3.4.4 Allocation of Issuance Costs

Issuance costs are specific incremental costs that are (1) paid to third parties and (2) directly attributable to the issuance of a debt or equity instrument. Thus, issuance costs represent costs incurred with third parties that result directly from and are essential to the financing transaction and would not have been incurred by the issuer had the financing transaction not occurred. Examples of costs that may qualify as issuance costs include underwriting fees, professional fees paid to attorneys and accountants, printing and other document preparation costs, travel costs, and registration and listing fees directly related to the issuance of the instrument. In accordance with ASC 470-20-30-13, however, “[a]ny amounts paid to the investor when the transaction is consummated represent a reduction in the proceeds received by the issuer (not issuance costs).” For example, commitment fees, origination fees, and other amounts paid to the investor (such as reimbursement of the investor’s expenses) represent a reduction of the proceeds, not an issuance cost.\(^1\)

Costs that would have been incurred irrespective of whether there is a proposed or actual offering do not qualify as issuance costs. For example, in accordance with SAB Topic 5.A (reproduced in ASC 340-10-S99-1), allocated management salaries and other general and administrative expenses do not represent an issuance cost. Similarly, legal and accounting fees that would have been incurred irrespective of whether the instrument was issued are not issuance costs (see AICPA Technical Q&As Section 4110.01).

Further, the SEC staff believes that if a proposed offering is aborted (including the postponement of an offering for more than 90 days), its associated costs do not represent issuance costs of a subsequent offering.

Unless a debt instrument is subsequently measured at fair value on a recurring basis, any issuance costs attributable to the initial sale of the instrument should be offset against the associated proceeds in the determination of the instrument’s initial net carrying amount (see ASC 835-30-45-1A). Similarly, issuance costs attributable to the initial sale of an equity instrument should be deducted from the related proceeds (see SAB Topic 5.A and AICPA Technical Q&As Section 4110.01).

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\(^1\) Depending on the relationship between the issuer and the investor, amounts paid to the investor could represent a dividend or other distribution as opposed to an issuance cost. An entity should use judgment and consider the particular facts and circumstances when determining what these amounts represent.
However, as indicated in ASC 825-10-25-3, if the fair value option has been elected, “[u]pfront costs and fees [are] recognized in earnings as incurred and not deferred.” Any issuance costs allocated to other instruments that are subsequently measured at fair value, with changes in fair value recognized in earnings (e.g., derivative instruments), also are recognized in the period incurred since they are not a characteristic of the asset or liability (see ASC 820-10-35-9B).

Entities should consistently apply a systematic and rational method for allocating issuance costs among freestanding financial instruments that form part of the same transaction. In limited circumstances, U.S. GAAP prescribe a specific allocation method for such costs (e.g., for allocating issuance costs between the liability and equity components of instruments subject to the CCF guidance in ASC 470-20; see Section 6.3.4 of Deloitte’s A Roadmap to the Issuer’s Accounting for Convertible Debt). Otherwise, the allocation method is based on the specific facts and circumstances. If the proceeds are allocated solely on the basis of the relative fair value method, issuance costs should also be allocated on that basis, which is consistent with the guidance in SAB Topic 2.A.6 (reproduced in ASC 340-10-S99-2). We generally believe that if an entity uses the with-and-without method (including allocation to a freestanding financial instrument that contains an embedded derivative that must be bifurcated from its host contract), one of the following two methods is appropriate:

- **The relative fair value method** — The issuer would allocate issuance costs on the basis of the relative fair values of the freestanding financial instruments by analogy to the allocation of proceeds to debt instruments with detachable warrants in ASC 470-20-25-2. SAB Topic 2.A.6 (reproduced in ASC 340-10-S99-2) states that this method should be applied in the allocation of costs between services received “[w]hen an investment banker provides services in connection with a business combination or asset acquisition and also provides underwriting services associated with the issuance of debt or equity securities.”

- **An approach that is consistent with the allocation of proceeds** — The issuer would allocate issuance costs in proportion to the allocation of proceeds between the freestanding financial instruments. ASC 470-20-30-31 requires entities to use this approach when allocating issuance costs between the liability and equity components of convertible instruments within the scope of the CCF guidance in ASC 470-20.

The method used should be applied consistently to similar transactions. Any issuance costs allocated to a freestanding or an embedded financial instrument that is subsequently measured at fair value through earnings must be expensed as of the issuance date (see, e.g., ASC 825-10-25-3).

### 3.3.5 Accelerated Share Repurchase Programs

**ASC 505-30**

**25-5** An accelerated share repurchase program is a combination of transactions that permits an entity to repurchase a targeted number of shares immediately with the final repurchase price of those shares determined by an average market price over a fixed period of time. An accelerated share repurchase program is intended to combine the immediate share retirement benefits of a tender offer with the market impact and pricing benefits of a disciplined daily open market stock repurchase program.

**25-6** An entity shall account for such an accelerated share repurchase program as the following two separate transactions:

a. As shares of common stock acquired in a treasury stock transaction recorded on the acquisition date

b. As a forward contract indexed to its own common stock. Subtopic 815-40 provides guidance on the accounting for contracts that are indexed to an entity’s own common stock.

Example 1 (see paragraph 505-30-55-1) provides an illustration of an accelerated share repurchase program that is addressed by this guidance.
ASC 505-30 contains unit-of-account guidance that applies to accelerated share repurchase programs. Under ASC 505-30-25-6, an entity accounts for an accelerated share repurchase as two separate units of account: a treasury stock repurchase and a separate forward contract on the entity’s shares. An entity should analyze the treasury stock repurchase and forward contract separately to determine whether ASC 480-10 applies.

The terms of accelerated share repurchases vary. In a traditional accelerated share repurchase, an entity (1) repurchases a targeted number of its own shares at the current stock price up front for cash and (2) simultaneously enters into a net-settled forward sale of the same number of shares. Economically, the forward serves as a true-up mechanism to adjust the price ultimately paid for the shares purchased. The purpose is to reduce the number of outstanding shares immediately at a repurchase price that reflects the average stock market price over an extended period (e.g., the volume-weighted average price on each trading day during the contract period). On a combined basis, the initial share repurchase and the forward sale put the issuer in an economic position similar to that of having conducted a series of open market purchases of its own stock over a specified period.

In practice, the settlement of the treasury stock repurchase often takes place one or a few days after the execution of the accelerated share repurchase (e.g., the initial share delivery date may be three business days after the transaction date), at which time the issuer pays cash and receives an initial number of shares. If so, the obligation to repurchase shares in exchange for cash is classified as a liability under ASC 480-10-25-8 (see Chapter 5) during the period between the accelerated share repurchase transaction date and the settlement date of the treasury stock repurchase (sometimes described as the “initial share delivery date” or the “prepayment date”). Note that in some accelerated share repurchase transactions, the payment of cash in the treasury stock repurchase occurs before the receipt of the initial shares, in which case ASC 480-10 may cease to apply once the obligation to pay cash has been settled.

In evaluating whether the forward component of an accelerated share repurchase is within the scope of ASC 480-10, the issuer should consider whether it embodies an obligation to transfer assets or a variable number of shares that meet the criteria in ASC 480-10-25-8 or ASC 480-10-25-14 (see Chapters 5 and 6, respectively). Usually, an issuer is not required to classify as a liability under ASC 480-10 the forward contract component in a traditional accelerated share repurchase because it does not embody an obligation to repurchase shares for assets and does not involve an obligation to deliver a variable number of shares with a monetary value that moves inversely with — or is based on something other than — the price of the issuer’s stock. However, an issuer cannot assume that the forward contract component of an accelerated share repurchase is outside the scope of ASC 480-10 without analyzing its specific terms and features.

In some accelerated share repurchase transactions, a portion of the prepayment amount on the initial share delivery date represents a premium paid by the issuer to increase the forward sale price that the issuer will receive in the forward component of the transaction (relative to an at-market forward) rather than a payment for the shares to be received in the initial treasury stock repurchase. For example, the issuer may apply 20 percent of the prepayment amount to the forward component to reduce the likelihood that the forward component will ever dilute earnings per share (EPS). In this case, the issuer may be required to account for the forward component as an asset or liability under ASC 480-10-25-8 in the period between the transaction date and the prepayment date (which may be the initial share delivery date) if the forward component permits net share settlement, because the forward component embodies an obligation to pay cash (on the initial share delivery date) to repurchase shares (the issuer will receive shares at the forward settlement date if the stock price is less than the forward price).
If the forward component is outside the scope of ASC 480-10, the issuer should evaluate it under other literature (e.g., ASC 815-40) to determine whether it must be accounted for as an asset or a liability (see Section 3.2.5 of Deloitte’s *A Roadmap to Accounting for Contracts on an Entity’s Own Equity*).

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**ASC 505-30**

**Example 1: Accelerated Share Repurchase Program**

55-1 This Example illustrates the guidance in paragraph 505-30-25-5 by identifying the two separate transactions, namely a treasury stock purchase and a forward contract, that are present in what is sometimes described as an accelerated share repurchase program.

55-2 The treasury stock purchase is as follows.

55-3 Investment Banker, an unrelated third party, borrows 1,000,000 shares of Company A common stock from investors, becomes the owner of record of those shares, and sells the shares short to Company A on July 1, 1999, at the fair value of $50 per share. Company A pays $50,000,000 in cash to Investment Banker on July 1, 1999, to settle the purchase transaction. The shares are held in treasury. Company A has legal title to the shares, and no other party has the right to vote those shares.

55-4 The forward contract is as follows.

55-5 Company A simultaneously enters into a forward contract with Investment Banker on 1,000,000 shares of its own common stock. On the October 1, 1999, settlement date, if the volume-weighted average daily market price of Company A’s common stock during the contract period (July 1, 1999, to October 1, 1999) exceeds the $50 initial purchase price (net of a commission fee to Investment Banker), Company A will deliver to Investment Banker cash or shares of common stock (at Company A’s option) equal to the price difference multiplied by 1,000,000. If the volume-weighted average daily market price of Company A’s common stock during the contract period is less than the $50 initial purchase price (net of a commission fee to Investment Banker), Investment Banker will deliver to Company A cash equal to the price difference multiplied by 1,000,000.

55-6 Under the guidance in paragraph 505-30-25-5, an entity would account for this accelerated share repurchase program as two separate transactions:

a. As shares of common stock acquired in a treasury stock transaction recorded on the July 1, 1999, acquisition date

b. As a forward contract indexed to its own common stock.

ASC 505-30-55-1 through 55-6 illustrate how accelerated share repurchase transactions are analyzed as two separate units of account (i.e., a treasury stock repurchase and a forward contract). The issuer would need to evaluate whether ASC 480-10 applies to the treasury stock repurchase, the forward contract, or both.
Example 3-7

An issuer enters into an accelerated share repurchase transaction on December 30 under which it is obligated to transfer a fixed amount of cash (a prepayment amount of $500 million) in exchange for a fixed number of its common shares (10 million initial shares) on the initial share delivery date (January 2). On the transaction’s final settlement date (March 31), the issuer will either deliver or receive shares. If the volume-weighted daily average market price (VWAP) of the issuer’s common shares exceeds $50, the issuer will deliver shares; if the VWAP is less than $50, the issuer will receive shares. The number of shares that will be received or delivered is calculated as the prepayment amount ($500 million) divided by the VWAP over the contract period less the initial shares (10 million) already delivered.

In these circumstances, the treasury stock repurchase is required to be accounted for as a liability under ASC 480-10-25-8. In accordance with ASC 480-10-30-3, the issuer recognizes the liability on the accelerated share repurchase transaction date initially measured “at the fair value of the shares at inception, adjusted for any consideration or unstated rights or privileges.” Simultaneously, in accordance with ASC 480-10-30-5, equity is “reduced by an amount equal to the fair value of the shares at inception.” Because under ASC 480-10-35-3(a) both the amount to be paid — $500 million — and the settlement date — January 2 — are fixed, the liability is measured at the present value of the amount to be paid at settlement — $500 million — with interest cost accruing at the rate implicit at inception during the period from the transaction date to the initial share delivery date. (Further, if any part of the prepayment amount represents a premium payment for the forward component of the accelerated share repurchase transaction, that portion would be accounted for separately as a liability measured at fair value under ASC 480-10-35-1, ASC 480-10-35-4A, or ASC 480-10-35-5, between the transaction date and the initial share delivery date, as discussed above.)

On the initial share delivery date, the liability for the treasury stock repurchase is extinguished by delivery of the prepayment amount. After the initial share delivery date, the transaction is outside the scope of ASC 480-10 and is therefore evaluated under other GAAP (including ASC 815-10 and ASC 815-40; see Section 3.2.5 of Deloitte’s A Roadmap to Accounting for Contracts on an Entity’s Own Equity).
Chapter 4 — Mandatorily Redeemable Financial Instruments

This chapter discusses the requirements in ASC 480-10 related to mandatorily redeemable financial instruments, including the scope of this classification category (see Section 4.1); certain application issues (see Section 4.2); accounting (see Section 4.3); reclassifications (see Section 4.4); and equity-for-debt exchanges (see Section 4.5).

4.1 Classification

4.1.1 Overview

**ASC 480-10 — Glossary**

**Mandatorily Redeemable Financial Instrument**

Any of various financial instruments issued in the form of shares that embody an unconditional obligation requiring the issuer to redeem the instrument by transferring its assets at a specified or determinable date (or dates) or upon an event that is certain to occur.

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### ASC 480-10

25-4 A mandatorily redeemable financial instrument shall be classified as a liability unless the redemption is required to occur only upon the liquidation or termination of the reporting entity.

25-6 In determining if an instrument is mandatorily redeemable, all terms within a redeemable instrument shall be considered. The following items do not affect the classification of a mandatorily redeemable financial instrument as a liability:

   a. A term extension option
   b. A provision that defers redemption until a specified liquidity level is reached
   c. A similar provision that may delay or accelerate the timing of a mandatory redemption.

25-7 If a financial instrument will be redeemed only upon the occurrence of a conditional event, redemption of that instrument is conditional and, therefore, the instrument does not meet the definition of mandatorily redeemable financial instrument in this Subtopic...

55-3 Various financial instruments issued in the form of shares embody unconditional obligations of the issuer to redeem the instruments by transferring its assets at a specified or determinable date or dates or upon an event that is certain to occur.
ASC 480-10 (continued)

55-4 This Section presents two examples of mandatorily redeemable financial instruments:
   a. Certain forms of trust-preferred securities (those that are required to be redeemed at specified or
determinable dates)
   b. Stock that must be redeemed upon the death or termination of the individual who holds it, which is an
   event that is certain to occur.

55-5 Although some mandatorily redeemable instruments are issued in the form of shares, those instruments
   are classified as liabilities under this Subtopic because of the embodied obligation on the part of the issuer to
   transfer its assets.

To meet ASC 480-10's definition of a mandatorily redeemable financial instrument, the instrument must
have all of the following characteristics:

- Its legal form must be a share (see Section 4.1.2).
- It must embody an unconditional obligation of the issuer to redeem the instrument at a specified
or determinable date (or dates) or upon an event that is certain to occur (i.e., redemption is certain
to occur in the absence of a breach of the instrument's contractual terms — see Section 4.1.3).
- The issuer must be required to satisfy the obligation by transferring its assets (see Section 4.1.4).

Paragraph B20 of the Background Information and Basis for Conclusions of FASB Statement 150 notes
that mandatorily redeemable financial instruments have all the characteristics of a liability as described
in FASB Concepts Statement 6 because they:

(a) embody a present duty that entails settlement by future transfer of assets at a specified or determinable
date or on occurrence of a specified event, (b) leave the issuer no discretion to avoid the future sacrifice of
assets, and (c) result from a transaction — the issuance of the instrument — that has already happened.

There are several exceptions in ASC 480-10 to the requirement to classify instruments that meet
the definition of a mandatorily redeemable financial instrument as liabilities. See the discussion in
Section 4.1.5.

4.1.2 Legal Form of a Share

ASC 480-10 — Glossary

Shares
Shares includes various forms of ownership that may not take the legal form of securities (for example,
partnership interests), as well as other interests, including those that are liabilities in substance but not in form.
(Business entities have interest holders that are commonly known by specialized names, such as stockholders,
partners, and proprietors, and by more general names, such as investors, but all are encompassed by the
descriptive term owners. Equity of business entities is, thus, commonly known by several names, such as
owners' equity, stockholders' equity, ownership, equity capital, partners' capital, and proprietorship. Some
entities [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.)

The term “mandatorily redeemable financial instrument” is limited to financial instruments “in the
form of shares.” In this context, shares include not just equity securities (including both common and
preferred stock). Rather, the term applies broadly to ownership interests in various forms, including
shares of stock not in the form of securities, partnership interests (including general partnership
interests and limited partnership interests), membership interests (or units) in limited liability companies or cooperative entities, and policyholder interests in mutual insurance companies. However, financial instruments in the legal form of debt are outside the scope of ASC 480-10 (see Section 2.2.4).

The following table lists examples of instruments that, unless a legal analysis of their form suggests otherwise, would and would not be considered shares under ASC 480-10:

<table>
<thead>
<tr>
<th>Share</th>
<th>Not a Share</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Common shares of stock</td>
<td>• Debt securities</td>
</tr>
<tr>
<td>• Preferred shares of stock</td>
<td>• Convertible debt securities</td>
</tr>
<tr>
<td>• Partnership interests</td>
<td>• Debentures</td>
</tr>
<tr>
<td>• Membership interests (or units) in limited liability companies</td>
<td>• Notes payable</td>
</tr>
<tr>
<td>• Membership interests in cooperative entities</td>
<td></td>
</tr>
<tr>
<td>• Policyholder interests in mutual insurance companies</td>
<td></td>
</tr>
</tbody>
</table>

### 4.1.3 Unconditional Redemption Obligation

To meet the definition of a mandatorily redeemable financial instrument, the instrument must embody an unconditional redemption obligation. An obligation involves a duty or responsibility to perform (see Section 2.2.1). A redemption obligation is unconditional if redemption is certain to occur in the absence of a violation of the contractual terms. Neither the issuer nor the holder can have the unilateral discretion to avoid redemption except by both parties’ consent (i.e., they mutually agree to modify the terms). Accordingly, a share that is redeemable at the option of either the issuer or the holder, or whose redemption is contingent upon the occurrence or nonoccurrence of an uncertain future event, does not meet the definition of a mandatorily redeemable financial instrument before the option is exercised or the event occurs, because such an obligation is conditional.

Paragraph B25 of the Background Information and Basis for Conclusions of FASB Statement 150, states, in part:

> The Board considered whether to include within the scope of this Statement shares that could be redeemed — mandatorily, at the option of the holder, or upon some contingent event that is outside the control of the issuer and the holder. However, this Statement limits the meaning of mandatorily redeemable to unconditional obligations to redeem the instrument by transferring assets at a specified or determinable date (or dates) or upon an event certain to occur.

If an instrument with a mandatory redemption date contains contractual features that have the effect of making redemption conditional, the instrument would not meet the definition of a mandatorily redeemable financial instrument in ASC 480-10-20 because redemption is not certain to occur.

#### Example 4-1

An instrument with a fixed redemption date includes an embedded option that permits the holder to convert the entire instrument into a fixed number of equity shares before the stated redemption date. Because the holder may elect to convert the instrument into equity shares rather than hold it until redemption, redemption is conditional on the holder’s not converting.
Accordingly, a fixed-term instrument that is convertible into the issuer’s shares of stock would not meet the definition of a mandatorily redeemable financial instrument in ASC 480-10-20 unless (1) the conversion option has expired, (2) the conversion option is nonsubstantive (see Section 3.2), (3) the shares that would be delivered upon conversion contain an unconditional redemption obligation, or (4) the issuer is required to settle all or part of the conversion value in cash or other assets upon conversion.

In evaluating whether an instrument meets the definition of a mandatorily redeemable financial instrument, the issuer does not consider redemption obligations accounted for as freestanding instruments that are separate from the instrument being evaluated. For example, a perpetual share that is issued along with a forward contract that requires the issuer to repurchase a similar share for cash on a specified date would not be viewed as embodying a redemption obligation as long as the contracts are two separate freestanding financial instruments (see Section 3.3).

A redemption obligation does not have to be for a fixed amount to qualify as unconditional. For example, the amount of the redemption obligation might be for the current fair value of the share or a participating interest in the issuer's net assets, or it may vary on the basis of a specified underlying (e.g., the S&P 500). Further, the timing of redemption does not have to be fixed if redemption is certain to occur at some point (e.g., upon an event that is certain to occur at an unknown time).

In determining whether a redemption obligation is unconditional, an entity does not consider the likelihood of redemption (although the likelihood that a term will be triggered might affect an evaluation of whether the term is substantive; see Section 3.2). For example, a high probability that the issuer will be unable to satisfy a contractually unconditional redemption obligation (e.g., because of a lack of funds) does not make that obligation conditional. Conversely, a high probability that an instrument will be redeemed (e.g., because of an economic incentive to redeem the instrument) does not make a conditional redemption obligation unconditional (see Section 2.2.1).

The following table contains examples of terms and conditions that would be considered unconditional redemption obligations and those that would not:

<table>
<thead>
<tr>
<th>Unconditional Redemption Obligations</th>
<th>Not Unconditional Redemption Obligations</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Redemption is required on a fixed or determinable date (e.g., five years from the issuance date).</td>
<td>• Redemption is required at the option of the holder (e.g., through an embedded put option). Although the issuer cannot control whether the holder will elect to redeem, the instrument is not a liability under ASC 480-10 because of the uncertainty related to whether the holder will elect redemption (i.e., redemption is conditional on the holder's election to redeem).</td>
</tr>
<tr>
<td>• Redemption may be deferred under a term extension option, but not indefinitely. For example, either the issuer or the holder might have an option to extend the term for a finite period. Alternatively, redemption may be automatically deferred for a finite period upon the occurrence or nonoccurrence of an event.</td>
<td>• Redemption is required at the option of the issuer (e.g., through an embedded call option).</td>
</tr>
<tr>
<td>• Redemption is required on a fixed or determinable date but may be accelerated upon an event that is not certain to occur (e.g., a call, prepayment, put, or other early-settlement provision).</td>
<td>• Redemption is highly probable because of an embedded put-call option combination with the same strike prices (ASC 480-10-55-40).</td>
</tr>
<tr>
<td>• Redemption is required upon an event that is certain to occur, for example:</td>
<td>• Redemption may be deferred indefinitely.</td>
</tr>
<tr>
<td>◦ The holder's death (ASC 480-10-55-4(b)).</td>
<td>◦ The holder's death, retirement, termination, or attainment of a certain age, whichever occurs first.</td>
</tr>
</tbody>
</table>
### Unconditional Redemption Obligations
- Redemption is required unless a specified liquidity level is not reached (ASC 480-10-25-6). If funds are not available, the shares get redeemed once those funds are available.
- Redemption is required unless redemption would be illegal because of a lack of legally available funds. (If funds are not available, the shares get redeemed once those funds are available.)
- Redemption is required unless payment would cause the issuer to become insolvent.
- Redemption is required unless a nonsubstantive conversion option is exercised.
- Redemption is unconditional because a substantive conversion option has expired.
- Redemption is required unless a nonsubstantive condition is met.
- Redemption is required because the issuer has issued an irrevocable notice to redeem the instrument (e.g., a callable preferred share).

### Not Unconditional Redemption Obligations
- Redemption is required upon an event that is not certain to occur, for example:
  - An IPO.
  - A change in control of the issuer (e.g., a merger or consolidation in which at least 50 percent of the entity's voting power is transferred; see ASC 480-10-55-10).
  - The issuer's failure to meet specified financial covenants.
  - Attainment of a specified revenue target.
  - A reduction in the issuer's credit rating.
  - Sale of substantially all of the entity's assets.
  - Liquidation, dissolution, or winding up of the entity.
  - Issuance of shares of common stock, preferred stock, or other capital stock in exchange for cash.
  - A vote by 50 percent of the holders of preferred stock.
  - The decision by a third party not to purchase the instrument.
- Redemption is required at the option of the holder upon an event that is certain to occur (e.g., death).
- Redemption is required upon an event that is certain to occur (e.g., the holder's death) if other terms in the instrument could cause the redemption obligation to expire before the occurrence of the event (e.g., the holder's termination of employment).
- Redemption is required unless a substantive conversion option is exercised.
- The issuer has a past practice of redeeming similar instruments.
- There is a high likelihood of redemption (e.g., because of economic compulsion).

If the redemption obligation in an outstanding share is conditional, an issuer that applies SEC guidance should consider whether it must classify the instrument in temporary equity (see Chapter 9).
4.1.4 Transfer of Cash or Other Assets

As defined, mandatorily redeemable financial instruments are limited to instruments that the issuer must settle in its assets (e.g., cash or investments in debt or equity securities issued by third parties). An instrument that does not involve a future transfer of assets (e.g., a prepaid obligation) does not meet this definition. Further, an instrument that the issuer must settle by providing services (e.g., an obligation to repurchase shares in exchange for services) would not meet the definition and would be outside the scope of ASC 480-10 (see Section 2.2.2).

Although the issuer's equity shares are assets of its shareholders, they are not the issuer's assets. Accordingly, an instrument that the issuer must or may settle in its equity shares would not qualify as a mandatorily redeemable financial instrument. However, an entity should evaluate whether ASC 480-20-25-14 requires such an instrument to be classified outside of equity (see Chapter 6). For example, under that guidance, an issuer would classify as a liability a share that it must settle in a variable number of its equity shares worth a fixed monetary amount known at inception (e.g., a preferred share that is mandatorily convertible in the a variable number of common shares worth a fixed monetary amount). A share that the issuer must “redeem” on a specified date by delivering a fixed number of the issuer's equity shares would not meet the definition of a mandatorily redeemable financial instrument because the transfer of cash or other assets is not involved. Further, because the delivery of a variable number of shares is not involved, the issuer would not be required to classify the share as a liability under ASC 480-10-25-14.

Note that shares issued by a parent and held by its subsidiary would be considered assets in the subsidiary's separate financial statements.

Example 4-2

Subsidiary S issues a preferred share that is mandatorily convertible into a fixed number of common shares issued by its parent on a specified date. In S's separate financial statements, S would account for any held shares issued by Parent P as assets. Therefore, in S's separate financial statements, the mandatorily convertible preferred shares may meet the definition of a mandatorily redeemable financial instrument. In P's consolidated financial statements, however, common shares issued by P are not assets but are considered the issuer's equity shares. Therefore, in P's consolidated financial statements, the mandatorily convertible preferred share issued by S is outside the scope of ASC 480-10.

Although the temporary-equity classification guidance in ASC 480-10-599-3A contains an exception for certain contracts for which redemption will be funded by an insurance policy (see Section 9.4.3), there is no similar exception from the liability classification guidance in ASC 480-10 for such contracts. An instrument that is required to be redeemed for cash or other assets upon the death of the holder is required to be classified as a liability even if the issuer has an insurance contract to cover the cost of redemption (see ASC 480-10-55-64).

The following table contains examples of obligations to transfer cash or other assets:

<table>
<thead>
<tr>
<th>Future Transfer of Cash or Other Assets</th>
<th>Not a Future Transfer of Cash or Other Assets</th>
</tr>
</thead>
<tbody>
<tr>
<td>• An obligation to transfer a fixed or determinable amount of cash</td>
<td>• An obligation to transfer the issuer's equity shares</td>
</tr>
<tr>
<td>• An obligation to transfer a fixed or determinable quantity of an asset (e.g., investments in debt or equity securities issued by third parties)</td>
<td>• An obligation to transfer services</td>
</tr>
<tr>
<td></td>
<td>• An obligation that has been fully prepaid</td>
</tr>
</tbody>
</table>

56
4.1.5 Exceptions

4.1.5.1 Overview

There are several exceptions to the liability classification requirement for instruments that meet the definition of a mandatorily redeemable financial instrument. Those exceptions apply to:

- Shares that are mandatorily redeemable only upon the liquidation or termination of the reporting entity (see Section 4.1.5.2).

- Mandatorily redeemable noncontrolling interests that are redeemable only upon the liquidation or termination of the subsidiary (see Section 4.1.5.3). (For other mandatorily redeemable noncontrolling interests that were issued before November 5, 2003, the classification provisions in ASC 480-10 apply, but not the measurement provisions.)

- Mandatorily redeemable financial instruments of nonpublic entities that are not SEC registrants unless they are mandatorily redeemable on fixed dates for amounts that are either fixed or are determined by reference to an external index (e.g., an interest rate index or currency index) (see Section 4.1.5.4).

The table below summarizes the various exceptions to the requirement to apply the guidance in ASC 480-10 to instruments that meet the definition of a mandatorily redeemable financial instrument:

<table>
<thead>
<tr>
<th>Affected Entities</th>
<th>Affected Instruments</th>
<th>Guidance in ASC 480-10 That Does Not Apply</th>
<th>Guidance in ASC 480-10 That Applies</th>
</tr>
</thead>
<tbody>
<tr>
<td>All entities</td>
<td>Shares that are mandatorily redeemable only upon the liquidation or termination of the reporting entity</td>
<td>Classification, Disclosure, Measurement</td>
<td>None</td>
</tr>
<tr>
<td>Parents preparing consolidated financial statements</td>
<td>Mandatorily redeemable noncontrolling interests that are redeemable only upon the liquidation or termination of the subsidiary</td>
<td>Classification, Measurement</td>
<td>Disclosure</td>
</tr>
<tr>
<td>Other mandatorily redeemable noncontrolling interests that were issued before November 5, 2003</td>
<td></td>
<td>Measurement</td>
<td>Classification, Disclosure</td>
</tr>
<tr>
<td>Subsidiaries preparing stand-alone financial statements</td>
<td>Mandatorily redeemable noncontrolling interests that were issued before November 5, 2003</td>
<td>Measurement</td>
<td>Classification, Disclosure</td>
</tr>
<tr>
<td>Nonpublic entities that are not SEC registrants</td>
<td>Mandatorily redeemable financial instruments other than those that are mandatorily redeemable on fixed dates for amounts that are either fixed or determined by reference to an interest rate index, currency index, or another external index</td>
<td>Classification, Disclosure, Measurement</td>
<td>None</td>
</tr>
</tbody>
</table>
If a mandatorily redeemable financial instrument qualifies for one of the exceptions in ASC 480-10, the issuer should consider the applicability of ASC 480-10-S99-3A to that instrument. That guidance requires SEC registrants to classify certain redeemable securities in temporary equity (see Chapter 9). In prepared remarks at the 2003 AICPA Conference on Current SEC Developments, then SEC Professional Accounting Fellow Gregory Faucette stated the following:

Entities with instruments that qualify for [the scope exceptions in ASC 480-10-15-7A through 15-15F (as added by ASU 2017-11)] should refer to [ASC 480-10-S99-3A] for guidance related to classification and/or measurement, as applicable, for those securities that . . . will not be fully accounted for in accordance with [ASC 480-10]. In other words, if both the classification and measurement guidance in [ASC 480-10 is inapplicable] for an instrument, look to [ASC 480-10-S99-3A] for both classification and measurement guidance. If only the measurement guidance in [ASC 480-10 is inapplicable] for an instrument, look to [ASC 480-10-S99-3A] for continued measurement guidance.

4.1.5.2 Only-Upon-Liquidation Exception

<table>
<thead>
<tr>
<th>ASC 480-10</th>
</tr>
</thead>
<tbody>
<tr>
<td>25-4 A mandatorily redeemable financial instrument shall be classified as a liability unless the redemption is required to occur only upon the liquidation or termination of the reporting entity.</td>
</tr>
</tbody>
</table>

Certain entities such as partnerships, limited liability companies, or trusts that are set up for a specific project or purpose may have a finite life. Their governing documents (e.g., partnership agreement or articles of organization) may specify a date (e.g., December 31, 2199) on which they will be terminated and on which their assets will be liquidated, their liabilities will be settled, and any remaining cash will be distributed to holders of their equity interests. When such entities issue equity interests, redemption is certain to occur. Therefore, those interests meet the definition in ASC 480-10-20 of a mandatorily redeemable financial instrument. Nevertheless, in developing the guidance in ASC 480-10, the FASB concluded that entities should not be required to classify such an interest as a liability under ASC 480-10. Paragraph B21 of the Background Information and Basis for Conclusions of FASB Statement 150 states, in part:

One commentator noted that “. . . if the issuing entity must be liquidated and ceases to exist when the mandatory redemption of its shares occurs, then the holders of those shares appear to have an ownership interest similar to the equity owners of the company.” The Board agreed and drafted [ASC 480-10-25-4] so that if redemption of an equity instrument is required on liquidation or termination of the reporting entity, the instrument is classified as equity.

In consolidated financial statements, a similar exception applies to instruments that are mandatorily redeemable upon the liquidation or termination of a subsidiary. In accordance with ASC 480-10-15-7E (as added by ASU 2017-11), such instruments are not classified as liabilities under ASC 480-10 even if they meet the definition of a mandatorily redeemable financial instrument.

We believe that if a finite-life entity issues an instrument that is mandatorily redeemable either upon the scheduled liquidation or termination of the reporting entity (e.g., in 2020) or upon an event that is certain to occur (e.g., the holder’s death), the only-upon-liquidation exception to liability classification is available if the event that would trigger redemption is not certain to occur before the entity’s scheduled liquidation or termination. In such a scenario, the potential requirement to redeem before the entity’s liquidation or dissolution represents a conditional obligation because the event that triggers it is not certain to occur before the entity’s scheduled liquidation or dissolution. Even though the instrument is certain to be redeemed, it is possible that redemption will be required only upon the entity’s liquidation or dissolution, in which case the only-upon-liquidation exception is available.
4.1.5.3 **Noncontrolling Interest Exception**

**ASC 480-10**

15-7E The guidance in this Subtopic does not apply to mandatorily redeemable noncontrolling interests (of all entities, public and nonpublic) as follows:

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

b. The measurement provisions of this Subtopic do not apply to other mandatorily redeemable noncontrolling interests that were issued before November 5, 2003, both for the parent in consolidated financial statements and for the subsidiary that issued the instruments that result in the mandatorily redeemable noncontrolling interest. For those instruments, the measurement guidance for redeemable shares and noncontrolling interests in other predecessor literature (for example, in paragraph 480-10-599-3A) continues to apply.

15-7F All public entities as well as nonpublic entities that are SEC registrants with mandatorily redeemable noncontrolling interests subject to the classification and measurement scope exception in paragraph 480-10-15-7E are required to follow the disclosure requirements in paragraphs 480-10-50-1 through 50-3 as well as disclosures required by other applicable guidance.

**480-10 — Glossary**

**Noncontrolling Interest**

The portion of equity (net assets) in a subsidiary not attributable, directly or indirectly, to a parent. A noncontrolling interest is sometimes called a minority interest.

In consolidated financial statements, instruments that are mandatorily redeemable only upon the liquidation or termination of a subsidiary (e.g., noncontrolling interests in limited-life subsidiaries) are not required to be classified as liabilities, even if they meet the definition of a mandatorily redeemable financial instrument. Further, such instruments are exempt from the measurement guidance in ASC 480-10, although its disclosure requirements apply. In evaluating whether the scope exception in ASC 480-10-15-7E applies to situations in which the subsidiary does not meet the definition of a business, an entity should carefully consider the substance of the arrangement. If the subsidiary is not a substantive entity, we believe that the scope exception does not apply. This conclusion is consistent with analogous guidance in ASC 815-40-15-5C (see Section 2.6.1 of Deloitte’s *A Roadmap to Accounting for Contracts on an Entity’s Own Equity*) as well as ASC 810-10-40-3A. For example, a subsidiary would not be considered a substantive entity if it was structured to circumvent the mandatorily redeemable guidance in ASC 480.

If a noncontrolling interest in an entity that does not have a limited life qualifies as a mandatorily redeemable financial instrument under ASC 480-10, the entity is subject to all of the requirements of ASC 480-10 unless the nonpublic entity exception applies or the interest is grandfathered. Under ASC 480-10-15-7E(b) (as added by ASU 2017-11), mandatorily redeemable noncontrolling interests are grandfathered out of ASC 480-10’s measurement provisions if the interests were issued before November 5, 2003. This applies both in the parent’s consolidated financial statements and in the financial statements of the subsidiary that issued the instrument. The classification and disclosure provisions of ASC 480-10 apply to such instruments.
4.1.5.4 Exception for Certain Instruments of Certain Nonpublic Entities

**ASC 480-10**

**15-7A** The classification, measurement, and disclosure guidance in this Subtopic does not apply to mandatorily redeemable financial instruments that meet both of the following:

- a. They are issued by nonpublic entities that are not Securities and Exchange Commission (SEC) registrants.
- b. They are mandatorily redeemable, but not on fixed dates or not for amounts that either are fixed or are determined by reference to an interest rate index, currency index, or another external index.

**15-7B** Mandatorily redeemable financial instruments issued by an SEC registrant are not eligible for the scope exception in paragraph 480-10-15-7A, even if the entity meets the definition of a nonpublic entity.

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

**15-7D** Although the disclosure requirements of this Subtopic do not apply for those mandatorily redeemable instruments of certain nonpublic companies that meet the scope exception in paragraph 480-10-15-7A, the requirements of Subtopic 505-10 still apply. In particular, paragraph 505-10-50-3 requires information about the pertinent rights and privileges of the various securities outstanding, which includes mandatory redemption requirements. Paragraph 505-10-50-11 also requires disclosure of the amount of redemption requirements for all issues of stock that are redeemable at fixed or determinable prices on fixed or determinable dates in each of the next five years.

**ASC 480-10 — Glossary**

**Securities and Exchange Commission Registrant**
An entity (or an entity that is controlled by an entity) that meets any of the following criteria:

- a. It has issued or will issue debt or equity securities that are traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local or regional markets).
- b. It is required to file financial statements with the Securities and Exchange Commission (SEC).
- c. It provides financial statements for the purpose of issuing any class of securities in a public market.

**ASC Master Glossary**

**Nonpublic Entity**
Any entity other than one that meets any of the following criteria:

- a. Has equity securities that trade in a public market either on a stock exchange (domestic or foreign) or in an over-the-counter market, including securities quoted only locally or regionally
- b. Makes a filing with a regulatory agency in preparation for the sale of any class of equity securities in a public market
- c. Is controlled by an entity covered by the preceding criteria.

An entity that has only debt securities trading in a public market (or that has made a filing with a regulatory agency in preparation to trade only debt securities) is a nonpublic entity.
For nonpublic entities that are not SEC registrants, ASC 480-10 does not apply to mandatorily redeemable financial instruments other than those that are mandatorily redeemable on fixed dates for amounts that either are fixed or are determined by reference to an interest rate index, currency index, or another external index. For example, if a nonpublic entity has outstanding shares that are mandatorily redeemable for cash upon the death of the holder, those shares would not be accounted for as liabilities under ASC 480-10, even if they meet the definition of a mandatorily redeemable financial instrument, because the redemption date is not fixed. Similarly, if the shares of a nonpublic entity are mandatorily redeemable at the appraised value or fair value of the holder's interest in the net assets of the entity, those shares would not be classified as liabilities under ASC 480, because the redemption amount is neither fixed nor determined on the basis of an external index.

The following table illustrates whether ASC 480 does or does not apply to a mandatorily redeemable financial instrument issued by a nonpublic entity that is not an SEC registrant:

<table>
<thead>
<tr>
<th>Redemption Terms</th>
<th>Fixed Date</th>
<th>Variable Date</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fixed amount</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Amount determined by reference to an interest rate</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>index, currency index, or another external index</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other variable amounts</td>
<td>No</td>
<td>No</td>
</tr>
</tbody>
</table>

ASC 480-10-15-7D (as added by ASU 2017-11) notes that in accordance with ASC 505-10-50-3 and ASC 505-10-50-11, a nonpublic entity that is not an SEC registrant that has issued securities to which the exception applies is required to disclose (1) “information about the pertinent rights and privileges of the various securities outstanding, which includes mandatory redemption requirements” and (2) “the amount of redemption requirements for all issues of stock that are redeemable at fixed or determinable prices on fixed or determinable dates in each of the next five years.”

To be eligible for the exception in ASC 480-10-15-7A (as added by ASU 2017-11), the issuer must be a nonpublic entity that is not an SEC registrant. ASC 480-10 defines an SEC registrant but not a nonpublic entity, and the ASC master glossary defines a nonpublic entity in a variety of ways. The pre-Codification definition of a nonpublic entity in FASB Statement 150 is similar to that in the employee stock option literature that was subsequently codified in ASC 718-10-20, which states that a nonpublic entity includes an “entity that has only debt securities trading in a public market (or that has made a filing with a regulatory agency in preparation to trade only debt securities).” However, according to ASC 480-10-20, an entity is an SEC registrant if it has debt securities trading in a public market (or will issue such securities). Therefore, an entity that has issued either debt or equity securities trading in a public market is not eligible for the exception.

Broker-dealers that are required to file financial statements with the SEC are not eligible for the exception for nonpublic entities that are not SEC registrants, even if they do not issue publicly traded stock or debt. In prepared remarks at the 2003 AICPA Conference on Current SEC Developments, Mr. Faucette stated the following:

“[S]ome broker-dealers have asserted that they should be eligible for the [exceptions] for mandatorily redeemable financial instruments of certain nonpublic entities . . . . However, certain nonpublic entities are defined as entities other than SEC registrants. The definition of an SEC registrant . . . . includes entities that are required to file financial statements with the SEC. Thus, the definition of an SEC registrant includes any broker-dealer that is required to file financial statements with the SEC, even if they do not issue publicly-traded stock or debt. Therefore, we believe that any broker-dealer that files statements with the SEC is not eligible for the additional [exceptions]."
If a nonpublic entity that is not an SEC registrant subsequently becomes an SEC registrant, the entity applies ASC 480-10 as if it were an SEC registrant for all periods presented. In such a scenario, the exception to some of the requirements in ASC 480-10 for nonpublic entities is not available for any period presented. The SEC staff communicated its view on this matter at the AICPA SEC Regulations Committee meeting on April 8, 2004, which is described in the highlights of that meeting:

An entity is generally no longer eligible for the nonpublic company treatment alternatives when it is in the process of becoming a public entity. Such entities must comply with public company treatment alternatives in the standard as of the date that all public companies were required to adopt the standard, even if that requires a company that is in the process of filing an IPO to restate prior period financial statements.

### 4.2 Application Issues

#### 4.2.1 Share That Is Both Puttable and Callable

<table>
<thead>
<tr>
<th>ASC 480-10</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>55-38</strong> An entity issues a share of stock that is not mandatorily redeemable. However, under its terms the stock is both of the following:</td>
</tr>
<tr>
<td>a. Puttable by the holder any time after five years or upon a change in control</td>
</tr>
<tr>
<td>b. Callable by the issuer any time after five years.</td>
</tr>
<tr>
<td><strong>55-39</strong> That instrument is outside the scope of this Subtopic. The instrument as a whole is not mandatorily redeemable under paragraphs 480-10-25-4 and 480-10-25-6 because of both of the following conditions:</td>
</tr>
<tr>
<td>a. The redemption is optional (conditional).</td>
</tr>
<tr>
<td>b. A written put option and a purchased call option issued together with the same terms differ from a forward purchase contract under this Subtopic.</td>
</tr>
<tr>
<td><strong>55-40</strong> That combination of embedded features does not render the stock mandatorily redeemable because the options could expire at the money, unexercised, and, thus, the redemption is not unconditional. Because the instrument as a whole is an outstanding share, it is not subject to paragraphs 480-10-25-8 through 25-12, nor, because the embedded obligation is conditional, is it subject to analysis under Subtopic 815-15 to determine whether the issuer must account for any embedded feature separately as a derivative instrument. Because of the guidance in paragraph 480-10-25-2, paragraphs 480-10-25-4 through 25-14 shall not be applied to any embedded feature for the purposes of that analysis. In applying paragraph 815-15-25-1, the embedded written put option is evaluated under the guidance in Subtopic 815-40 and would generally be classified in equity. If so, the embedded written put option meets the criterion for exclusion in paragraph 815-10-15-74(a) and, therefore, is not separated from its host contract. If the written put option was not embedded in the share, but was issued as a freestanding instrument, it would be a liability under this Subtopic.</td>
</tr>
</tbody>
</table>

ASC 480-10-55-38 through 55-40 illustrate that a share whose terms contain both an embedded issuer call option and an embedded investor put option would not be classified as a liability under ASC 480-10 even if the options have mirroring terms (e.g., the same strike price). If a redemption option in an outstanding share can be exercised by either party at the same exercise price over a specified period, it may be unlikely that both parties will elect not to exercise the option. Nevertheless, such a redemption option is analyzed as conditional under ASC 480-10 because redemption is not certain to occur (e.g., it is possible the options could expire at-the-money). (Although not explicitly stated in ASC 480-10-55-38, the discussion in ASC 480-10-55-40 implies that the options have an expiration date. See also Section 3.2.1.) An outstanding share is not classified as a liability under ASC 480-10 if redemption is conditional.

The accounting analysis for embedded option combinations in ASC 480-10 differs from that in ASC 815. Under ASC 815-10-25-10, “an embedded (nontransferable) purchased call (put) option and an
embedded (nontransferable) written put (call) option [that are combined] in a single hybrid instrument” are “considered as a single forward contract” when they have the same strike price and meet certain other criteria (i.e., such an option combination is treated as an unconditional obligation under ASC 815; see ASC 815-10-25-10 through 25-13). Under ASC 480-10, the same option combination is analyzed as a conditional obligation.

If an option combination is embedded in the shares issued by a subsidiary, the parent should consider whether it is required to apply the special accounting guidance in ASC 480-10-55-55 and ASC 480-10-55-59 when preparing its consolidated financial statements. That guidance provides a limited exception to the guidance in ASC 480-10-55-38 through 55-40 by requiring such embedded option combinations and the noncontrolling interest to be accounted for on a combined basis as a financing of the parent’s purchase of the noncontrolling interest (see Section 7.1).

4.2.2 Exchangeable Share

Under ASC 480-10-25-4, an exchangeable share would be classified as a liability if it (1) is mandatorily redeemable for cash on a stated redemption date and (2) contains an option that permits the holder to require the issuer to exchange the share for the shares of a third party. Such an instrument meets the definition of a mandatorily redeemable financial instrument because delivery by the issuer of either cash or assets in the form of third-party shares is certain. Similarly, an exchangeable share would be classified as a liability in the separate financial statements of a subsidiary if it (1) is mandatorily redeemable for cash on a stated redemption date and (2) contains an option for the holder to require the issuer (the subsidiary) to exchange it for nonredeemable shares of its parent. The instrument would meet the definition of a mandatorily redeemable financial instrument in the subsidiary’s separate financial statements because delivery by the subsidiary of either cash or assets is certain. (Note that shares issued by a parent would be presented as assets rather than as equity in the separate financial statements of the subsidiary.)

**Example 4-3**

Entity X has issued shares that are exchangeable, at the option of Holder H, into trust units of Parent P. The trust units are traded in an active market. The key terms and rights of the exchangeable shares are as follows:

- Initially, each share is exchangeable into one trust unit. The exchangeable shares do not have any voting rights, and H cannot obligate X to pay cash instead of trust units at redemption. As P makes distributions to its unit holders, the exchange ratio increases, thereby increasing the number of trust units to be received when the exchangeable shares are redeemed for trust units.
- The shares can be exchanged by H for trust units at any time for 10 years after the date of issuance. However, X must redeem the shares at the end of year 10, in which case X may elect to deliver either trust units or an equivalent amount of cash.
- In the event of liquidation, dissolution, or the winding up of X, or any other distribution among X’s shareholders, exchangeable shares are entitled to a preference over X’s common shares with respect to the payment of dividends. The holders of exchangeable shares are entitled to a cumulative preferred-cash dividend.

In its separate financial statements, X should classify the exchangeable shares as liabilities. The exchangeable shares meet the definition of a mandatorily redeemable financial instrument since they are mandatorily redeemable on the 10th anniversary of their issuance and will require payment, at X’s option, in either trust units or cash, both of which represent assets of X.
4.2.3 Redemption Requirement That Is Contingent on the Issuer’s Liquidity

A redemption obligation that is unconditional (e.g., it has a mandatory redemption date and no terms that make redemption uncertain) except for a condition that a specified liquidity level must be reached (i.e., the term is extended in case of insufficient liquidity) is treated as an unconditional redemption obligation under ASC 480-10. In developing the guidance in ASC 480-10, the FASB concluded that a share with a provision that makes the share mandatorily redeemable for cash or other assets when a specified liquidity level is reached meets the definition of a mandatorily redeemable financial instrument and should be classified as a liability (see ASC 480-10-25-6). Paragraph B22 of the Background Information and Basis for Conclusions of FASB Statement 150 states, in part:

Some commentators inquired about certain shares that allow the issuer to extend their term, defer redemption until a specified liquidity level is reached, or have similar provisions that may delay or accelerate the timing of a required redemption. The Board concluded that such shares meet the definition of mandatorily redeemable financial instruments and should be classified as liabilities because those kinds of provisions may affect the timing of but do not remove the unconditional requirement for redemption.

Similarly, statutory requirements (e.g., corporate state law) may limit an entity’s ability to redeem its own stock in cash or other assets if the entity lacks the wherewithal to pay (i.e., if a lack of sufficient net assets would result in the impairment of the entity’s capital). In these circumstances, the payment of cash or other assets to satisfy a redemption obligation might result in personal liability for directors and potential liability for stockholders. To protect the entity from the risk of breaching the terms of a mandatorily redeemable share, the share may include a provision that defers redemption by the entity if such redemption would be illegal under the applicable state law because of a lack of legally available funds. We believe that such a limitation on an entity’s ability to redeem shares should not cause an otherwise unconditionally redeemable instrument to be considered conditionally redeemable. This kind of limitation is similar to a provision that prevents an entity from redeeming an instrument unless a specified liquidity level is reached. However, that guidance should not be applied by analogy to redemption requirements that are contingent upon uncertain future circumstances or events other than the entity’s liquidity (e.g., future revenue).

If an outstanding share must be redeemed only to the extent that the issuer has a sufficient amount of available cash or meets another similar liquidity measure, the issuer should consider whether the redemption requirement represents an unconditional obligation under the above guidance. That is, the issuer should consider whether (1) the lack of sufficient liquidity to redeem the instrument is akin to a default, in which case an unconditional obligation exists, or (2) the issuer controls the ability to determine whether the instrument is redeemed, in which case an unconditional obligation does not exist. We believe that a redemption feature that is contingent on a measure of available liquidity that is determined by the entity on the basis of the application of significant judgment or discretion should be viewed as conditional under ASC 480. Only if the entity controls the ability to avoid redemption is the obligation deemed conditional.

**Example 4-3A**

Company A has issued perpetual preferred stock that must be redeemed to the extent that A has available cash. Available cash is defined in the preferred stock terms in a manner that permits subjective adjustments at A’s discretion, as follows:

Available Cash means, as of any date, (1) the amount of cash on hand, less (2) all amounts due and payable as of such date, and less (3) working capital and other amounts, which the Company deems necessary for the Company’s business in its commercially reasonable discretion.

We believe that the stock does not meet the definition of a mandatory redeemable financial instrument under ASC 480-10 because (1) it has no stated redemption date and (2) the determination of whether available cash exists is subject to A’s significant judgment and discretion (i.e., it is within A’s control).
4.2.4 Preferred Stock With CCFs

For a convertible preferred share to meet the definition of a mandatorily redeemable financial instrument and be classified as a liability under ASC 480-10, it must embody an unconditional obligation to transfer assets. A convertible preferred share that the issuer must settle at least partially in cash irrespective of whether it is converted embodies such an obligation, since a transfer of cash or other assets is certain to occur unless there is a violation of the contractual terms. A fixed-term convertible preferred share with conversion terms that are similar to those of Instrument C (as described in Section 2.5) typically would meet the definition of a mandatorily redeemable financial instrument and be classified as a liability under ASC 480-10. Such an instrument would be within the scope of the CCF guidance in ASC 470-20 unless the CCF must be bifurcated as a derivative instrument under ASC 815-15.

Example 4-3B

Convertible Preferred Stock Subject to CCF Guidance

A convertible preferred share has (1) a fixed redemption date on which the issuer will settle its stated par amount in cash and (2) a substantive conversion option that, if exercised by the counterparty, requires the issuer to settle the par amount in cash but permits it to settle the excess of the conversion value over the par amount (the conversion spread) in either cash or shares. The convertible preferred share meets the definition of a mandatorily redeemable financial instrument and is classified as a liability under ASC 480-10 since the issuer has an unconditional obligation to transfer cash or other assets in exchange for the par amount. Because the issuer has the option to settle the conversion spread in either cash or shares upon conversion, the instrument is within the scope of the CCF guidance in ASC 470-20 unless the issuer concludes that the conversion feature must be bifurcated as an embedded derivative under ASC 815-15 (see Section 2.3 of Deloitte’s A Roadmap to the Issuer’s Accounting for Convertible Debt).

A convertible preferred share that has a stated redemption date and permits the issuer to elect settlement of the entire instrument in either cash or shares (in a manner similar to Instrument B as described in Section 2.5) or any combination of cash or shares (in a manner similar to Instrument X as described in Section 2.5) does not contain an unconditional obligation to transfer assets because the issuer has the right to settle the entire conversion value in shares. Accordingly, preferred stock with terms similar to those of Instrument B or X would not meet the definition of a mandatorily redeemable financial instrument in ASC 480-10 and is not within the scope of the CCF guidance in ASC 470-20.

A requirement to transfer assets that is contingent on the counterparty's election of a cash settlement or the occurrence (or nonoccurrence) of an uncertain future event represents a conditional, rather than an unconditional, obligation to transfer assets. Thus, convertible preferred stock that has such a requirement is not a mandatorily redeemable financial instrument under ASC 480-10. For example, a perpetual convertible preferred share that must be settled in cash or other assets upon the counterparty's election to convert does not meet the definition of a mandatorily redeemable financial instrument in ASC 480-10 because the obligation to transfer cash or other assets is contingent on such an election.
4.3 Accounting

4.3.1 Measurement

4.3.1.1 Initial Measurement

<table>
<thead>
<tr>
<th>ASC 480-10</th>
</tr>
</thead>
<tbody>
<tr>
<td>30-1</td>
</tr>
<tr>
<td>Mandatorily redeemable financial instruments shall be measured initially at fair value.</td>
</tr>
</tbody>
</table>

On initial recognition, mandatorily redeemable financial instruments must be measured at their fair value. An entity applies ASC 820-10 to determine fair value. See Section 4.3.3 for a discussion of the accounting for issuance costs.

4.3.1.2 Subsequent Measurement

<table>
<thead>
<tr>
<th>ASC 480-10</th>
</tr>
</thead>
<tbody>
<tr>
<td>35-3</td>
</tr>
<tr>
<td>Forward contracts that require physical settlement by repurchase of a fixed number of the issuer’s equity shares in exchange for cash and mandatorily redeemable financial instruments shall be measured subsequently in either of the following ways:</td>
</tr>
<tr>
<td>a. If both the amount to be paid and the settlement date are fixed, those instruments shall be measured subsequently at the present value of the amount to be paid at settlement, accruing interest cost using the rate implicit at inception.</td>
</tr>
<tr>
<td>b. If either the amount to be paid or the settlement date varies based on specified conditions, those instruments shall be measured subsequently at the amount of cash that would be paid under the conditions specified in the contract if settlement occurred at the reporting date, recognizing the resulting change in that amount from the previous reporting date as interest cost.</td>
</tr>
</tbody>
</table>

Unless the entity elects to account for the instrument at fair value, with changes in fair value recognized in earnings under ASC 825-10, a mandatorily redeemable financial instrument is measured subsequently in one of two ways depending on whether the redemption amount or the redemption date varies on the basis of specified conditions:

<table>
<thead>
<tr>
<th>Redemption Amount</th>
<th>Redemption Date</th>
<th>Subsequent Measurement</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fixed</td>
<td>Fixed</td>
<td>Present value of the amount to be paid at settlement, discounted by using the implicit rate at inception (i.e., effective interest method)</td>
</tr>
<tr>
<td>Fixed</td>
<td>Varies</td>
<td>Amount of cash that would be paid under the conditions specified in the contract if settlement occurred as of the reporting date (settlement value)</td>
</tr>
<tr>
<td>Varies</td>
<td>Fixed</td>
<td></td>
</tr>
<tr>
<td>Varies</td>
<td>Varies</td>
<td></td>
</tr>
</tbody>
</table>

4.3.1.2.1 Fixed Date and Fixed Amount

If the redemption date and the redemption amount are both fixed, the instrument is subsequently measured at the present value of the amount to be paid at settlement, discounted by using the implicit rate at inception. The implicit rate is calculated by using the effective interest method (i.e., the implicit rate is the rate that makes the present value of the instrument’s cash flows equal to the initial measurement amount).
If the redemption consists of a stated amount along with accrued and unpaid dividends, whether or not declared, the present value as of each measurement date is calculated by using an effective interest rate that is determined on the basis of the total redemption amount (i.e., including both the stated redemption amount and cumulative dividends, whether or not declared). For example, if a liquidation preference is payable at redemption of a mandatorily redeemable financial instrument, and the instrument accrues dividends at a per annum rate of 8 percent (whether or not declared), the calculation of the effective interest rate would take into account not just the liquidation preference but also the cumulative dividends at the per annum rate of 8 percent. Any dividends paid before the redemption date would reduce the carrying amount of the instrument.

4.3.1.2.2 Variable Date or Redemption Amount

If the redemption date, the redemption amount, or both vary, the instrument is subsequently measured at the amount of cash that would be paid under the conditions specified in the contract if settlement occurred on the reporting date. Examples of mandatorily redeemable financial instruments with a varying redemption amount include those for which the redemption amount varies on the basis of the instrument’s current fair value or a formula (e.g., one that is dependent on the issuer’s most recent financial year’s EBIT or EBITDA). Examples of instruments for which the redemption date varies include those that are mandatorily redeemable upon an event that is certain to occur but whose timing is uncertain (e.g., the holder’s death).

In estimating the amount of cash that would be paid under the conditions specified in the contract if settlement occurred on the reporting date, an issuer should not incorporate projected changes in the factors that affect a variable redemption price (e.g., forward projections of EBITDA if the redemption price is a function of EBITDA). Instead, the redemption amount is calculated on the basis of the conditions that exist as of the balance sheet date (e.g., the most recent EBITDA measure if the redemption price is a function of EBITDA). This view is consistent with the guidance on redeemable equity securities classified in temporary equity under ASC 480-10-S99-3A (see Chapter 9). In paragraph 14 of ASC 480-10-S99-3A, the SEC staff states that if “the maximum redemption amount is contingent on an index or other similar variable (for example, the fair value of the equity instrument at the redemption date or a measure based on historical EBITDA), the amount presented in temporary equity should be calculated based on the conditions that exist as of the balance sheet date (for example, the current fair value of the equity instrument or the most recent EBITDA measure).”

We believe that if the redemption amount varies (e.g., as a function of EBITDA), an entity should not reduce the carrying amount of the liability below the initially recorded amount. ASC 480-10-45-3 implies that the amount of reported interest cost cannot be less than zero on a cumulative basis from the date of initial recognition (see Section 4.3.2). This is consistent with the view that an entity cannot recognize interest income on a liability as well as with the guidance on redeemable securities classified in temporary equity under ASC 480-10-S99-3A (see Section 9.5). In paragraph 16(e) of ASC 480-10-S99-3A, the SEC staff states that “the amount presented in temporary equity should be no less than the initial amount reported in temporary equity for the instrument. That is, reductions in the carrying amount of a redeemable equity instrument . . . are appropriate only to the extent that the registrant has previously recorded increases in the carrying amount of the redeemable equity instrument.” If the instrument is redeemed for an amount less than the net carrying amount, the issuer recognizes the difference as an extinguishment gain.
4.3.1.3 **Embedded Features**

If an embedded feature must be separated as an embedded derivative under ASC 815-15, an entity should analyze the host contract separately from the embedded derivative in determining the appropriate measurement under ASC 480-10-35-3 (e.g., in estimating the redemption amount). This is consistent with ASC 815-15-25-54, which requires an entity to account for a host contract that remains after separation of an embedded derivative on the basis of GAAP applicable to instruments of that type that do not contain embedded derivatives.

**Example 4-4**

A mandatorily redeemable financial instrument has a fixed redemption date and a redemption price that is indexed to the price of gold (i.e., $100,000 plus the cumulative change in the price of 100 ounces of gold, if positive). Entity X determines that (1) the initial fair value of the entire instrument is $100,000, (2) the indexation to gold should be separated as an embedded derivative under ASC 815-15, (3) the derivative has an initial fair value of $5,000, and (4) the host contract that remains after separation of the embedded derivative has a fixed redemption amount of $100,000.

Entity X measures the host contract as a mandatorily redeemable financial instrument with an initial carrying amount of $95,000 (determined by using a with-and-without method in accordance with ASC 815-15-30-2), a fixed redemption amount of $100,000, and a fixed redemption date. It would subsequently measure the host contract at the present value of the assumed fixed redemption amount of $100,000 discounted by using the implicit rate at inception (i.e., a rate determined on the basis of an initial carrying amount of $95,000) in accordance with ASC 480-10-35-3(a).

**Example 4-5**

A mandatorily redeemable financial instrument contains a feature that could accelerate an otherwise fixed redemption date if uncertain future events occur (e.g., a put option contingent on a change in control). If the acceleration feature is separated as an embedded derivative, the host contract is analyzed as a mandatorily redeemable financial instrument with a fixed settlement date.

A mandatorily redeemable financial instrument with a fixed redemption amount at maturity may contain a put or call feature that permits the holder or the issuer to settle the instrument early at an amount other than the fixed redemption amount. For example, the issuer may have an option to call the instrument before the stated redemption date at a premium to its fixed redemption amount, or the holder may have an option to put the instrument early at a discount to its fixed redemption amount. Although such an instrument could be viewed as having a variable redemption amount and a variable redemption date, we believe that it may be appropriate for an entity to treat such an instrument as having a fixed redemption amount at maturity under ASC 480-10-35-3 and to analyze the put or call feature separately in determining whether the feature must be bifurcated as an embedded derivative under ASC 815-15. In the application of the interest method (see Section 4.3.1.2), any discount from the amount payable on the first noncontingent put date would be amortized to that date.

4.3.1.4 **Preferred Stock With CCF**

If a convertible preferred share meets the definition of a mandatorily redeemable financial instrument in ASC 480-10 because (1) it specifies the date on which it will be redeemed for cash (or other assets) and (2) the issuer is required to settle it either fully or partially in cash (or other assets) upon conversion (see Sections 2.5 and 4.2.4), the issuer should consider whether the instrument is subject to the guidance on convertible debt with CCFs in ASC 470-20.
The issuer of an instrument within the scope of the cash conversion guidance in ASC 470-20 is required to separate the instrument into its liability and equity components by allocating the issuance proceeds and any direct transaction costs between the two components. Under the cash conversion guidance, the issuer determines the measurement of the liability and equity components by using a “liability-first” allocation approach as follows:

- The issuer first determines the carrying amount of the liability component before considering any allocation of transaction costs. It determines the carrying amount on the basis of a hypothetical nonconvertible debt instrument that includes any or all features embedded in the convertible debt except for the conversion feature and any feature that is nonsubstantive at inception. The measurement attribute for the liability component at initial recognition is its fair value.
- Then, the issuer determines the carrying amount of the equity component before considering any allocation of transaction costs. The issuer measures the equity component by using a residual approach under which the amount of issuance proceeds that remains after allocation to the liability component is allocated to the equity component.
- Finally, the issuer allocates qualifying transaction costs between the liability and equity components in proportion to the allocation of proceeds between each component in the first two steps.

After initial recognition, the issuer measures the liability component at amortized cost by applying the interest method in ASC 835 and treats as a debt discount the excess of the principal amount to be repaid at the end of the expected life of similar hypothetical nonconvertible debt over the initial carrying amount of the liability component. The debt discount and any transaction costs allocated to the liability component (i.e., the debt issuance costs) are amortized over the expected life of similar nonconvertible debt by using the interest method.

In accordance with ASC 825-10-15-5(f), the issuer is not permitted to elect the fair value option in ASC 825-10 for an instrument within the scope of the cash conversion guidance in ASC 470-20 since such an instrument contains a separated equity component.

Connecting the Dots
For further discussion of the CCF guidance in ASC 470-20, see Chapter 6 of Deloitte’s *A Roadmap to the Issuer’s Accounting for Convertible Debt*.

### 4.3.2 Interest Cost

<table>
<thead>
<tr>
<th>ASC 480-10</th>
</tr>
</thead>
</table>
| **45-2B** Depending on the settlement terms, this Subtopic requires that mandatorily redeemable shares that are not subject to the deferral in paragraphs 480-10-15-7A through 15-7F be measured at either the present value of the amount to be paid at settlement or the amount of cash that would be paid under the conditions specified in the contract if settlement occurred at the reporting date, recognizing the resulting change in that amount as interest cost (change in redemption amount).

| **45-3** Any amounts paid or to be paid to holders of the contracts discussed in paragraph 480-10-35-3 in excess of the initial measurement amount shall be reflected in interest cost. |
For a mandatorily redeemable financial instrument, the following items are reported as interest cost:

- Changes in its carrying amount, including the amortization of any discount if the contract is measured at the present value of the amount to be paid at settlement.
- Any amounts paid or to be paid to the holder in excess of the initial measurement amount, including the payment or declaration of dividends and the accrual of cumulative dividends.

Accrued cumulative dividends are recognized as interest cost, even if not declared, if the holder is entitled to such dividends during the life of the contract or at settlement. Conversely, undeclared dividends are not recognized as interest cost if the holder is not entitled to them before they are declared.

### 4.3.3 Issuance Costs

ASC 480-10 does not specifically state how to account for issuance costs associated with mandatorily redeemable financial instruments. We believe that unless the issuer elects to account for the mandatorily redeemable financial instrument at fair value with changes in fair value recognized in earnings under ASC 825-10, an entity should treat any issuance costs as a direct deduction from the amount reported for the liability on the face of the balance sheet in a manner similar to its treatment of debt issuance costs under ASC 835-30-45-1A (after the issuer’s adoption of ASU 2015-03). Subsequently, the entity reports the amortization of the issuance costs as interest cost in a manner similar to its amortization of a debt discount. If the entity elects to measure the instrument at fair value with changes in fair value recognized in earnings under ASC 825-10, any up-front costs and fees are expensed at inception under ASC 825-10-25-3.

**Connecting the Dots**

For a discussion of what qualifies as an issuance cost, see Section 3.3.4.4.

### 4.4 Reclassifications

#### 4.4.1 Ongoing Reassessment

<table>
<thead>
<tr>
<th><strong>ASC 480-10</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>25-5</strong> A financial instrument that embodies a conditional obligation to redeem the instrument by transferring assets upon an event not certain to occur becomes mandatorily redeemable if that event occurs, the condition is resolved, or the event becomes certain to occur.</td>
</tr>
<tr>
<td><strong>25-7</strong> If a financial instrument will be redeemed only upon the occurrence of a conditional event, redemption of that instrument is conditional and, therefore, the instrument does not meet the definition of mandatorily redeemable financial instrument in this Subtopic. However, that financial instrument would be assessed at each reporting period to determine whether circumstances have changed such that the instrument now meets the definition of a mandatorily redeemable instrument (that is, the event is no longer conditional). If the event has occurred, the condition is resolved, or the event has become certain to occur, the financial instrument is reclassified as a liability.</td>
</tr>
<tr>
<td><strong>55-10</strong> The guidance that follows discusses the requirement in paragraph 480-10-25-7 for reclassification of stock that becomes mandatorily redeemable. For example, an entity may issue equity shares on January 2, 2004, that must be redeemed (not at the option of the holder) six months after a change in control. When issued, the shares are conditionally redeemable and, therefore, do not meet the definition of mandatorily redeemable. On December 30, 2008, there is a change in control, requiring the shares to be redeemed on June 30, 2009. On December 31, 2008, the issuer would treat the shares as mandatorily redeemable and reclassify the shares as liabilities, measured initially at fair value. Additionally, the issuer would reduce equity by the amount of that initial measure, recognizing no gain or loss.</td>
</tr>
</tbody>
</table>
For another example of a conditionally redeemable instrument, an entity may issue preferred shares with a stated redemption date 30 years hence that also are convertible at the option of the holders into a fixed number of common shares during the first 10 years. Those instruments are not mandatorily redeemable for the first 10 years because the redemption is conditional, contingent upon the holder’s not exercising its option to convert into common shares. However, when the conversion option (the condition) expires, the shares would become mandatorily redeemable and would be reclassified as liabilities, measured initially at fair value.

If the conversion option were nonsubstantive, for example, because the conversion price is extremely high in relation to the current share price, it would be disregarded as provided in paragraph 480-10-25-1. If that were the case at inception, those preferred shares would be considered mandatorily redeemable and classified as liabilities with no subsequent reassessment of the nonsubstantive feature.

An entity should reassess in each reporting period whether any of its equity-classified shares have become mandatorily redeemable financial instruments. If circumstances change, a share that previously did not meet the definition of a mandatorily redeemable financial instrument may subsequently meet it. For example, a perpetual share that is required to be redeemed in cash upon the occurrence of an event that is not certain to occur (e.g., a deemed liquidation event) would not initially meet the definition of a mandatorily redeemable financial instrument, because redemption is conditional. If the event subsequently becomes certain to occur so that redemption becomes unconditional, the share would begin to meet the definition of a mandatorily redeemable financial instrument and should be reclassified as a liability unless a specific exception from liability classification applies.

Examples include:

- The expiration of a substantive conversion option in a preferred share with a stated redemption date on which the issuer is required to redeem the share for cash (see ASC 480-10-55-11). The share would be reclassified as a liability on the expiration date of the conversion option. For a discussion of the evaluation of whether a term or feature is nonsubstantive, see Section 3.2.

- The holder’s exercise of a physically settled put or redemption option in a perpetual preferred share that makes redemption certain to occur. That share would be reclassified as a liability on the option exercise date and remain a liability until the redemption date. (Redemption would continue to be considered conditional, however, if the issuer has the right to reject the redemption request under the redemption option without penalty.)

- The issuer’s exercise of a physically settled call or redemption option embedded in a perpetual preferred share that makes redemption certain to occur. The share would be reclassified as a liability on the option exercise date.

- The occurrence of an event (e.g., an IPO or change of control) that triggers the mandatory redemption of a perpetual preferred share for cash (see ASC 480-10-55-10 for an example). The share would be reclassified as a liability upon the occurrence of the event.

Reclassification is also required if the terms of a share are modified so that it begins to meet or ceases to meet the definition of a mandatorily redeemable financial instrument. However, the modification must be legally binding. An agreement in principle to change the contractual terms of an instrument may not be legally binding (e.g., if it allows either party to walk away without recourse).

A share might have to be reclassified as a liability even if the period until the required redemption date is short. For example, when an entity gives an irrevocable notice to purchase an outstanding redeemable share, it should consider whether the share must be reclassified as a mandatorily redeemable financial instrument.
An instrument for which redemption is not certain to occur does not meet the definition of a mandatorily redeemable financial instrument. For instance, a preferred share might contain an option for the issuer to redeem the preferred share for cash and an option for the holder to convert the share into common stock. In such a scenario, even if the issuer notifies holders of its intent to exercise the redemption option, the share would not meet the definition of a mandatorily redeemable financial instrument if the holders have the ability to convert the preferred stock into common stock before the redemption date.

An instrument that previously did not meet the definition of a mandatorily redeemable financial instrument is reclassified as of the date it meets it. Thus, if a conditionally redeemable financial instrument in the form of a share became unconditionally redeemable after the balance sheet date, but before the financial statements were issued or available to be issued, an entity would not classify it as a liability as of the balance sheet date. However, the entity may be required to disclose the subsequent event in accordance with ASC 855-10-50-2 to keep the financial statements from being misleading.

### 4.4.2 Accounting for Reclassifications

<table>
<thead>
<tr>
<th>ASC 480-10</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>30-2</strong> If a conditionally redeemable instrument becomes mandatorily redeemable, upon reclassification the issuer shall measure that liability initially at fair value and reduce equity by the amount of that initial measure, recognizing no gain or loss.</td>
</tr>
</tbody>
</table>

When a conditionally redeemable financial instrument becomes a mandatorily redeemable financial instrument (see Section 4.1), the issuer reclassifies it from the equity to liabilities category at its current fair value as of the date of the reclassification. The FASB decided that no gain or loss should be recognized in the income statement upon reclassification. Paragraph B64 of the Background Information and Basis for Conclusions of FASB Statement 150 states, in part:

> The Board . . . believes that recognition of a liability to a former owner on removal of a contingency about redemption is, like other distributions to owners, not an occasion for recognizing gain or loss.

Under the SEC guidance in ASC 260-10-S99-2, the reclassification of an equity-classified security as a liability (e.g., a preferred share becomes mandatorily redeemable) is treated as a redemption of equity by issuance of a debt instrument in the calculation of EPS.

We believe that in accordance with ASC 260-10-S99-2, because the reclassification is accounted for as the issuance of a new debt instrument to redeem the old equity instrument (see Section 9.7.1), previously recognized equity issuance costs would not be expensed through the income statement but rather recognized as an adjustment to EPS for the redemption of the preferred stock.

If the instrument was previously classified in temporary equity under ASC 480-10-S99-3A, the issuer may need to adjust its method of measuring the instrument, because ASC 480-10-25-30-2 requires the instrument to be initially measured at fair value as of the reclassification date, and ASC 480-10-S99-3A permits certain accounting policies that are not available under ASC 480-10-35. Unlike paragraph 15 of ASC 480-10-S99-3A, for example, ASC 480-10-35 does not permit an entity to apply an accounting policy of measuring the instrument at the amount of cash that would be paid if settlement occurred as of the reporting date if the redemption date and the redemption amount are both fixed.
Example 4-5A

Reclassification of Preferred Stock From Equity to Liability

Company D has outstanding preferred stock with the following terms:

- The preferred stock is automatically converted into common stock at a conversion price of $25 per share in the event that D effects a qualified IPO within the next five years.
- If D does not effect a qualified IPO by the end of the fifth year from the issuance date, the preferred stock becomes mandatorily redeemable in five years.

Company D should not classify the preferred stock as a liability under ASC 480 before the fifth year from the issuance date if it concludes that the conversion upon a qualified IPO is a substantive feature. Furthermore, while D is required to classify the preferred stock within temporary equity under ASC 480-10-S99-3A, it should not remeasure the preferred stock to its redemption amount as long as the occurrence of a qualified IPO by the end of year five is more than remote (see Section 9.5.4.3).

However, if a qualified IPO does not happen by the end of year five, the preferred stock becomes a mandatorily redeemable financial instrument for which reclassification as a liability is required under ASC 480. In this circumstance, in accordance with ASC 480-10-30-2, D should reflect the reclassification by measuring the liability initially at fair value and reducing equity by the same amount without recognizing a gain or loss. This reclassification is treated in the same manner as any other extinguishment of preferred stock under ASC 260-10-S99-2. Therefore, the difference between the initial fair value amount recognized for the preferred stock upon reclassification as a liability and the net carrying amount of the preferred stock (which should be adjusted under other applicable GAAP, including ASC 480-10-S99-3A if applicable, immediately before such reclassification) reflects a charge (or credit) to net income in arriving at income available to common stockholders. See Section 3.2.2.8 of Deloitte’s A Roadmap to the Presentation and Disclosure of Earnings per Share for further discussion of the reclassification of preferred stock to a liability.

Connecting the Dots

For further discussion of the EPS impact of a reclassification, see Sections 3.2.2, 3.2.3.5, and 3.2.4.4 of Deloitte’s A Roadmap to the Presentation and Disclosure of Earnings per Share.

4.5 Equity-for-Debt Exchange

Entities sometimes enter into transactions involving the exchange of redeemable securities classified in equity (or in temporary equity by SEC registrants, as discussed in ASC 480-10-S99-3A; see Section 9.7) for mandatorily redeemable securities classified as liabilities pursuant to ASC 480-10-25-4 (an “equity-for-debt exchange”). For example, an entity that seeks to defer redemption of outstanding preference shares that are currently redeemable at their holders’ option for cash may offer those holders an exchange of existing preference shares for new preference shares that are mandatorily redeemable at a later date.

Assuming that the exchange is not akin to a troubled-debt restructuring, the issuer should account for such an equity-for-debt exchange as a reacquisition (extinguishment) of the equity-classified securities and an issuance of new liability-classified securities. The redemption of the equity-classified securities should be accounted for as a treasury stock transaction under ASC 505, with no gain or loss recognized in net income. The liability-classified securities should be initially recognized and measured at fair value in accordance with ASC 480-10-30-1. To the extent that the initial fair value of the liability differs from the carrying amount of the extinguished equity-classified securities, the difference should be deducted from or added to net earnings available to common shareholders in the calculation of EPS. ASC 260-10-S99-2 provides SEC registrants with guidance on how redemptions of equity-classified preferred securities affect the calculation of EPS.
In some situations, entities analyze modifications or exchanges of equity-classified redeemable securities by analogizing to ASC 470-50 or other accounting literature. However, such analogies are typically applied when the redeemable securities both before and after the modification or exchange are classified in equity (including temporary equity); they do not apply to equity-for-debt exchanges.

Example 4-6

Company R, an SEC registrant, has 1 million outstanding shares of Series A redeemable convertible preferred stock. Company R issued the Series A stock on January 1, 20X1, at its par value of $20 per share, or $20 million in issuance proceeds. The stock is convertible into 5 million shares of R’s common stock (conversion ratio of 5:1 or $4 per share) at the option of each holder at any time and is mandatorily redeemable on June 30, 20X6.

Company R determined that the Series A stock should not be classified as a liability under ASC 480-10 because redemption is contingent on the holders’ not exercising their conversion option. Because R is an SEC registrant, it applied the guidance in ASC 480-10-S99-3A and classified the preferred stock in temporary equity. Company R also determined that the conversion feature does not need to be bifurcated or separately recognized as a derivative instrument in accordance with ASC 815.

In June 20X6, R reached an agreement with holders on December 31, 20X5, to exchange the 1 million shares of its Series A stock for 4 million shares of new, Series B nonconvertible preferred stock in a transaction that was not akin to a troubled-debt restructuring. Company R determines that the fair value of the Series B stock is $21 million. The Series B stock is not convertible into R’s common stock but is mandatorily redeemable at par in February 20X9. The company determines that the new stock must be classified as a liability under ASC 480-10.

Company R should account for the exchange of the temporary-equity classified stock for liability-classified stock as a treasury stock repurchase of the temporary-equity classified stock and the issuance of new liability-classified stock measured at the fair value of the newly issued liability-classified stock. Below are sample journal entries.

On January 1, 20X1, R issues the Series A preferred shares for an amount equal to their aggregate par value — $20 million.

**Journal Entry — January 1, 20X1**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>20,000,000</td>
</tr>
<tr>
<td>Temporary equity — Series A preferred</td>
<td>20,000,000</td>
</tr>
</tbody>
</table>

On December 31, 20X5, R issues Series B preferred shares in exchange for the Series A stock. The aggregate fair value of the Series B preferred shares is $21 million, so R recognizes a liability of $21 million. Since the fair value of the consideration paid to repurchase the Series A stock (i.e., the Series B preferred stock) is $1 million more than the Series A carrying amount, R records a debit to retained earnings in the amount of $1 million and deducts $1 million from net earnings in calculating EPS to arrive at net earnings available to common shareholders.

**Journal Entry — December 31, 20X5**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Temporary equity — Series A preferred</td>
<td>20,000,000</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>1,000,000</td>
</tr>
<tr>
<td>Liability — Series B preferred</td>
<td>21,000,000</td>
</tr>
</tbody>
</table>
Chapter 5 — Obligations to Repurchase Shares by Transferring Assets

This chapter discusses the requirements in ASC 480-10 related to financial instruments that embody an obligation to repurchase shares by transferring assets, including the scope of this classification category (see Section 5.1); certain application issues (see Section 5.2); accounting (see Section 5.3); and reassessments (see Section 5.4).

5.1 Classification

5.1.1 Overview

<table>
<thead>
<tr>
<th>ASC 480-10</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>25-8</strong> An entity shall classify as a liability (or an asset in some circumstances) any financial instrument, other than an outstanding share, that, at inception, has both of the following characteristics:</td>
</tr>
<tr>
<td>a. It embodies an obligation to repurchase the issuer's equity shares, or is indexed to such an obligation.</td>
</tr>
<tr>
<td>b. It requires or may require the issuer to settle the obligation by transferring assets.</td>
</tr>
<tr>
<td><strong>25-9</strong> In this Subtopic, <em>indexed to</em> is used interchangeably with &lt;i&gt;based on variations in the fair value of&lt;/i&gt;. The phrase &lt;i&gt;requires or may require&lt;/i&gt; encompasses instruments that either conditionally or unconditionally obligate the issuer to transfer assets. If the obligation is conditional, the number of conditions leading up to the transfer of assets is irrelevant.</td>
</tr>
<tr>
<td><strong>25-10</strong> Examples of financial instruments that meet the criteria in paragraph 480-10-25-8 include forward purchase contracts or written put options on the issuer’s equity shares that are to be physically settled or net cash settled.</td>
</tr>
<tr>
<td><strong>25-11</strong> All obligations that permit the holder to require the issuer to transfer assets result in liabilities, regardless of whether the settlement alternatives have the potential to differ.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>ASC 480-10 — Glossary</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Net Cash Settlement</strong></td>
</tr>
<tr>
<td>A form of settling a financial instrument under which the entity with a loss delivers to the entity with a gain cash equal to the gain.</td>
</tr>
<tr>
<td><strong>Physical Settlement</strong></td>
</tr>
<tr>
<td>A form of settling a financial instrument under which both of the following conditions are met:</td>
</tr>
<tr>
<td>a. The party designated in the contract as the buyer delivers the full stated amount of cash or other financial instruments to the seller.</td>
</tr>
<tr>
<td>b. The seller delivers the full stated number of shares of stock or other financial instruments or nonfinancial instruments to the buyer.</td>
</tr>
</tbody>
</table>
ASC 480-10-25-8 requires a financial instrument to be classified as an asset or a liability if all of the following apply:

- It is not an outstanding share (see Section 5.1.2).
- It either (1) “embodies an obligation to repurchase the issuer’s equity shares” or (2) “is indexed to such an obligation” (see Section 5.1.3).
- “It requires or may require the issuer to settle the obligation by transferring assets” (see Section 5.1.4).

For example, a forward purchase contract on an entity’s own equity shares or a written put option on the entity’s own equity shares is classified as a liability if the issuer could be required to physically settle the contract by delivering cash in exchange for the issuer’s equity shares. Similarly, a forward purchase or written put option contract that permits the counterparty to net cash settle the contract would be classified as an asset or a liability. These requirements apply even if the purchase obligation is contingent upon the occurrence or nonoccurrence of an event (unless the event is solely within the entity’s control) or upon the counterparty’s exercise of an option. Further, the requirements apply even if the contract cannot be net settled (e.g., contracts that permit physical settlement only in private-company stock). Thus, contracts that are outside the scope of the derivative accounting guidance because they do not possess the net settlement characteristic in the definition of a derivative in ASC 815-10 (see Section 2.3.1) may be within the scope of ASC 480-10.

### 5.1.2 Not an Outstanding Share

ASC 480-10-25-8 applies to instruments other than those in the legal form of an outstanding share. For example, it applies to certain contracts that are indexed to, and potentially settled in, the entity’s own shares (e.g., forward repurchase and written put option contracts on own shares). For outstanding shares, an entity should instead consider the guidance on mandatorily redeemable financial instruments (see Chapter 4), certain obligations to deliver a variable number of shares (see Chapter 6), and temporary equity (see Chapter 9). The following are examples of instruments that are not outstanding shares and those that are:

<table>
<thead>
<tr>
<th>Not Outstanding Shares (ASC 480-10-25-8 Might Apply)</th>
<th>Outstanding Shares (ASC 480-10-25-8 Does Not Apply)</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Forward contracts on own shares</td>
<td>• Common shares</td>
</tr>
<tr>
<td>• Option contracts on own shares</td>
<td>• Preferred shares</td>
</tr>
<tr>
<td>• Warrant contracts on own shares</td>
<td>• Convertible shares</td>
</tr>
<tr>
<td>• Share purchase agreements</td>
<td>• Redeemable shares</td>
</tr>
<tr>
<td></td>
<td>• Noncontrolling interest</td>
</tr>
</tbody>
</table>

### 5.1.3 An Obligation to Repurchase the Issuer’s Equity Shares or One That Is Indexed to Such an Obligation

ASC 480-10-25-8 applies both to contracts that embody obligations to repurchase shares (such as forward purchase and written put option contracts that require gross physical settlement) and to contracts that embody obligations indexed to obligations to repurchase shares (such as warrants on puttable shares). Obligations that are indexed to obligations to repurchase shares have a fair value that is based on variations in the fair value of obligations to repurchase shares, although they may not involve an actual share repurchase (e.g., contracts that the issuer is required or may be required to net cash settle).
The fact that an obligation to repurchase shares is of short duration does not exempt it from the requirements of ASC 480-10. Accordingly, the issuer should evaluate treasury stock transactions to determine whether they must be classified as liabilities under ASC 480-10 in the period between the trade date and the settlement date. For example, the treasury stock repurchase component of a typical accelerated share repurchase transaction would be within the scope of ASC 480-10 (see Section 3.3.5).

Although a net-cash-settled forward sale or a net-cash-settled written call option on the issuer’s equity shares may require the issuer to transfer assets, such a contract does not require the issuer to repurchase shares and is not indexed to an obligation to repurchase the issuer’s equity shares (unless the underlying equity shares include a redemption obligation). Accordingly, ASC 480-10-25-8 does not apply to such a contract. Nevertheless, ASC 815-40 precludes equity classification for such net-cash-settled contracts on own equity.

The following are examples of contracts that embody an obligation to repurchase the issuer’s equity shares or are indexed to such an obligation (“repurchase obligations”) and those that do not (“no repurchase obligations”):

<table>
<thead>
<tr>
<th>Repurchase Obligations (ASC 480-10-25-8 Might Apply)</th>
<th>No Repurchase Obligations (ASC 480-10-25-8 Does Not Apply)</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Written put options to purchase the issuer's equity shares</td>
<td>• Purchased call options or warrants that permit the holder to purchase the issuer's nonredeemable equity shares</td>
</tr>
<tr>
<td>• Forward contracts to repurchase the issuer's equity shares</td>
<td>• Forward sales of the issuer's nonredeemable equity shares</td>
</tr>
<tr>
<td>• Share purchase agreements that require the issuer to repurchase outstanding shares</td>
<td></td>
</tr>
<tr>
<td>• Physically settled written call options or warrants on own shares that the counterparty can put to the issuer (e.g., put warrants)</td>
<td></td>
</tr>
<tr>
<td>• Physically settled written call options or forward sale contracts under which the issuer will deliver shares that contain an unconditional or conditional redemption obligation (e.g., shares that are redeemable upon an event that is outside the control of the issuer)</td>
<td></td>
</tr>
</tbody>
</table>

As noted in Section 2.2.4.2, ASC 480-10-20 suggests that the term “equity share” is limited to shares that qualify, and are classified, as equity (including both permanent and temporary equity) in the reporting entity’s financial statements. Nevertheless, ASC 480-10-25-13 and ASC 480-10-55-33 imply that ASC 480-10-25-8 applies to financial instruments, such as warrants, options, or forwards, that involve the issuance of mandatorily redeemable shares that would be accounted for as liabilities when they are issued. FASB Staff Position FAS 150-5 contains the following observation:

[ASC 480-10-25-13] states: “[a]n instrument that requires the issuer to settle its obligation by issuing another instrument (for example, a note payable in cash) ultimately requires settlement by a transfer of assets.” In that sentence, it is clear that a warrant for mandatorily redeemable shares would be a liability under [ASC 480-10]. In applying [ASC 480-10-25-8], [ASC 480-10-25-13] also would apply for an instrument settled with another instrument that ultimately may require settlement by a transfer of assets (warrants for puttable shares).
5.1.4 Requires or MayRequire the Transfer of Assets

ASC 480-10-25-8 applies to instruments that require or may require the issuer to transfer assets. The phrase "requires or may require" encompasses instruments that either unconditionally or conditionally obligate the issuer to transfer assets. To be classified outside of equity under ASC 480-10-25-8, an obligation to transfer assets does not have to be for a fixed amount. ASC 480-10-25-8 may apply even if the monetary amount of the obligation varies on the basis of a specified underlying (e.g., the S&P 500).

An example of an unconditional obligation to transfer assets is a noncontingent physically settled forward contract to purchase the issuer’s equity shares for cash. Examples of conditional obligations to transfer assets include obligations that are contingent on events or conditions outside the issuer’s control (see Sections 2.2.1 and 9.4.2), such as any of the following:

- The holder’s exercise of an option (e.g., a written put option on the issuer’s equity shares).
- The occurrence or nonoccurrence of an event outside the issuer’s control (e.g., a contingent forward purchase contract).
- The possibility that the fair value of a contract might be in a loss position (e.g., a net-cash-settled forward purchase contract).
- The counterparty’s choice of settlement method (e.g., a written put option that the holder can elect to settle either net in shares or net in cash).

A warrant or call option that permits the holder to purchase equity shares is considered to embody an obligation that may require the transfer of assets if the shares that would be delivered upon exercise of the warrant or option embody such an obligation (e.g., if the shares that would be delivered upon exercise contain a redemption feature that either unconditionally or conditionally requires the issuer to deliver cash).

The issuer’s equity shares are assets of its shareholders, not of the issuer. Accordingly, ASC 480-10-25-8 does not apply to an instrument that the issuer must or may settle in its equity shares (e.g., a net-share-settled written put option on own shares). However, an entity should evaluate whether it must classify such an instrument outside of equity under ASC 480-20-25-14 (see Chapter 6).

In the separate financial statements of a subsidiary, shares issued by its parent would be assets of the subsidiary. Accordingly, if the subsidiary issues a contract that it must settle in parent shares, that contract requires assets to be transferred in the separate financial statements of the subsidiary. In the consolidated financial statements that include the parent, however, that contract does not require assets to be transferred, because the parent’s equity shares are not the parent’s assets. Accordingly, it is possible that a contract that must be classified as a liability in the subsidiary’s separate financial statements under ASC 480-10-25-8 qualifies as equity in the consolidated financial statements.

An instrument that the issuer must settle by providing services (e.g., an obligation to repurchase shares in exchange for services) does not meet the definition of a financial instrument and therefore is outside the scope of ASC 480-10 (see Section 2.2.2).
The following are examples of instruments that require or may require the transfer of assets and those that do not:

<table>
<thead>
<tr>
<th>Asset Transfer Required</th>
<th>Asset Transfer Not Required</th>
</tr>
</thead>
<tbody>
<tr>
<td>(ASC 480-10-25-8 Might Apply)</td>
<td>(ASC 480-10-25-8 Does Not Apply)</td>
</tr>
<tr>
<td>• Net-cash-settled written put options or forward purchase contracts</td>
<td>• Net-share-settled options or forward contracts</td>
</tr>
<tr>
<td>• Written put options or forward purchase contracts that may be settled either in shares or assets at the counterparty's option (e.g., net cash or net shares)</td>
<td>• Written put options or forward purchase contracts that may be settled in either shares or assets at the issuer's option (e.g., net cash or net shares)</td>
</tr>
<tr>
<td>• Gross physically settled written put options or forward purchase contracts under which the issuer will receive shares and deliver cash</td>
<td>• Obligations that have been fully prepaid (e.g., prepaid forward repurchase contracts or prepaid written put options)</td>
</tr>
<tr>
<td>• Written call options or warrants on own shares that the counterparty can put to the issuer for cash (e.g., a put warrant)</td>
<td></td>
</tr>
<tr>
<td>• Physically settled written call options or forward sale contracts under which the issuer will receive cash and deliver shares that contain a cash-settled redemption obligation (e.g., warrant on redeemable shares)</td>
<td></td>
</tr>
<tr>
<td>• Written put options or forward purchase contracts under which the issuer will receive shares and deliver a fixed or determinable quantity of an asset (e.g., investments in debt or equity securities issued by third parties)</td>
<td></td>
</tr>
</tbody>
</table>

We believe that a contractual term that requires or might require a transfer of assets would not preclude equity classification in any of the following circumstances:

- The event that would cause a transfer of assets is under the sole control of the issuer (see Section 5.2.1.3). Section 9.4.2 discusses the evaluation of whether an event is within the issuer's control.

- The issuer is or could be required to transfer assets only upon its final liquidation. This is analogous to the exceptions for only-upon-liquidation features in ASC 480-10-25-4 (see Section 4.1.5.2), ASC 480-10-S99-3A(3)(f) (see Section 9.4.5.2), and ASC 815-40-25-9 (see Section 5.2.3.2 of Deloitte's *A Roadmap to Accounting for Contracts on an Entity's Own Equity*).

- The issuer is or could be required to transfer assets only upon the occurrence of a deemed liquidation event (e.g., a change in control) that would entitle all holders of equity instruments that are equally or more subordinated than the equity instruments underlying the contract to receive the same form of consideration (e.g., cash or shares) upon the occurrence of the deemed liquidation event. This is analogous to the limited exception for certain deemed liquidation features in ASC 480-10-S99-3A(3)(f) (see Section 9.4.5.4). See Section 5.2.2 for further discussion.
5.2 Application Issues

5.2.1 Obligation to Issue an Instrument That Embodies an Obligation That Requires or May Require a Transfer of Assets

5.2.1.1 Overview

<table>
<thead>
<tr>
<th>ASC 480-10</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>25-13</strong> An instrument that requires the issuer to settle its obligation by issuing another instrument (for example, a note payable in cash) ultimately requires settlement by a transfer of assets, accordingly:</td>
</tr>
<tr>
<td>a. When applying paragraphs 480-10-25-8 through 25-12, this also would apply for an instrument settled with another instrument that ultimately may require settlement by a transfer of assets (warrants for puttable shares).</td>
</tr>
<tr>
<td>b. It is clear that a warrant for mandatorily redeemable shares would be a liability under this Subtopic.</td>
</tr>
</tbody>
</table>

ASC 480-10 applies to contracts that require or could require the issuer to deliver redeemable equity securities (e.g., warrants, written call options, and forward sales of redeemable preferred stock) if the entity could ultimately be forced to redeem those securities by transferring assets. The guidance applies irrespective of whether the redeemable equity securities would be classified within equity (including temporary equity) when issued. FASB Staff Position FAS 150-5 contains the following commentary:

[ASC 480-10-25-8] requires warrants or similar instruments to acquire redeemable shares to be classified as liabilities even though the underlying shares may be classified as equity under other accounting guidance. Additionally, SEC registrants may be required to classify underlying instruments as temporary equity.

For example, if an entity issues a warrant that permits the holder to purchase the entity's equity shares, that warrant is classified as a liability if the underlying equity shares contain a redemption requirement that is not solely within the entity's control (e.g., an investor put option embedded in preferred stock). Such a warrant must be classified as a liability under ASC 480-10-25-8 because (1) a warrant is a financial instrument other than an outstanding share and (2) a warrant on a puttable share embodies an obligation that may require the issuer to ultimately transfer assets. That is, the issuer is required to transfer assets if the holder exercises the warrant and subsequently elects to put the shares back to the issuer for cash or other assets. Although the warrant must be classified as a liability, the redeemable equity securities may qualify for classification as equity or temporary equity once issued. Similarly, a written call option or a forward sale contract on redeemable equity securities would be classified as a liability under ASC 480-10 if the entity could be required to transfer assets.

If the redemption feature could require the entity to transfer assets, a contract on redeemable shares is classified outside of equity regardless of the feature's timing (e.g., immediately after exercise of the contract or on some subsequent date in the future) or the redemption price (e.g., fair value or a fixed price). FASB Staff Position FAS 150-5 contains the following commentary:

Questions arose as to whether (a) the timing of the redemption feature or (b) the redemption price (for example, either a fair value or a fixed redemption price) affects the application of [ASC 480-10-25-8] to warrants for shares that are puttable. Some constituents questioned whether [ASC 480-10-25-8] applies only to warrants with underlying shares that are puttable immediately after exercise of the warrants or also to those that are puttable at some date in the future. ... [ASC 480-10-25-8] applies to freestanding warrants and other similar instruments on shares that are either puttable or mandatorily redeemable regardless of the timing of the redemption feature or the redemption price because those instruments embody obligations to transfer assets. Therefore, [ASC 480-10-25-8] applies to warrants on shares that are redeemable immediately after exercise of the warrants and also to those that are redeemable at some date in the future.
In addition, a contract on redeemable shares is classified outside of equity even if the redemption feature is contingent on the occurrence or nonoccurrence of a specified event (such as a change in control, reduction in the issuer’s credit rating, conversion, or failure to obtain by a designated date the SEC’s declaration that a registration statement is effective) unless the contingency is (1) solely within the control of the issuer or (2) a deemed liquidation event under which “all of the holders of equally and more subordinated equity instruments of the entity would always be entitled to also receive the same form of consideration (for example, cash or shares) upon the occurrence of the event that gives rise to the redemption (that is, all subordinate classes would also be entitled to redeem),” as described in ASC 410-10-599-3A(3)(f) (see Section 5.2.2).

5.2.1.2 Warrant for Puttable Shares That May Require Cash Settlement

**ASC 480-10**

55-32 Entity B issues a warrant for shares that can be put back by Holder immediately after exercise of the warrant. The warrant feature allows Holder to purchase 1 equity share at a strike price of $10 on a specified date. The put feature allows Holder to put the shares obtained by exercising the warrant back to Entity B on that date for $12, and to require physical settlement in cash. If the share price on the settlement date is greater than $12, Holder would be expected to exercise the warrant obligating Entity B to issue a fixed number of shares in exchange for a fixed amount of cash, and retain the shares. That feature alone does not result in a liability under paragraphs 480-10-25-8 through 25-12. However, if the share price is equal to or less than $12, Holder would be expected to put the shares back to Entity B and could choose to obligate Entity B to pay $12 in cash. That feature does result in a liability, because the financial instrument embodies an obligation to repurchase the issuer’s shares and may require a transfer of assets. Therefore, those paragraphs require Entity B to classify the warrant as a liability. A warrant to issue shares that will be mandatorily redeemable is also classified as a liability, and should be analyzed under Topic 815.

55-33 A warrant for puttable shares conditionally obligates the issuer to ultimately transfer assets — the obligation is conditioned on the warrant’s being exercised and the shares obtained by the warrant being put back to the issuer for cash or other assets. Similarly, a warrant for mandatorily redeemable shares also conditionally obligates the issuer to ultimately transfer assets — the obligation is conditioned only on the warrant’s being exercised because the shares will be redeemed. Thus, warrants for both puttable and mandatorily redeemable shares are analyzed the same way and are liabilities under paragraphs 480-10-25-8 through 25-12, even though the number of conditions leading up to the possible transfer of assets differs for those warrants. The warrants are liabilities even if the share repurchase feature is conditional on a defined contingency.

ASC 480-10-55-32 and ASC 480-10-55-33 illustrate the application of ASC 480-10-55-8 through 55-12 to a physically settled freestanding warrant that obligates the issuer to deliver a fixed number of the issuer’s puttable equity shares in exchange for cash if the warrant is exercised by the holder. The puttable equity shares include a redemption feature that permits the holder to tender the share to the issuer in exchange for cash. In this scenario, the put feature associated with the shares causes the warrant to be classified as a liability under ASC 480-10-25-8 because that feature represents an obligation to repurchase the issuer’s shares and may require the issuer to transfer assets. Without the put feature, the warrant would have been outside the scope of ASC 480-10.

ASC 480-10-55-13(b) and ASC-480-10-55-33 state that a freestanding warrant for mandatorily redeemable shares would be a liability under ASC 480-10 even though the obligation to transfer assets is conditional on the exercise of the warrant. We believe that guidance would apply to a forward to issue puttable or mandatorily redeemable shares as well (see also Section 2.2.4).
Example 5-1

In 20X5, Company C issues a warrant to Company D. The warrant gives D the right to purchase, for a fixed price, C’s Series A convertible preferred stock on December 31, 20X5. The Series A preferred stock that will be delivered upon exercise of the warrant is convertible into Series A common stock or is redeemable for cash at its par amount at the option of the holder on December 31, 20X8.

Because the Series A preferred stock is only conditionally (rather than mandatorily) redeemable and, upon issuance, will take the form of an outstanding share, C will account for the shares (if they are issued) as equity instruments when they are issued.

However, in its 20X5 financial statements, C is required to classify the warrant as a liability in accordance with ASC 480-10-25-8 because the warrant itself (1) is not an outstanding share and (2) embodies an obligation to transfer assets (cash) if D elects to put the Series A convertible preferred stock back to C.

5.2.1.3 Contracts on Redeemable Equity Shares That Do Not Require a Transfer of Assets

If a freestanding contract on redeemable equity shares cannot require the entity to transfer assets, the contract is not subject to ASC 480-10-25-8. For example, the following types of contracts on redeemable equity securities would not fall within the scope of ASC 480-10:

- A purchased put option that permits the issuer, at its option, to sell redeemable equity securities (because the entity has no obligation to issue redeemable equity securities).
- A purchased call option that permits the issuer, at its option, to repurchase redeemable equity securities (because the entity has no obligation to repurchase the redeemable equity securities).

Further, a contract that requires or might require the issuer to deliver equity shares that contain a cash-settled redemption requirement (e.g., a written warrant or call option or a forward sale contract on redeemable equity securities) would not be subject to ASC 480-10-25-8 if the share redemption requirement is solely within the issuer’s control. Although the shares are redeemable, the issuer cannot be required to transfer assets if it has discretion to avoid a share redemption (see Section 2.2.1).

5.2.2 Deemed Liquidation Events

<table>
<thead>
<tr>
<th>ASC 815-40</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>55-2</strong> An event that causes a change in control of an entity is not within the entity’s control and, therefore, if a contract requires net cash settlement upon a change in control, the contract generally must be classified as an asset or a liability.</td>
</tr>
<tr>
<td><strong>55-3</strong> However, if a change-in-control provision requires that the counterparty receive, or permits the counterparty to deliver upon settlement, the same form of consideration (for example, cash, debt, or other assets) as holders of the shares underlying the contract, permanent equity classification would not be precluded as a result of the change-in-control provision. In that circumstance, if the holders of the shares underlying the contract were to receive cash in the transaction causing the change in control, the counterparty to the contract could also receive cash based on the value of its position under the contract.</td>
</tr>
<tr>
<td><strong>55-4</strong> If, instead of cash, holders of the shares underlying the contract receive other forms of consideration (for example, debt), the counterparty also must receive debt (cash in an amount equal to the fair value of the debt would not be considered the same form of consideration as debt).</td>
</tr>
</tbody>
</table>
Chapter 5 — Obligations to Repurchase Shares by Transferring Assets

ASC 480-10 — SEC Materials — SEC Staff Guidance

SEC Staff Announcement: Classification and Measurement of Redeemable Securities

S99-3A(3)(f) Certain redemptions upon liquidation events. Ordinary liquidation events, which involve the redemption and liquidation of all of an entity's equity instruments for cash or other assets of the entity, do not result in an equity instrument being subject to ASR 268. In other words, if the payment of cash or other assets is required only from the distribution of net assets upon the final liquidation or termination of an entity (which may be a less-than-wholly-owned consolidated subsidiary), then that potential event need not be considered when applying ASR 268. Other transactions are considered deemed liquidation events. For example, the contractual provisions of an equity instrument may require its redemption by the issuer upon the occurrence of a change-in-control that does not result in the liquidation or termination of the issuing entity, a delisting of the issuer's securities from an exchange, or the violation of a debt covenant. Deemed liquidation events that require (or permit at the holder's option) the redemption of only one or more particular class of equity instrument for cash or other assets cause those instruments to be subject to ASR 268. However, as a limited exception, a deemed liquidation event does not cause a particular class of equity instrument to be classified outside of permanent equity if all of the holders of equally and more subordinated equity instruments of the entity would always be entitled to also receive the same form of consideration (for example, cash or shares) upon the occurrence of the event that gives rise to the redemption (that is, all subordinate classes would also be entitled to redeem).

Under ASC 480-10-25-8, an entity must classify as liabilities or equity those contracts, other than outstanding shares, that require or could require the issuer to repurchase its equity shares by transferring assets. Therefore, a freestanding financial instrument that embodies an obligation (e.g., a warrant, written call option, or forward) to issue the issuer's equity shares (either preferred or common stock) typically would be classified as an asset or liability under ASC 480-10-25-8 if those shares are puttable by the holder for cash (or other assets) upon the occurrence of a deemed liquidation event (e.g., a change in control) even if the underlying shares will be classified by the issuer as equity upon issuance.

However, we believe that the warrants should be classified as equity by analogy to ASC 815-40-55-2 through 55-4 (see Section 5.2.3.3 of Deloitte’s A Roadmap to Accounting for Contracts on an Entity’s Own Equity) and ASC 480-10-S99-3A(3)(f) (see Section 9.4.5.4 in the narrow and limited circumstances in which (1) the equity shares into which the instrument is convertible becomes puttable only upon the occurrence of a deemed liquidation event (e.g., a change in control) and (2) in accordance with ASC 480-10-S99-3A(3)(f), “all of the holders of equally and more subordinated equity instruments of the entity would always be entitled to also receive the same form of consideration (for example, cash or shares) upon the occurrence of the [deemed liquidation] event . . . (that is, all subordinate classes would also be entitled to redeem” their shares). We have discussed this view with the FASB staff as part of a formal technical inquiry.

Example 5-2

In 20X1, Company Y issues a warrant to Company Z that gives Z the right to purchase, for a fixed price, Y’s Series A preferred stock on December 31, 20X3. Under Y’s articles of incorporation, Y is obligated to redeem each class of its common and preferred stock (including Series A) upon the occurrence of a change-in-control transaction that does not result in the final liquidation or termination of Y (a “deemed liquidation event”). That is, all shareholders of any class of common or preferred stock of Y immediately before the deemed liquidation event will be entitled to redeem their shares upon the occurrence of the deemed liquidation event. The common and preferred stock is not otherwise redeemable.

Each holder of Y’s common and preferred stock would always be entitled to receive the same form of consideration (cash or other assets or both) upon redemption, although the amount of consideration received may vary by shareholder in accordance with the liquidation preference waterfall specified in the articles of incorporation.
Example 5-2 (continued)

Because the Series A preferred stock is only conditionally redeemable and, upon issuance, will take the form of an outstanding share, Y will account for the shares (if they are issued) as equity instruments when they are issued.

In its 20X1 financial statements, Y would not classify the warrants as liabilities under ASC 480-10-25-8 because (1) the preferred stock into which the warrant is convertible becomes redeemable only upon the occurrence of a deemed liquidation event and (2) upon the occurrence of the deemed liquidation event, all investors in "equally and more subordinated equity instruments of the entity would always be entitled to also receive the same form of consideration (for example, cash or shares)." If the warrants meet the conditions for equity classification in ASC 815-40, Y would classify them as equity instruments.

5.2.3 Obligations With Settlement Alternatives

Some obligations give one of the parties the choice of whether the obligation will be settled by the issuer's transfer of assets or by its issuance of shares (e.g., option or forward contracts on own shares that permit either net cash or net share settlement). In these circumstances, the issuer should determine whether ASC 480-10-25-8 or ASC 480-10-25-14 takes precedence in the assessment of whether the contract must be accounted for outside of equity under ASC 480-10.

5.2.3.1 Issuer Choice

If the issuer can elect the settlement method and has discretion to avoid a transfer of assets upon settlement (e.g., by electing net share settlement of the contract), liability classification is required to the extent that (1) the conditions in ASC 480-10-25-14 (see Chapter 6) related to changes in monetary value are met or (2) the shares that would be delivered require or may require the transfer of assets (e.g., puttable shares; see Section 5.2.1). Paragraph B48 of the Background Information and Basis for Conclusions of FASB Statement 150 states:

"Certain financial instruments embody obligations that permit the issuer 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 those obligations should be treated like obligations that require settlement by issuance of equity shares. That is, the Board concluded that this Statement should require liability classification of obligations that provide the issuer with the discretion to determine how the obligations will be settled if, and only if, the conditions in [ASC 480-10-25-14] related to changes in monetary value are met."

5.2.3.2 Counterparty Choice

If the counterparty can elect the settlement method and can require the issuer to transfer assets (e.g., by electing physical settlement or net cash settlement of the contract), the obligation must be evaluated under ASC 480-10-25-8. In such a scenario, ASC 480-10-25-14 does not apply. Under ASC 480-10-25-11, such an obligation may be a liability in accordance with ASC 480-10-25-8 even if the monetary values of the two settlement alternatives (shares or assets) have the potential to differ. Paragraph B49 of the Background Information and Basis for Conclusions of FASB Statement 150 states, in part:

Other obligations permit the holder to determine whether the issuer will be required to transfer assets or issue equity shares to settle the obligation. . . . The Board concluded that all obligations that permit the holder to require the issuer to transfer assets result in liabilities, regardless of whether the [monetary values of the] settlement alternatives have the potential to differ. The Board reasoned that such an obligation could leave the issuer with no discretion to avoid the future sacrifice of having to transfer assets and, therefore, is a liability under the definition in Concepts Statement 6.

84
5.2.3.3 Summary
The following table summarizes the analysis under ASC 480-10 of financial instruments other than outstanding shares embodying obligations to repurchase shares that give the issuer or the holder a choice of settlement either in assets or nonredeemable equity shares.

<table>
<thead>
<tr>
<th>Settlement Alternatives</th>
<th>Issuer Choice</th>
<th>Counterparty Choice</th>
</tr>
</thead>
<tbody>
<tr>
<td>Transfer of assets (physical settlement or net cash) or a variable number of nonredeemable equity shares (net shares)</td>
<td>Evaluate as variable-share obligation under ASC 480-10-25-14</td>
<td>Evaluate as an obligation to repurchase shares by transferring assets under ASC 480-10-25-8</td>
</tr>
<tr>
<td>Transfer of assets (physical settlement or net cash) or a fixed number of nonredeemable equity shares</td>
<td>Outside scope of ASC 480-10</td>
<td>Evaluate as an obligation to repurchase shares by transferring assets under ASC 480-10-25-8</td>
</tr>
</tbody>
</table>

5.2.4 Financial Instruments That Embody Multiple Obligations

ASC 480-10

55-29 The implementation guidance that follows addresses financial instruments involving multiple components that embody (or are indexed to) an obligation to repurchase the issuer's shares and that may require settlement by transferring assets. Some freestanding financial instruments composed of more than one option or forward contract embodying obligations require or may require settlement by transfer of assets. Paragraphs 480-10-15-3 through 15-4 state that the provisions of this Subtopic apply to freestanding financial instruments, including those that comprise more than one option or forward contract, and paragraphs 480-10-25-4 through 25-14 shall be applied to a freestanding financial instrument in its entirety. Under paragraphs 480-10-25-8 through 25-12, if a freestanding instrument is composed of a written call option and a written put option, the existence of the written call option does not affect the classification. Unlike the application of paragraph 480-10-25-14, applying paragraphs 480-10-25-8 through 25-12 does not involve making any judgments about predominance among obligations or contingencies.

Some financial instruments contain more than one option or forward component (e.g., a puttable warrant that contains both a written put option and a written call option). Unless the financial instrument is an outstanding share, the instrument is classified as an asset or a liability under ASC 480-10-25-8 if it embodies any obligation to repurchase the issuer's equity shares (or is indexed to such an obligation) and requires or may require the issuer to transfer assets. Unlike ASC 480-10-25-14, under which an entity evaluates variable-share obligations (see Section 6.2.4), ASC 480-10-25-8 does not require an entity to determine whether the obligation to transfer assets is predominant.

5.2.5 Put Warrants

ASC 815-40

55-16 Put warrants are frequently issued concurrently with debt securities of the entity, are detachable from the debt, and may be exercisable only under specified conditions. The put feature of the instrument may expire under varying circumstances, for example, with the passage of time or if the entity has a public stock offering. Under Subtopic 470-20, a portion of the proceeds from the issuance of debt with detachable warrants must be allocated to those warrants.
ASC 815-40 (continued)

55-17 Put warrants are instruments with characteristics of both warrants and put options. The holder of the instrument is entitled to do any of the following:
   a. Exercise the warrant feature to acquire the common stock of the entity at a specified price
   b. Exercise the put option feature to put the instrument back to the entity for a cash payment
   c. Exercise both the warrant feature to acquire the common stock and the put option feature to put that stock back to the entity for a cash payment.

55-18 Because the contract gives the counterparty the choice of cash settlement or settlement in shares, entities should report the proceeds from the issuance of put warrants as liabilities and subsequently measure the put warrants at fair value with changes in fair value reported in earnings as required by Topic 480. That is, a put warrant that embodies an obligation to repurchase the issuer's equity shares, or is indexed to such an obligation, and that requires or may require a transfer of assets is within the scope of that Topic and therefore is to be recognized as a liability.

A put warrant is an example of a contract that must be classified as a liability under ASC 480-10. Even though the warrant gives the counterparty an option to purchase the entity's stock, the contract is classified as a liability in its entirety under ASC 480-10 if the entity could be forced to repurchase the warrant for cash or other assets because it represents an obligation that is indexed to an obligation to repurchase the entity's equity shares, and the entity may be required to transfer cash or other assets. Alternatively, the counterparty may have the right to put back to the entity for cash the stock it received upon exercise of the warrant. In that case, the contract embodies an obligation to repurchase equity shares for cash (see Section 5.2.1).

ASC 480-10

55-30 Consider, for example, a puttable warrant that allows the holder to purchase a fixed number of the issuer's shares at a fixed price that also is puttable by the holder at a specified date for a fixed monetary amount that the holder could require the issuer to pay in cash. The warrant is not an outstanding share and therefore does not meet the exception for outstanding shares in paragraphs 480-10-25-8 through 25-12. As a result, the example puttable warrant is a liability under those paragraphs, because it embodies an obligation indexed to an obligation to repurchase the issuer's shares and may require a transfer of assets. It is a liability even if the repurchase feature is conditional on a defined contingency in addition to the level of the issuer's share price.

55-31 Entity A issues a puttable warrant to Holder. The warrant feature allows Holder to purchase 1 equity share at a strike price of $10 on a specified date. The put feature allows Holder instead to put the warrant back to Entity A on that date for $2, and to require settlement in cash. If the share price on the settlement date is greater than $12, Holder would be expected to exercise the warrant, obligating Entity A to issue a fixed number of shares in exchange for a fixed amount of cash. That feature does not result in a liability under paragraphs 480-10-25-8 through 25-12. However, if the share price is equal to or less than $12, Holder would be expected to put the warrant back to Entity A and could choose to obligate Entity A to pay $2 in cash. That feature does result in a liability, because the financial instrument embodies an obligation that is indexed to an obligation to repurchase the issuer's shares (as the share price decreases toward $12, the fair value of the issuer's obligation to stand ready to pay $2 begins to increase) and may require a transfer of assets. Therefore, paragraphs 480-10-25-8 through 25-12 require Entity A to classify the instrument as a liability.

ASC 480-10-55-30 and 55-31 illustrate the application of ASC 480-10-55-8 through 55-12 to a physically settled warrant that (1) obligates the issuer to deliver a fixed number of nonredeemable equity shares in exchange for cash if the holder elects to exercise it and (2) contains a put feature that permits the holder to require the issuer to redeem the warrant for cash. In such a scenario, the put feature causes the entire warrant to be classified as a liability under ASC 480-10-25-8 because that feature is indexed
Chapter 5 — Obligations to Repurchase Shares by Transferring Assets

to an obligation to repurchase the issuer’s shares and may require the issuer to transfer assets. The fact that the warrant has a potential settlement outcome for which asset or liability classification is not required under ASC 480-10 is irrelevant to the accounting analysis if at least one of the warrant’s settlement outcomes is subject to ASC 480-10-25-8. If the warrant instead had been issued without the put feature, it would have been outside the scope of ASC 480-10 because that guidance does not apply to a written warrant that requires the issuer to deliver a fixed number of nonredeemable equity shares upon exercise.

In the example in ASC 480-10-55-31, the put feature is exercisable on the same date as the option to require delivery of a fixed number of shares. If the facts in ASC 480-10-55-31 were changed so that the put feature was not exercisable until a later date (e.g., the put was embedded in the shares delivered upon exercise) or was conditional upon the occurrence or nonoccurrence of an uncertain future event (e.g., a change in control), the classification of the warrant as a liability under ASC 480-10-25-8 would not change, because the possibility that the instrument will require the issuer to settle the obligation by transferring assets is sufficient for liability classification. Further, the warrant would be classified as a liability even if the put feature is not expected to be exercised.

5.3 Accounting

The initial and subsequent accounting for a financial instrument classified as an asset or a liability under ASC 480-10-25-8 depends on whether it is a forward contract that requires physical settlement by repurchase of a fixed number of equity shares in exchange for cash (including foreign currency).

5.3.1 Forward Contracts That Require Physical Settlement by Repurchase of a Fixed Number of Shares for Cash

5.3.1.1 Scope

Under ASC 480-10, unconditional forward purchase contracts that require physical settlement by repurchase of a fixed number of the issuer’s shares for cash are treated as treasury stock transactions that use borrowed funds (i.e., debit to equity, credit to payable) rather than as derivatives or executory contracts. In other words, such transactions are treated as if the repurchase has already occurred and the payment for the shares has been financed with interest on the financing arising from the difference between the spot price of the shares repurchased and the ultimate settlement amount paid on the forward settlement date.

Paragraph B27 of the Background Information and Basis for Conclusions of FASB Statement 150 states, in part:

Forward purchase contracts that must be physically settled by delivering cash in exchange for shares embody an unconditional obligation to transfer cash to pay the full repurchase price. The Board considers that situation as more akin to a treasury stock purchase using borrowed funds than to participating in a derivative instrument; put another way, such a forward contract effectively converts the shares that the counterparty must deliver into mandatorily redeemable instruments, which this Statement classifies as liabilities. The Board rejected the view that forward purchase contracts that must be physically settled by delivering cash should be reported like other derivative instruments.

The special accounting for physically settled forward contracts to repurchase shares applies irrespective of whether the amount of cash the issuer will pay is fixed or variable (e.g., a stated amount of cash plus interest at a variable interest rate). However, the accounting does not apply to forward contracts that have settlement alternatives (e.g., the holder or the issuer has the option to elect net cash settlement or net share settlement). Further, the guidance does not apply to forward contracts that require the issuer
to transfer noncash assets (e.g., debt securities) rather than cash to settle the contract. Paragraph B80 of the Background Information and Basis for Conclusions of FASB Statement 150 states, in part:

The Board views physically settled forward purchase contracts of an entity’s own shares in exchange for cash as being similar to financing a stock purchase or a treasury stock transaction and, therefore, would require the recognition of a liability for the future sacrifice of assets, but that view holds only if the obligation to purchase is unconditional and requires physical settlement in exchange for cash.

Forward contracts that require physical settlement by repurchase of a fixed number of the issuer’s shares for cash are outside the scope of the derivative accounting literature under ASC 815-10-15-74(d) and cannot be designated as derivative hedging instruments (see Section 2.3.1).

The special measurement guidance in ASC 480-10 on gross physically settled forward contracts does not apply to forward contracts that will be settled by the delivery of noncash assets. Such forward contracts are instead measured at their fair value (see Section 5.3.2). Paragraphs B29 and B61 of the Background Information and Basis for Conclusions of FASB Statement 150 state, in part:

Forward purchase contracts that must be physically settled by delivering assets other than cash in exchange for shares — barter contracts — also embody an unconditional obligation. However, the Board did not consider barter contracts akin to a treasury stock purchase using borrowed funds, since no cash is involved. Therefore, it decided that those contracts should be accounted for in the same manner as conditional obligations to purchase the issuer’s equity shares. . . . If the exchange involves barter (for example, specified quantities of gold for shares), the Board saw no reason to reconsider, in this limited scope project, guidance under [ASC 815-10] under which that forward purchase contract would be accounted for as a derivative at its fair value.

5.3.1.2 Initial Measurement

<table>
<thead>
<tr>
<th>ASC 480-10</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>30-3</strong> Forward contracts that require physical settlement by repurchase of a fixed number of the issuer’s equity shares in exchange for cash shall be measured initially at the fair value of the shares at inception, adjusted for any consideration or unstated rights or privileges.</td>
</tr>
<tr>
<td><strong>30-4</strong> Two ways to obtain the adjusted fair value include:</td>
</tr>
<tr>
<td>a. Determining the amount of cash that would be paid under the conditions specified in the contract if the shares were repurchased immediately</td>
</tr>
<tr>
<td>b. Discounting the settlement amount, at the rate implicit at inception after taking into account any consideration or unstated rights or privileges that may have affected the terms of the transaction.</td>
</tr>
<tr>
<td><strong>30-5</strong> Equity shall be reduced by an amount equal to the fair value of the shares at inception.</td>
</tr>
<tr>
<td><strong>30-6</strong> Cash (as that term is used in paragraph 480-10-30-3) includes foreign currency, so physically settled forward purchase contracts in exchange for foreign currency shall be measured as provided in paragraphs 480-10-30-3 through 30-5 and 480-10-35-3, then remeasured under Topic 830.</td>
</tr>
</tbody>
</table>

Although ASC 480-10-30-3 specifies that a forward contract that requires settlement by repurchase of a fixed number of shares for cash should initially be measured at the “fair value of the shares at inception, adjusted for any consideration or unstated rights or privileges,” ASC 480-10-30-4 permits an entity to use the following approaches in determining that amount:

- The “amount of cash that would be paid under the conditions specified in the contract if the shares were repurchased immediately.” This amount is not discounted. In a manner consistent with the guidance on subsequent measurement in ASC 480-10-35-3(b), this method may be suitable when either the amount to be paid or the settlement date varies.
• The present value of “the settlement amount [discounted] at the rate implicit at inception.” In a manner consistent with the guidance on subsequent measurement in ASC 480-10-35-3(a), this method may be suitable when the amount to be paid and the settlement date are both fixed.

Regardless of the approach used, the entity should consider the need to adjust the accounting for the forward contract to reflect any consideration (e.g., if either party made an up-front cash payment) or unstated (or stated) rights or privileges that may have affected the terms of the transaction (e.g., off-market terms). Unlike ASC 480-10-30-3 and 30-4(b), ASC 480-10-30-4(a) does not specifically mention the need for such an adjustment when the initial measurement is determined on the basis of the amount of cash that would be paid under the conditions specified in the contract if the shares were repurchased immediately. However, in paragraph B61 of the Background Information and Basis for Conclusions of FASB Statement 150, the Board suggests that, in such a scenario, an entity also should adjust the accounting “for any consideration or unstated rights or privileges.”

The requirement in ASC 480-10-30 to adjust the initial measurement to reflect any consideration or unstated rights or privileges is analogous to the requirement in ASC 835-30-25-6 to separately recognize any unstated (or stated) rights or privileges upon the issuance of a note (e.g., when an entity lends cash at no interest in exchange for a contract to purchase products at a below-market price, the difference between the amount of cash lent and the present value of the receivable may represent an addition to the cost of the products purchased).

The issuer recognizes the forward by crediting liabilities and debiting equity for the amount of the initial measurement. (If the forward is over the shares of a consolidated subsidiary, the noncontrolling interest would be debited.) In effect, the forward is accounted for as if two transactions had occurred: (1) a spot repurchase of the shares that will be repurchased under the contract and (2) the issuance of debt for the obligation to pay the share repurchase price on the forward settlement date.

5.3.1.3 Subsequent Measurement

| ASC 480-10 | 35-3 Forward contracts that require physical settlement by repurchase of a fixed number of the issuer’s equity shares in exchange for cash and mandatorily redeemable financial instruments shall be measured subsequently in either of the following ways:
|  | a. If both the amount to be paid and the settlement date are fixed, those instruments shall be measured subsequently at the present value of the amount to be paid at settlement, accruing interest cost using the rate implicit at inception.
|  | b. If either the amount to be paid or the settlement date varies based on specified conditions, those instruments shall be measured subsequently at the amount of cash that would be paid under the conditions specified in the contract if settlement occurred at the reporting date, recognizing the resulting change in that amount from the previous reporting date as interest cost.
| 35-4 Cash (as that term is used in the preceding paragraph) includes foreign currency, so physically settled forward purchase contracts in exchange for foreign currency shall be measured as provided in the preceding paragraph then remeasured under Topic 830. |

The subsequent measurement guidance that applies to forward contracts that require physical settlement by repurchase of a fixed number of the issuer’s equity shares in exchange for cash is similar to the guidance applicable to mandatorily redeemable financial instruments (see Section 4.3). Thus, the
“debt” component of such a forward contract is measured subsequently in one of two ways depending on whether the repurchase amount or the repurchase date varies on the basis of specified conditions:

<table>
<thead>
<tr>
<th>Repurchase Amount</th>
<th>Repurchase Date</th>
<th>Subsequent Measurement</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fixed</td>
<td>Fixed</td>
<td>Present value of the amount to be paid at settlement discounted by using the implicit rate at inception (i.e., effective interest method)</td>
</tr>
<tr>
<td>Fixed</td>
<td>Varies</td>
<td>Amount of cash that would be paid under the conditions specified in the contract if settlement occurred as of the reporting date (settlement value)</td>
</tr>
<tr>
<td>Varies</td>
<td>Fixed</td>
<td>Varies</td>
</tr>
<tr>
<td>Varies</td>
<td>Varies</td>
<td>Varies</td>
</tr>
</tbody>
</table>

Paragraph B27 of the Background Information and Basis for Conclusions of FASB Statement 150 states, in part:

The Board concluded that the unconditional obligation should result in recognition of a liability that, like many other liabilities that require cash payments, should be subsequently measured at the present value of the full repurchase price, if the amounts to be paid and the settlement date are fixed, or at the (undiscounted) amounts that would be paid under the conditions specified in the contract if the shares were repurchased at the reporting date if the amounts or settlement date can vary.

5.3.1.3.1 Fixed Date and Fixed Amount

If the repurchase date and the repurchase amount are both fixed, the instrument is subsequently measured at the present value of the amount to be paid at settlement, discounted by using the implicit rate at inception. The implicit rate is calculated by using the effective interest method (i.e., the rate that makes the present value of the instrument’s cash flows equal to the initial measurement amount).

5.3.1.3.2 Variable Date or Redemption Amount

If either the repurchase date or the repurchase amount or both vary, the instrument is subsequently measured at the amount of cash that would be paid under the conditions specified in the contract if settlement occurred as of the reporting date. Under this method, the amount to be paid is not discounted. Examples of instruments with a varying redemption amount include those for which the repurchase amount is based on the issuer’s stock price or a formula (e.g., one that depends on the issuer’s most recent financial year’s EBIT or EBITDA). An example of an instrument for which the redemption date varies includes one that will be settled upon the occurrence of an event that is certain to occur but whose timing is uncertain.

In estimating the amount of cash that would be paid under the conditions specified in the contract if settlement occurred as of the reporting date, an issuer should not incorporate projected changes in the factors that affect a variable repurchase price (e.g., forward projections of EBITDA if the repurchase price is a function of EBITDA). Instead, the issuer should calculate the repurchase amount on the basis of the conditions that exist as of the balance sheet date (e.g., the most recent EBITDA measure if the repurchase price is a function of EBITDA). This view is consistent with the guidance that applies to redeemable equity securities classified in temporary equity under ASC 480-10-S99-3A (see Section 9.5.2). Paragraph 14 of ASC 480-10-S99-3A states, in part:

If the maximum redemption amount is contingent on an index or other similar variable (for example, the fair value of the equity instrument at the redemption date or a measure based on historical EBITDA), the amount presented in temporary equity should be calculated based on the conditions that exist as of the balance sheet date (for example, the current fair value of the equity instrument or the most recent EBITDA measure).
We believe that if the repurchase amount varies (e.g., as a function of EBITDA), an entity should not reduce the carrying amount of the liability below the initially recorded amount, because ASC 480-10-45-3 implies that the amount of reported interest cost cannot be less than zero on a cumulative basis from the date of initial recognition. This is consistent with the view that an entity cannot recognize interest income on a liability as well as with the guidance that applies to redeemable securities classified in temporary equity under ASC 480-10-599-3A (see Section 9.5.2). Paragraph 16(e) of ASC 480-10-599-3A states, in part:

[The amount presented in temporary equity should be no less than the initial amount reported in temporary equity for the instrument. That is, reductions in the carrying amount of a redeemable equity instrument . . . are appropriate only to the extent that the registrant has previously recorded increases in the carrying amount of the redeemable equity instrument.]

If the instrument is redeemed for an amount less than its net carrying amount, the issuer recognizes the difference as an extinguishment gain.

5.3.1.3.3 Interest Cost

<table>
<thead>
<tr>
<th>ASC 480-10</th>
</tr>
</thead>
<tbody>
<tr>
<td>45-3 Any amounts paid or to be paid to holders of the contracts discussed in paragraph 480-10-35-3 in excess of the initial measurement amount shall be reflected in interest cost.</td>
</tr>
</tbody>
</table>

After the execution of a forward contract that requires physical settlement by repurchase of a fixed number of the issuer's equity shares in exchange for cash, changes in the contract's carrying amount and any amounts paid to the holder in excess of the initial measurement amount must be presented as interest cost.

5.3.1.4 Example

<table>
<thead>
<tr>
<th>ASC 480-10</th>
</tr>
</thead>
<tbody>
<tr>
<td>55-14 For example, an entity may enter into a forward contract to repurchase 1 million shares of its common stock from another party 2 years later. At inception, the forward contract price per share is $30, and the current price of the underlying shares is $25. The contract's terms require that the entity pay cash to repurchase the shares (the entity is obligated to transfer $30 million in 2 years). Because the instrument embodies an unconditional obligation to transfer assets, it is a liability under paragraphs 480-10-25-8 through 25-12. The entity would recognize a liability and reduce equity by $25 million (which is the present value, at the 9.54 percent rate implicit in the contract, of the $30 million contract amount, and also, in this example, the fair value of the underlying shares at inception). Interest would be accrued over the 2-year period to the forward contract amount of $30 million, using the 9.54 percent rate implicit in the contract. If the underlying shares are expected to pay dividends before the repurchase date and that fact is reflected in the rate implicit in the contract, the present value of the liability and subsequent accrual to the contract amount would reflect that implicit rate. Amounts accrued are recognized as interest cost.</td>
</tr>
</tbody>
</table>

55-15 In this example, no consideration or other rights or privileges changed hands at inception. If the same contract price of $30 per share had been agreed to even though the current price of the issuer's shares was $30, because the issuer had simultaneously sold the counterparty a product at a $5 million discount, that right or privilege unstated in the forward purchase contract would be taken into consideration in arriving at the appropriate implied discount rate — 9.54 percent rather than 0 percent — for that contract. That entity would recognize a liability for $25 million, reduce equity by $30 million, and increase its revenue for the sale of the product by $5 million. Alternatively, if the same contract price of $30 per share had been agreed to even though the current price of the issuer's shares was only $20, because the issuer received a $5 million payment at inception of the contract, the issuer would recognize a liability for $25 million and reduce equity by $20 million. In both examples, interest would be accrued over the 2-year period using the 9.54 percent implicit rate, increasing the liability to the $30 million contract price.
If a variable-rate forward contract requires physical settlement, a different measurement method is required subsequently, as set forth in paragraph 480-10-35-3.

The three related examples in ASC 480-10-55-14 and 55-15 illustrate the accounting for physically settled forward purchase contracts that require the repurchase of a fixed number of equity shares for cash. In each of the examples, the issuer is obligated to repurchase equity shares in exchange for cash of $30 million in two years. Further, the initial amount of the liability recognized is the same in the examples ($25 million). However, the fair value of the shares at inception differs and, in two of the examples, consideration or other rights or privileges are exchanged.

In the example in ASC 480-10-55-14, no consideration or other rights or privileges are exchanged at the inception of the contract, and the fair value of the shares at inception is $25 million. Under ASC 480-10-30-3, the liability is initially recognized at an amount equal to fair value of the shares at inception ($25 million). In accordance with ASC 480-10-30-5, the offsetting entry is to equity. Accordingly, the accounting entries at inception are (in millions):

<table>
<thead>
<tr>
<th>Equity</th>
<th>25</th>
</tr>
</thead>
<tbody>
<tr>
<td>Liability</td>
<td>25</td>
</tr>
</tbody>
</table>

In the two examples in ASC 480-10-55-15, consideration or other unstated rights or privileges are exchanged at inception:

- In the first example in ASC 480-10-55-15, the fair value of the shares at inception is $30 million. The repurchase price in two years is also $30 million, which is favorable to the issuer. To compensate the counterparty, the issuer provides a sales discount of $5 million to the counterparty at the same time as the issuance of the forward contract. In accordance with ASC 480-10-30-3, the liability is initially recognized at $25 million, which is the fair value of the shares at inception ($30 million) adjusted for the value of the sales discount ($5 million). Under ASC 480-10-30-5, the offsetting entry reduces equity. The value of the sales discount represents consideration paid for the off-market element of the contract to repurchase equity shares and reduces equity by another $5 million, with an offsetting entry to sales revenue. Thus, the accounting entries at inception are (in millions):

<table>
<thead>
<tr>
<th>Equity</th>
<th>30</th>
</tr>
</thead>
<tbody>
<tr>
<td>Liability</td>
<td>25</td>
</tr>
<tr>
<td>Sales revenue</td>
<td>5</td>
</tr>
</tbody>
</table>

- In the second example in ASC 480-10-55-15, the fair value of the shares at inception is $20 million. The repurchase price in two years is $30 million, which is unfavorable to the issuer. To compensate the issuer, the counterparty pays $5 million at the inception of the forward contract. In accordance with ASC 480-10-30-3, the liability is initially recognized at an amount equal to the fair value of the shares at inception ($20 million), adjusted for the cash payment received ($5 million). The initial measurement of the liability is therefore $25 million. Under ASC 480-10-30-5, the offsetting entry is to equity. The up-front cash payment of $5 million is consideration received from the counterparty for the off-market element of the contract to
repurchase equity shares and increases cash and equity by $5 million. Therefore, the accounting entries at inception are as follows (in millions):

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>5</td>
</tr>
<tr>
<td>Equity</td>
<td>20</td>
</tr>
<tr>
<td>Liability</td>
<td>25</td>
</tr>
</tbody>
</table>

While not discussed in ASC 480-10-55-14 and 55-15, the implicit rate used to calculate interest cost over the life of the instrument in each of the three examples is determined by solving for the interest rate that equates the present value of $30 million in two years to the initial measurement amount of $25 million. If annual compounding is used, this rate is approximately 9.545 percent. In year one, the issuer records interest cost of $2.386 million by increasing the carrying amount of the liability to $27.386 million. In year two, the issuer records interest cost of $2.614 million by increasing the carrying amount to $30 million, which equals the settlement amount to be paid in cash at that time.

### 5.3.2 Other Contracts

<table>
<thead>
<tr>
<th>ASC 480-10</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>30-7</strong>  All other financial instruments recognized under the guidance in Section 480-10-25 shall be measured initially at fair value.</td>
</tr>
<tr>
<td><strong>35-1</strong>  Financial instruments within the scope of Topic 815 shall be measured subsequently as required by the provisions of that Topic.</td>
</tr>
<tr>
<td><strong>35-4A</strong> Contingent consideration issued in a business combination that is classified as a liability in accordance with the requirements of this Topic shall be subsequently measured at fair value in accordance with 805-30-35-1.</td>
</tr>
<tr>
<td><strong>35-5</strong>  All other financial instruments recognized under the guidance in Section 480-10-25 shall be measured subsequently at fair value with changes in fair value recognized in earnings, unless either this Subtopic or another Subtopic specifies another measurement attribute.</td>
</tr>
<tr>
<td><strong>55-17</strong> In contrast to forward purchase contracts that require physical settlement in exchange for cash, forward purchase contracts that require or permit net cash settlement, require or permit net share settlement, or require physical settlement in exchange for specified quantities of assets other than cash are measured initially and subsequently at fair value, as provided in paragraphs 480-10-30-2, 480-10-30-7, 480-10-35-1, and 480-10-35-5 (as applicable), and classified as assets or liabilities depending on the fair value of the contracts on the reporting date.</td>
</tr>
</tbody>
</table>
Except for forward contracts that require the issuer to repurchase a fixed number of shares for cash, contracts that are classified as assets or liabilities under ASC 480-10-25-8 are measured initially and subsequently at their fair value (i.e., they are accounted for in a manner similar to derivatives under ASC 815-10). For example, this measurement applies to:

- Net-cash-settled forward purchase contracts on own stock.
- Forward purchase contracts on own stock that permit the counterparty to elect either net cash settlement or net share settlement.
- Forward contracts that require or may require the repurchase of a variable number of equity shares for cash.
- Forward contracts that require or may require the repurchase of equity shares for noncash assets.
- Written put options on own equity shares that require or may require the repurchase of equity shares by the transfer of assets.
- Written warrants or call options on own equity shares that require or may require the repurchase of the warrants or options by the transfer of assets.
- Written warrants or call options on equity shares that require or may require the repurchase of the equity shares that would be delivered upon the exercise of the warrant or option by the transfer of assets.

5.4 Reassessment

Under ASC 480-10-25-8, an issuer assesses at inception whether a financial instrument, other than an outstanding share, embodies an obligation to repurchase the issuer’s equity shares (or is indexed to such an obligation) and therefore requires or may require the issuer to settle the obligation by transferring assets. We believe that if an outstanding instrument ceases to embody such an obligation after inception (e.g., because the contract specifies that the obligation expires on a specific date or upon the occurrence of a specified event, such as an IPO), an issuer may elect to apply either of the following two views as an accounting policy choice under ASC 480-10-25-8:

- **View A: No reassessment** — An issuer does not subsequently reassess whether an instrument should be classified as an asset or a liability under ASC 480-10-25-8 unless the instrument is treated as a new instrument for accounting purposes (e.g., as a result of a modification or exchange that is accounted for as an extinguishment of the existing instrument; see ASC 470-50). That is, the issuer applies literally the requirement in ASC 480-10-25-8 to perform the evaluation “at inception.”

- **View B: Reassessment** — An issuer reassesses whether an instrument that was classified as an asset or a liability under ASC 480-10-25-8 should continue to be classified as an asset or a liability under ASC 480-10, ASC 815-40, and any other applicable GAAP if the obligation that caused the instrument to be classified as an asset or a liability under ASC 480-10-25-8 no longer exists. That is, the classification of an instrument reflects its operative terms as of the assessment date, but not any expired terms. (As discussed in Section 3.2.1, however, the issuer does not reassess whether any feature is nonsubstantive or minimal after inception.) If reclassification is appropriate, it is performed as of the date the obligation ceases to exist. This view is consistent with the reassessment guidance in ASC 480-10-25-4 (see Section 4.4.1) and ASC 815-40 that applies to instruments within the scope of that guidance (see Section 5.4 of Deloitte’s *A Roadmap to Accounting for Contracts on an Entity’s Own Equity*).
Example 5-3

Company A issues physically settled warrants on its convertible preferred stock. The convertible preferred stock includes a provision that requires A to redeem the stock for cash upon a deemed liquidation event (e.g., a change of control). Further, the convertible preferred stock includes a mandatory conversion feature that requires the stock to be converted into nonredeemable common stock upon an IPO. If an IPO were to occur, therefore, the warrants would no longer be settleable in convertible preferred stock but in nonredeemable common stock. At inception, A classifies the warrants as liabilities under ASC 480-10-25-8 because the deemed liquidation provision represents an obligation to repurchase shares of A's convertible preferred stock that may require the issuer to transfer assets under ASC 480-10-25-8 (see Section 5.2.2).

After inception, A undergoes an IPO. On the IPO date, all of A's outstanding series of convertible preferred stock are converted into shares of nonredeemable common stock in accordance with the mandatory conversion terms of the convertible preferred stock. Further, the warrants are no longer settleable in convertible preferred stock. Therefore, the warrants no longer embody an obligation that requires or may require the issuer to transfer assets under ASC 480-10-25-8.

We believe that depending on its accounting policy for reassessment under ASC 480-10-25-8, A could elect either to continue to classify the warrants as liabilities under ASC 480-10-25-8 or to reclassify them to equity provided that they meet all the conditions for equity classification in ASC 815-40 and any other applicable GAAP.
Chapter 6 — Certain Variable-Share Obligations

This chapter discusses the requirements in ASC 480-10 related to certain financial instruments that embody an obligation to issue a variable number of shares, including the scope of this classification category (see Section 6.1); certain application issues (see Section 6.2); accounting (see Section 6.3); and the absence of reassessments (see Section 6.4).

6.1 Classification

6.1.1 Overview

ASC 480-10

25-14 A financial instrument that embodies an unconditional obligation, or a financial instrument other than an outstanding share that embodies a conditional obligation, that the issuer must or may settle by issuing a variable number of its equity shares shall be classified as a liability (or an asset in some circumstances) if, at inception, the monetary value of the obligation is based solely or predominantly on any one of the following:

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

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

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

See paragraph 480-10-55-21 for related implementation guidance.

In certain circumstances, ASC 480-10 requires an issuer to classify share-settled obligations as assets or liabilities even if the issuer is not required to deliver cash or other assets. ASC 480-10-25-14 applies to a financial instrument with all of the following characteristics:

- It embodies an obligation (see Section 6.1.1.1). If the instrument is an outstanding share, the obligation must be unconditional. For other instruments, the obligation may be either conditional or unconditional.
- It requires or may require the issuer to settle the obligation by delivering a variable number of its equity shares (see Section 6.1.2).
- The monetary value of the obligation is based solely or predominantly on one of three specified factors (see Sections 6.1.1.3, 6.1.2, 6.1.3, and 6.1.4).

If a financial instrument embodies an obligation that the entity must or may settle by delivering its own equity shares, the issuer should evaluate whether the instrument must be classified as an asset or a liability under ASC 480-10-25-14.
6.1.1.1 Obligation

Like other requirements in ASC 480-10, ASC 480-10-25-14 applies only to instruments that embody obligations of the issuer (see Section 2.2.1).

For outstanding shares (e.g., convertible preferred stock), that guidance is limited to obligations that are unconditional and for which the delivery of a variable number of equity shares is certain to occur (e.g., mandatory conversion of preferred shares into a variable number of common shares). If an outstanding share conditionally requires the issuer to deliver a variable number of shares (e.g., upon an IPO, a change of control, or the holder's exercise of an embedded put option), ASC 480-10-25-14 does not apply.

For financial instruments other than an outstanding share (e.g., net-share-settled written put options and forward contracts), ASC 480-10-25-14 applies irrespective of whether the obligation is unconditional or conditional (e.g., contingent on the counterparty’s exercise of an option). The issuer’s purchased put or call option on the issuer’s equity shares would not be within the scope of ASC 480-10, however, because it does not embody an obligation of the issuer.

6.1.1.2 Requires or May Require the Transfer of a Variable Number of Equity Shares

### ASC 480-10 — Glossary

<table>
<thead>
<tr>
<th><strong>Equity Shares</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity shares refers only to shares that are accounted for as equity.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th><strong>Net Share Settlement</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>A form of settling a financial instrument under which the entity with a loss delivers to the entity with a gain shares of stock with a current fair value equal to the gain.</td>
</tr>
</tbody>
</table>

Although an obligation to deliver equity shares is not included in the definition of a liability in FASB Concepts Statement 6, certain of these obligations must be classified as liabilities under ASC 480-10-25-14 (see Section 2.2.1.1). The FASB developed this requirement because it was concerned that some share-settled obligations have risks and benefits that are dissimilar from ownership interests. Paragraphs B31 and B36 of the Background Information and Basis for Conclusions of FASB Statement 150 state, in part:

> [C]ertain share-settled obligations establish relationships that, in the Board’s view, have little if anything in common with ownership interests. . . . To be classified as equity, the Board believes that an obligation must expose the holder of the instrument that embodies that obligation to certain risks and benefits that are similar to those to which an owner (that is, a holder of an outstanding share of the entity’s equity) is exposed.

### Example 6-1

An instrument embodies an obligation that the issuer must or may settle in its own equity shares. The terms of the instrument specify that the number of shares that will be delivered is variable and that the shares will have an aggregate settlement-date fair value equal to the monetary amount of the obligation. The monetary amount of the obligation might be fixed (e.g., $10,000), indexed (e.g., $10,000 adjusted for changes in the price of gold), or move inversely with changes in the entity’s stock price (e.g., when the stock price increases, the monetary amount of the obligation decreases). Accordingly, although the issuer uses its own equity shares to settle the obligation, the risks and benefits associated with holding the obligation are dissimilar from those associated with holding equity shares. Effectively, the issuer is using its own shares as a means of payment (currency) to settle an obligation whose risks and characteristics are different from those of equity shares.
ASC 480-10-25-14 only applies to contracts that may require the issuance of a variable number of shares. It does not apply to contracts that require the issuance of a fixed number of shares.

**Example 6-2**

Under a range forward sales contract, an issuer agrees to sell a fixed number of its own shares in exchange for cash. The cash price is defined as the current stock price subject to a cap ($80) and a floor ($60). Accordingly, the issuer’s economic payoff profile is similar to the purchase of a put option (the floor) and the sale of a call option (the cap) on its own stock. The contract would be outside the scope of ASC 480-10 because it is not a mandatorily redeemable financial instrument, it does not embody an obligation to repurchase shares by transferring assets (it is selling shares), and it requires the issuance of a fixed number of shares for a variable amount of cash. (Note, however, that if the issuer instead was obligated to deliver a variable number of shares subject to a cap and a floor, the contract potentially would be within the scope of ASC 480-10. See Section 6.2.4).

ASC 480-10-25-14 does not apply to obligations that require or may require the issuer to deliver cash or other assets. Such obligations are instead evaluated under ASC 480-10-25-4 and ASC 480-10-25-8 (see Chapters 4 and 5). Obligations that the issuer is permitted to settle either in cash or a variable number of shares, however, should be assessed under ASC 480-10-25-14 (see Section 6.2.6).

### 6.1.1.3 Monetary Value

**ASC 480-10**

05-4 For certain financial instruments, Section 480-10-25 requires consideration of whether monetary value would remain fixed or would vary in response to changes in market conditions.

05-5 How the monetary value of a financial instrument varies in response to changes in market conditions depends on the nature of the arrangement, including, in part, the form of settlement.

**ASC 480-10 — Glossary**

**Monetary Value**

What the fair value of the cash, shares, or other instruments that a financial instrument obligates the issuer to convey to the holder would be at the settlement date under specified market conditions.

In determining whether a financial instrument that embodies a share-settled obligation must be accounted for as an asset or a liability, an issuer is required under ASC 480-10-25-14 to evaluate the monetary value of the obligation. That value is defined in ASC 480-10-20 by reference to the fair value of the shares or other items the issuer is required to deliver on the settlement date of the instrument. Paragraphs B38 and B39 of the Background Information and Basis for Conclusions of FASB Statement 150 state, in part:

The Board developed the notion of monetary value to assist in determining whether the risks or benefits from changes in fair value of the issuer’s equity shares to which a holder of a financial instrument that embodies an obligation is exposed are similar to those to which a holder of outstanding equity shares is exposed. . . The Board concluded that the relationship between changes in the monetary value of an instrument that embodies an obligation and changes in the fair value of the issuer’s equity shares during the period the obligation is outstanding would be an effective basic principle to assess whether the holder of the instrument is exposed to risks and benefits that are similar to those to which a holder of a corresponding number of outstanding equity shares (an owner) is exposed.

Under ASC 480-10-25-14, a share-settled obligation (which must be unconditional if the instrument is an outstanding share but otherwise could be either conditional or unconditional) is classified as an asset
Chapter 6 — Certain Variable-Share Obligations

or a liability if, at inception, the obligation’s monetary value is based solely or predominantly on one of three factors:

- A fixed monetary amount known at inception (see Section 6.1.2).
- Variations in something other than the fair value of the issuer’s equity shares (see Section 6.1.3).
- Variations inversely related to changes in the fair value of the issuer’s equity shares (see Section 6.1.4).

The FASB concluded that the requirement in ASC 480-10-25-14 should apply not just to obligations whose monetary value is based solely on one of the three factors identified in that paragraph but also to those whose monetary value is based *predominantly* on one of them. The Board was concerned that an entity otherwise might structure transactions to circumvent the requirement. For example, an issuer is not able to avoid liability classification by “embedding a small amount of monetary value variation in response to changes in the fair value of the issuer’s equity shares [if] the overall variation would predominantly respond to something else” (see paragraph B47 of the Background Information and Basis for Conclusions of FASB Statement 150).

ASC 480-10 does not define “predominantly.” In developing the requirements in ASC 480-10, the FASB acknowledged that an entity will need to use judgment in assessing predominance. Paragraph B47 of the Background Information and Basis for Conclusions of FASB Statement 150 states, in part:

> [J]udgment will be required to distinguish instruments with monetary values predominantly based on one of those three factors from instruments with monetary values that are indexed both to the issuer’s equity shares and to one or more other factors and, thus, are excluded from this Statement’s scope.

In the predominance assessment, different considerations apply depending on whether the instrument embodies a single, dual-indexed obligation (see Section 6.2.3) or multiple-component obligations (see Section 6.2.4).

A share-settled obligation may have multiple possible outcomes, and some (but not all) of those outcomes may have a monetary value that is determined on the basis of one of the three factors in ASC 480-10-25-14. In practice, we have considered an outcome to be predominant if it is more likely than not (i.e., greater than 50 percent) to occur (see Section 6.2.4). Accordingly, if an outcome is reasonably possible, but not more likely than not, to occur, it is not predominant.

The following table provides some examples of contracts that would be accounted for as assets or liabilities because they require or may require the issuer to deliver a variable number of equity shares and have a monetary value that is based solely or predominantly on one of the factors in ASC 480-10-25-14:

<table>
<thead>
<tr>
<th>Fixed monetary value (see Section 6.1.2)</th>
<th>• Share-settled debt (e.g., an obligation to pay a supplier for goods or services that will be settled in a variable number of the issuer’s equity shares worth a fixed monetary amount)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>• A preferred equity security that is mandatorily convertible into a variable number of common shares worth a fixed monetary amount</td>
</tr>
<tr>
<td></td>
<td>• A prepaid variable share forward on the entity’s stock that obligates the entity to deliver shares with a monetary value that is predominantly a fixed monetary amount known at inception</td>
</tr>
<tr>
<td></td>
<td>• A puttable warrant that gives the counterparty the right to either (1) purchase a fixed number of the issuer’s equity shares for cash or (2) require the issuer to repurchase the warrant for a specified fixed monetary amount payable in a variable number of shares</td>
</tr>
<tr>
<td></td>
<td>• A prepaid forward sale contract on a variable number of shares worth a fixed monetary amount</td>
</tr>
</tbody>
</table>
Examples of contracts that would not be accounted for as assets or liabilities under ASC 480-10-25-14 because their monetary value moves directly with the fair value of the issuer's equity shares include:

- Fixed-for-fixed net-share-settled forward contracts to sell the issuer's equity shares.
- Fixed-for-fixed net-share-settled written call options on the issuer's equity shares.

ASC 480-10

55-2 Paragraph 480-10-05-5 explains that how the monetary value of a financial instrument varies in response to changes in market conditions depends on the nature of the arrangement, including, in part, the form of settlement. For example, for a financial instrument that embodies an obligation that requires:

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

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

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

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

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

55-51 Some financial instruments that are composed of more than one option or forward contract embody an obligation to issue a fixed number of shares and, once those shares are issued, potentially to issue a variable number of additional shares. The issuer must analyze that kind of financial instrument, at inception, to assess whether the possibility of issuing a variable number of shares in which the monetary value of that obligation meets one of the conditions in paragraph 480-10-25-14 is predominant.
ASC 480-10-55-2 illustrates how the monetary value of various financial instruments may be defined:

- The financial instruments in ASC 480-10-55-2(a) and (b) represent obligations for a fixed monetary amount.
- The financial instruments in ASC 480-10-55-2(c) and (d) have a monetary value that is based on the issuer's equity shares.
- The financial instrument in ASC 480-10-55-2(e) has a monetary value that is based on a variable other than the issuer's stock price (e.g., the price of gold).

6.1.2 Fixed Monetary Amount Known at Inception

The first of the three categories of instruments that are classified as assets or liabilities under ASC 480-10-25-14 consists of those instruments that embody obligations that the issuer must or may satisfy by delivering a variable number of shares that have a monetary value that is fixed or predominantly fixed. For such instruments, the number of shares delivered is determined on the basis of (1) the fixed monetary amount and (2) the current stock price at settlement, so that the aggregate fair value of the shares delivered equals the monetary value of the obligation. Accordingly, the holder is not significantly exposed to gains and losses attributable to changes in the fair value of the issuer's equity shares. Instead the issuer is using its own equity shares as currency to settle a monetary obligation.

Paragraphs B13 and B42 of the Background Information and Basis for Conclusions of FASB Statement 150 state, in part:

[N]ot all . . . obligations [that require (or permit at the issuer's discretion) settlement by issuance of the issuer's equity shares] establish the type of relationship that exists between an entity and its owners. For example, a financial instrument that requires settlement by issuance of $100,000 worth of equity shares establishes something more akin to a debtor-creditor relationship than to an ownership relationship, because it requires that the issuer convey a fixed amount of value to the holder that does not vary with the issuer's equity shares. . . . The holder of that instrument does not benefit if the fair value of the issuer's equity shares increases and does not bear the risk that the fair value of those shares might decrease. The Board decided that that type of instrument 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 instrument has more characteristics of a liability than of equity because the holder's return is fixed and, thus, unrelated to changes in the fair value of the issuer's equity shares.
Example 6-3

The terms of a contract specify that the number of shares to be delivered will have an aggregate settlement-date fair value of $10,000 (i.e., the number of shares is defined as $10,000 divided by the current stock price). Although the number of equity shares to be delivered depends on the entity's stock price, the aggregate value of those shares does not depend on the stock price but represents a fixed monetary amount known at inception. If the stock price is $20 at settlement, the entity would deliver 500 shares. If the share price is $10, the entity would deliver 1,000 shares. In both cases, the value of the shares delivered equals $10,000.

A share is classified as a liability if it embodies an obligation that the issuer must or may satisfy by delivering a variable number of shares that have a monetary value that is fixed or predominantly fixed and the obligation is unconditional. Under this guidance, preferred stock is classified as a liability if it is mandatorily convertible into a variable number of common shares worth a fixed monetary amount on a specified date. ASC 480-10 does not apply if a share embodies a conditional obligation to deliver a variable number of shares (e.g., preferred stock that is mandatorily converted into a variable number of shares worth a fixed monetary amount upon an event that is not certain to occur, such as an IPO or the holder's exercise of a put option).

Instruments other than outstanding shares that embody an obligation that the issuer must or may satisfy by delivering a variable number of shares that have a monetary value that is fixed or predominantly fixed are classified as an asset or a liability irrespective of whether the obligation is conditional or unconditional.

Examples of obligations that are required to be classified as liabilities under ASC 480-10-25-14(a) are:

- Share-settled debt (i.e., obligations to deliver a variable number of common shares worth a fixed monetary amount).
- Preferred shares that are mandatorily convertible into a variable number of common shares equal in value to a fixed monetary amount. (However, the requirement does not apply to preferred shares that are optionally convertible, because outstanding shares that embody conditional obligations are exempt.)
- Warrants that upon exercise would be settled in a variable number of equity shares worth a fixed monetary amount.
- Mandatorily redeemable preferred shares that are contingently convertible into a variable number of shares worth a fixed monetary amount.

Some instruments permit multiple settlement methods that are triggered by predefined conditions. If only one of those methods requires the issuer to settle its obligation by issuing a variable number of shares equal in value to a fixed monetary amount known at inception, a question arises regarding whether the obligation's monetary value is based predominantly on a fixed monetary amount known at inception. A variable-share forward contract that involves the issuance of the entity's common stock is one example of this type of instrument. A variable-share forward has different outcomes depending on the price of the issuer's common stock as of the date the forward contract settles. If the stock price is within a specified range, the issuer will deliver a variable number of shares equivalent to a fixed monetary amount known at inception (the “dead zone”). We believe that the variable-share forward should be classified as a liability if it is more likely than not that the variable-share forward will settle within the range in which the company will issue a variable number of shares equal to a fixed monetary amount. An entity assesses this likelihood at inception of the contract (see Section 6.2.4).
6.1.3 Amount Indexed to Something Other Than Own Equity

<table>
<thead>
<tr>
<th>ASC 480-10</th>
</tr>
</thead>
<tbody>
<tr>
<td>25-14 A financial instrument that embodies an unconditional obligation, or a financial instrument other than an outstanding share that embodies a conditional obligation, that the issuer must or may settle by issuing a variable number of its equity shares shall be classified as a liability (or an asset in some circumstances) if, at inception, the monetary value of the obligation is based solely or predominantly on any one of the following: . . .</td>
</tr>
<tr>
<td>b. Variations in something other than the fair value of the issuer's equity shares (for example, a financial instrument indexed to the Standard and Poor's S&amp;P 500 Index and settleable with a variable number of the issuer's equity shares) . . .</td>
</tr>
</tbody>
</table>

The second of the three categories of instruments that are classified as assets or liabilities under ASC 480-10-25-14 consists of those instruments that require the issuer to deliver a variable number of shares that have a monetary value that is based solely or predominantly on variations in something other than the fair value of the issuer's equity shares. For instance, the amount may be calculated on the basis of changes in a stock market index (e.g., the S&P 500) or changes in a commodity price (e.g., the price of a specified quantity of gold). For such instruments, the number of shares delivered is determined on the basis of (1) the monetary value of the obligation and (2) the current stock price at settlement, so that the aggregate fair value of the shares delivered equals or approximates the monetary value of the obligation.

A share that embodies such an obligation is classified as a liability if the obligation is unconditional and the issuer must or may settle it in equity shares. Under this guidance, preferred stock that is mandatorily convertible into a variable number of common shares that have a monetary value that is based solely or predominantly on variations in something other than the fair value of the issuer's equity shares is classified as a liability. If a share embodies a conditional obligation to deliver a variable number of shares upon an event that is not certain to occur, such as an IPO or the holder's exercise of a put option, ASC 480-10 does not apply.

A contract other than shares that embody such an obligation is classified as an asset or a liability if the issuer must or may settle it in equity shares irrespective of whether the obligation is conditional or unconditional. For instance, certain contingent consideration arrangements in business combinations may fall within the scope of this requirement.

Examples of obligations that are required to be classified as liabilities under ASC 480-10-25-14(b) include:

- Preferred equity securities that are mandatorily convertible into a variable number of shares equal in value to the face value of the preferred stock adjusted for changes in the price of crude oil.
- Written call options on a fixed quantity of gold at a fixed strike price if the options are required to be settled in a variable number of the issuer's equity shares whose fair value at settlement is equal to the fair value of the options.
- Certain share-settled guarantee obligations (see Section 6.2.2).
6.1.4 Amount Inversely Related to Own Equity

**ASC 480-10**

25-14 A financial instrument that embodies an unconditional obligation, or a financial instrument other than an outstanding share that embodies a conditional obligation, that the issuer must or may settle by issuing a variable number of its equity shares shall be classified as a liability (or an asset in some circumstances) if, at inception, the monetary value of the obligation is based solely or predominantly on any one of the following: . . .

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

55-26 A freestanding forward purchase contract, a freestanding written put option, or a net written option (otherwise similar to the example in paragraphs 480-10-55-18 through 55-19) that must or may be net share settled is a liability under paragraph 480-10-25-14(c), because the monetary value of the obligation to deliver a variable number of shares embodied in the contract varies inversely in relation to changes in the fair value of the issuer's equity shares; when the issuer's share price decreases, the issuer's obligation under those contracts increases. Such a contract is measured initially and subsequently at fair value (with changes in fair value recognized in earnings) and classified as a liability or an asset, depending on the fair value of the contract on the reporting date. . . .

Entities may structure share-settled obligations so that the monetary value of the obligation moves inversely to changes in the price of the entity's equity shares. The number of shares to be delivered is determined on the basis of (1) the monetary value of the obligation and (2) the current stock price at settlement, so that the aggregate fair value of the shares delivered equals or approximates the monetary value of the obligation. As the entity's stock price increases, the aggregate fair value of the equity shares to be delivered at settlement decreases and, conversely, as the entity's stock price decreases, the aggregate fair value of the equity shares to be delivered at settlement increases. Accordingly, the counterparty has an exposure to the value of the entity's equity shares that is inverse to that of a holder of the entity's equity shares.

Paragraph B44 of the Background Information and Basis for Conclusions of FASB Statement 150 states, in part:

Some obligations to issue a variable number of shares have monetary values that are indexed or otherwise tied to the fair value of the issuer's equity shares, but those monetary values vary inversely with changes in the fair value of the issuer's shares. Examples include forward purchase contracts, written put options, or net written (or purchased or zero-cost) options or collars that require or permit net share settlement. Because the interests of holders of those instruments are diametrically opposed to those of holders of the issuer's equity shares, the Board concluded that the issuer's obligations under those instruments could not be considered equity interests and, therefore, must be liabilities (or assets in some circumstances).

Further, paragraph B13 states, in part:

A share-settled put option on the issuer's equity shares establishes the opposite (inverse) of an ownership relationship, because it requires the issuer to convey value to the holder that increases as the value of other owners' interests decreases.

An outstanding share that embodies such an obligation is classified as a liability if the obligation is unconditional. One example is a preferred equity security that is mandatorily convertible into a variable number of common shares equal in value to an amount that declines as the price of the issuing entity's common shares increases.

An instrument other than an outstanding share that embodies such an obligation is classified as an asset or a liability irrespective of whether the obligation is conditional or unconditional. Examples include
forward purchase contracts or written put options on the entity's own stock that the entity must settle net in shares.

The monetary value of a net-share-settled fixed-for-fixed written call option or forward sale contract on the issuer's equity shares moves directly with the price of the issuer's equity shares. Similarly, a net-share-settled written call option or forward sale contract on the issuer’s equity shares that includes a standard-dilution adjustment intended to neutralize the impact on the fair value of the contract of dilutive events involving the issuer’s equity shares would have a monetary value that moves directly with the price of the issuer's equity shares. Therefore, the counterparty in such contracts does not have an exposure to the value of the entity's equity shares that is inverse to that of a holder of the entity's equity shares. Accordingly, the contracts do not fall within the scope of the guidance in ASC 480-10-25-14(c) even though their settlement might require the issuer to deliver a variable number of equity shares.

ASC 480-10-25-14(c) only applies to instruments that embody obligations of the issuer. Therefore, it does not apply to the following types of contracts even if their monetary value moves inversely with changes in the fair value of the issuer’s equity shares:

- Prepaid written put options on own equity.
- Prepaid forward purchase contracts on own equity.
- Purchased options on own equity.

### 6.2 Application Issues

#### 6.2.1 Obligations to Deliver a Variable Number of Shares on the Basis of an Average Stock Price

<table>
<thead>
<tr>
<th>ASC 480-10</th>
</tr>
</thead>
<tbody>
<tr>
<td>55-22 Certain financial instruments embody obligations that require (or permit at the issuer's discretion) settlement by issuance of a variable number of the issuer's equity shares that have a value equal to a fixed monetary amount. . . . Some share-settled obligations of this kind require that the variable number of shares to be issued be based on an average market price for the shares over a stated period of time, such as the average over the last 30 days before settlement, instead of the fair value of the issuer's equity shares on the date of settlement. Thus, if the average market price differs from the share price on the date of settlement, the monetary value of the obligation is not entirely fixed at inception and is based, in small part, on variations in the fair value of the issuer’s equity shares. Although the monetary amount of the obligation at settlement may differ from the initial monetary value because it is tied to the change in fair value of the issuer's equity shares over the last 30 days before settlement, the monetary value of the obligation is predominantly based on a fixed monetary amount known at inception. The obligation is classified as a liability under paragraph 480-10-25-14(a). Upon issuance of the shares to settle the obligation, equity is increased by the amount of the liability and no gain or loss is recognized for the difference between the average and the ending market price.</td>
</tr>
</tbody>
</table>

For an instrument to be classified as a liability under ASC 480-10-25-14, the number of shares used to settle the variable-share obligation does not necessarily need to be determined on the basis of the stock price on the settlement date. The number of shares might alternatively be calculated on the basis of an average stock market price over some period (e.g., the last 30 days before settlement). The instrument is a liability under ASC 480-10-25-14 as long as the monetary value of the obligation (i.e., the current value of the shares delivered to settle the obligation) is based predominantly on a fixed monetary amount, on variations in something other than the fair value of the issuer’s equity shares, or on variations inversely related to changes in the fair value of the issuer’s equity shares.

However, if the monetary amount of a variable-share obligation moves directly with the stock price (e.g., the monetary amount increases when the stock price increases and vice versa), the obligation would
not be a liability under ASC 480-10-25-15 irrespective of whether the stock price used in the calculation of the settlement value is a current stock price or an average stock price. ASC 815-40-55-38 contains an example that suggests that a forward contract to sell shares at a fixed price in which the stock price used in the calculation of the settlement amount is based on a 30-day volume-weighted-average daily market price of the issuer’s equity shares would be considered indexed to the issuer’s stock (see Section 4.3.5.1 of Deloitte’s A Roadmap to Accounting for Contracts on an Entity’s Own Equity).

### 6.2.2 Share-Settled Guarantee Obligations

<table>
<thead>
<tr>
<th>ASC 480-10</th>
</tr>
</thead>
<tbody>
<tr>
<td>55-23 An entity’s guarantee of the value of an asset, liability, or equity security of another entity may require or permit settlement in the entity’s equity shares. For example, an entity may guarantee that the value of a counterparty’s equity investment in another entity will not fall below a specified level. The guarantee contract requires that the guarantor stand ready to issue a variable number of its shares whose fair value equals the deficiency, if any, on a specified date between the guaranteed value of the investment and its current fair value. Upon issuance, unless the guarantee is accounted for as a derivative instrument, the obligation to stand ready to perform is a liability addressed by Topic 460. If, during the period the contract is outstanding, the fair value of the guaranteed investment falls below the specified level, absent an increase in value, the guarantor will be required to issue its equity shares. At that point in time, the liability recognized in accordance with that Topic would be subject to the requirements of Topic 450. This Subtopic establishes that, even though the loss contingency is settleable in equity shares, the obligation under that Topic is a liability under paragraph 480-10-25-14(b) until the guarantor settles the obligation by issuing its shares. That is because the guarantor’s conditional obligation to issue shares is based on the value of the counterparty’s equity investment in another entity and not on changes in the fair value of the guarantor’s equity instruments.</td>
</tr>
</tbody>
</table>

ASC 480-10-25-14(b) applies to guarantee contracts that will be settled in a variable number of the issuer’s equity shares (see Sections 2.8, 6.1.3, and 6.2.3). Paragraph B43 of the Background Information and Basis for Conclusions of FASB Statement 150 states:

Some obligations to issue a variable number of shares are indexed or otherwise tied to the value of something other than the issuer’s equity shares. One example is a guarantee contract that requires that the guarantor issue a variable number of its shares whose fair value equals the deficiency on a specified date between the guaranteed value of the investment and its current market value. Even though the issuer’s equity shares will be issued in settlement of the obligation, that type of contract 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 guaranteed party’s return is unrelated to changes in the fair value of the issuer’s equity shares.

### 6.2.3 Financial Instruments That Embody Dual-Indexed Obligations

#### 6.2.3.1 Overview

If a financial instrument embodies only one obligation, and that obligation must be share settled, the financial instrument is classified as an asset or a liability under ASC 480-10-25-14 if at inception, the obligation’s monetary value is based either solely or predominantly on one of three factors: (1) a fixed monetary amount, (2) variations in something other than the fair value of the issuer’s equity shares, or (3) variations inversely related to changes in the fair value of the issuer’s equity shares. If the monetary value of a financial instrument embodies only one obligation that must be share settled, and that monetary value is not based solely on one of these three factors, the issuer should evaluate whether the monetary value is based predominantly on one of them. Special considerations apply to instruments with multiple component obligations (see Section 6.2.4).
If a financial instrument embodies only one obligation, and that obligation must (1) be share settled and (2) has a monetary value that varies at least in part with the price of the issuer's equity shares, the financial instrument is outside the scope of ASC 480-10 unless its monetary value is based predominantly on one of the three factors in ASC 480-10-25-14. If an obligation is dual-indexed both to the entity's stock price and to something other than the entity's stock price (e.g., both to the fair value of the issuer's equity shares and to a foreign currency or the entity's sales revenue), ASC 480-10 therefore does not apply unless the monetary value of the obligation is based predominantly on the variable other than the fair value of the issuer's equity shares. (Dual-indexed contracts should be assessed under ASC 815-10 and ASC 815-40 if ASC 480-10 does not apply.)

We believe that if a contract is solely and explicitly indexed to a variable other than the fair value of the issuer's equity shares, an entity would not consider the contract to be based on the fair value of the issuer's equity shares even if that variable is highly correlated with the fair value of the issuer's equity shares. For example, the monetary value of an obligation to deliver shares may be solely indexed to a multiple of the issuer's trailing EBITDA (e.g., 10 times EBITD). In such a scenario, there is no assurance that the formula will produce a monetary value that equals the fair value of the issuer's equity shares, because the EBITDA multiple applied in the marketplace may vary significantly over time, and all the factors that may affect fair value of the issuer's equity shares are not captured in EBITDA. Thus, even though a formula for determining the number of shares to be delivered by the issuer under a contract may be designed to approximate the fair value of the issuer's equity shares, the fact that a contract is not explicitly indexed in at least in part to the fair value of the equity shares suggests that the contract should be classified as a liability under ASC 480-10 irrespective of the degree of correlation between the changes in the variable and the fair value of the issuer's shares. In other words, the evaluation of predominance applies to obligations that are dual-indexed to the issuer's shares and one or more additional variables. It does not apply to obligations that are explicitly and solely indexed to a variable other than the issuer's equity shares.

### 6.2.3.2 Evaluating Predominance — Contract Indexed to Issuer’s Stock Price and Foreign Exchange Rate

As illustrated in ASC 480-10-55-25, an instrument that embodies no other obligation than one to deliver a variable number of equity shares equal in value to the change in the price of a fixed number of the issuer's equity shares multiplied by the Euro/U.S. dollar exchange rate would not be within the scope of ASC 480-10, because the monetary value of that obligation is not based predominantly on foreign exchange rates or on any of the other factors that would cause an instrument to be an asset or a liability under ASC 480-10-25-14. Note, however, that if an issuer concludes that a dual-indexed instrument is not required to be classified outside of equity under ASC 480-10, the issuer must assess whether the instrument is required to be classified outside of equity under other GAAP (including ASC 815-10 and ASC 815-40). A contract on own equity that is indexed in part to a currency other than the issuer's functional currency would not qualify as equity under ASC 815-40-15-71I (see Section 4.3.8 of Deloitte's *A Roadmap to Accounting for Contracts on an Entity's Own Equity*).
6.2.3.3 Evaluating Predominance — Dual-Indexed Guarantee Obligation

ASC 480-10

55-23 An entity's guarantee of the value of an asset, liability, or equity security of another entity may require or permit settlement in the entity's equity shares. For example, an entity may guarantee that the value of a counterparty's equity investment in another entity will not fall below a specified level. The guarantee contract requires that the guarantor stand ready to issue a variable number of its shares whose fair value equals the deficiency, if any, on a specified date between the guaranteed value of the investment and its current fair value.

55-24 If this example were altered so that the monetary value of the obligation is based on the deficiency on a specified date between the guaranteed value of the investment in another entity and its current fair value plus .005 times the change in value of 100 of the guarantor's equity shares, the monetary value of the obligation would not be solely based on variations in something other than the fair value of the issuer's (guarantor's) equity shares.

55-25 However, the monetary value of the obligation would be predominantly based on variations in something other than the fair value of the issuer's (guarantor's) equity shares and, therefore, the obligation would be classified as a liability under paragraph 480-10-25-14(b). That obligation differs in degree from the obligation under a contract that is indexed in part to the issuer's shares and in part (but not predominantly) to something other than the issuer's shares (commonly called a dual-indexed obligation). The latter contract is not within the scope of this Subtopic. That paragraph applies only if the monetary value of an obligation to issue equity shares is based solely or predominantly on variations in something other than the fair value of the issuer's equity shares.

ASC 480-10-55-24 and 55-25 address a guarantee obligation that requires the issuer to deliver a variable number of its equity shares with a monetary value that is based on both (1) the fair value of the issuer's equity shares (0.005 times the change in the value of 100 of the issuer's equity shares) and (2) any deficiency in the fair value of a third-party equity investment held by the counterparty below a specified level. However, because the monetary value of the obligation is based predominantly on something other than the fair value of the issuer's equity shares, ASC 480-10-25-14(b) requires the obligation to be classified as a liability.

Alternatively, an instrument may embody no obligation other than one to deliver a variable number of equity shares worth a fixed monetary amount plus 0.005 times the change in the value of 100 of the issuer's equity shares. That instrument would be classified as a liability under ASC 480-10-25-14(a) because it embodies an obligation to deliver a variable number of shares that have a value equal to a predominantly fixed monetary amount.

6.2.4 Financial Instruments That Embody Multiple Obligations

6.2.4.1 Overview

ASC 480-10

55-42 A financial instrument composed of more than one option or forward contract embodying obligations to issue shares must be analyzed to determine whether the obligations under any of its components have one of the characteristics in paragraph 480-10-25-14, and if so, whether those obligations are predominant relative to other obligations. For example, a puttable warrant that allows the holder to purchase a fixed number of the issuer's shares at a fixed price that also is puttable by the holder at a specified date for a fixed monetary amount to be paid, at the issuer's discretion, in cash or in a variable number of shares.)
Freestanding instruments sometimes contain multiple obligations, and only some of those obligations would be classified as liabilities under ASC 480-10 if they were issued on a freestanding basis. For example, a single freestanding financial instrument may contain both (1) a physically settled written call option that requires the issuer to deliver a fixed number of equity shares for cash if exercised by the holder and (2) a written put option that requires the issuer to deliver a variable number of shares equal in value to a fixed monetary amount if the holder elects to put the instrument to the issuer.

The evaluation of whether a freestanding financial instrument (other than a mandatorily redeemable financial instrument) that contains multiple obligations must be classified as an asset or a liability under ASC 480-10 differs depending on whether the instrument embodies at least one obligation to which ASC 480-10-25-8 applies (i.e., obligations to repurchase equity shares by transferring assets):

- If any of an instrument's component obligations requires or may require the issuer to repurchase equity shares by transferring assets, the entire instrument is classified as an asset or a liability under ASC 480-10-25-8, and there is no assessment of the predominance of individual component obligations or settlement outcomes.

- If ASC 480-10-25-8 does not apply, and the instrument embodies at least one component obligation to transfer a variable number of shares as described in ASC 480-10-25-14 (e.g., a net-share-settled written put component), the issuer must consider all possible outcomes to determine whether the component obligation is predominant relative to any component obligations to which ASC 480-10 does not apply (e.g., a fixed-for-fixed written call option on equity shares). If a component obligation to which ASC 480-10-25-14 applies is predominant, the entire instrument is classified as an asset or a liability under ASC 480-10 irrespective of the other component obligations and potential settlement outcomes.

ASC 480-10-55-42 and 55-43 suggests that entities apply a two-step approach in performing this assessment:

- **Step 1** — Identify each of the component obligations of the financial instruments (e.g., forwards and written options). Separately identify those obligations that would be classified as liabilities under ASC 480-10-25-14 if they were freestanding.

- **Step 2** — Evaluate whether the monetary value of the component obligations that would be classified as liabilities under ASC 480-10-25-14 if the obligations were freestanding is (collectively) predominant relative to the (collective) monetary value of any component obligations that would not be within the scope of ASC 480-10. If it is, the entire instrument is classified as an asset or a liability under ASC 480-10-25-14. If it is not, the instrument is outside the scope of ASC 480-10.
An obligation could have multiple outcomes, and some of those outcomes may have a monetary value that is determined on the basis of one of the three factors in ASC 480-10-25-14. We believe that in such a scenario, an outcome is predominant if it is more likely than not (i.e., greater than 50 percent) to occur (see Section 6.1.1.3).

**Example 6-4**

A preferred stock instrument will be automatically converted into nonredeemable common stock on a specified date. The number of common shares that the issuer will deliver to settle the instrument depends on the current price of common stock at settlement. If the stock price exceeds $25, the issuer delivers 40 common shares. If the stock price is less than $20, the issuer delivers 50 common shares. If the stock price is between $20 and $25 (the “dead zone”), the issuer delivers a variable number of common shares equal in value to $1,000.

The issuer should evaluate whether dead-zone conversion (i.e., delivering common shares equal in value to a fixed monetary amount of $1,000) is the predominant settlement outcome. If it is, the issuer must classify the preferred stock as a liability under ASC 480-10-25-14(a). In evaluating whether an outcome in the dead zone is predominant, the issuer considers the expected growth rate of, and expected variability in, the price of its common stock. If all else is unchanged, the smaller the price range in which dead-zone conversion will be triggered, the more likely the stock price will be outside of the dead zone at settlement. If dead-zone conversion is not the predominant settlement outcome, the preferred stock would not be classified as a liability under ASC 480-10.

### 6.2.4.2 Warrant With Share-Settleable Put

**ASC 480-10**

55-44 In an instrument that allows the holder either to purchase a fixed number of the issuer's shares at a fixed price or to compel the issuer to reacquire the instrument at a fixed date for shares equal to a fixed monetary amount known at inception, the holder's choice will depend on the issuer's share price at the settlement date. The issuer must analyze the instrument at inception and consider all possible outcomes to judge which obligation is predominant. To do so, the issuer considers all pertinent information as applicable, which may include its current stock price and volatility, the strike price of the instrument, and any other factors. If the issuer judges the obligation to issue a variable number of shares based on a fixed monetary amount known at inception to be predominant, the instrument is a liability under paragraph 480-10-25-14. Otherwise, the instrument is not a liability under this Subtopic but is subject to other applicable guidance such as Subtopic 815-40.

55-45 Entity C issues a puttable warrant to Holder. The warrant feature allows Holder to purchase 1 equity share at a strike price of $10 on a specified date. The put feature allows Holder instead to put the warrant back to Entity C on that date for $2, settleable in fractional shares. If the share price on the settlement date is greater than $12, Holder would be expected to exercise the warrant, obligating Entity C to issue a fixed number of shares in exchange for a fixed amount of cash; the monetary value of the shares varies directly with changes in the share price above $12. If the share price is equal to or less than $12, Holder would be expected to put the warrant back to Entity C obligating the entity to issue a variable number of shares with a fixed monetary value, known at inception, of $2. Thus, at inception, the number of shares that the puttable warrant obligates Entity C to issue can vary, and the financial instrument must be examined under paragraph 480-10-25-14.

55-46 The facts and circumstances should be considered in judging whether the monetary value of the obligation to issue a number of shares that varies is predominantly based on a fixed monetary amount known at inception; if so, it is a liability under paragraph 480-10-25-14(a). For example, if the following circumstances existed, they would suggest that the monetary value of the obligation to issue shares would be judged to be based predominantly on a fixed monetary amount known at inception ($2 worth of shares), and the instrument would be classified as a liability:

a. Entity C's share price is well below the $10 exercise price of the warrant at inception of the instrument.

b. The warrant has a short life.

c. Entity C's stock is determined to have very low volatility.
The example in ASC 480-10-55-44 through 55-46 illustrates the issuer’s assessment of predominance in connection with a freestanding financial instrument that consists of multiple component obligations. The financial instrument in that example contains (1) a warrant on own equity that allows the holder to purchase a fixed number of the issuer’s shares at a fixed price and (2) a share-settled put option that permits the holder to put the instrument on a specified date for a fixed monetary amount settleable in a variable number of shares.

The instrument is not subject to ASC 480-10-25-4 because it does not meet the definition of a mandatorily redeemable financial instrument (e.g., it is not an outstanding share). It is also not subject to ASC 480-10-25-8 because it neither requires nor may require the issuer to transfer assets.

In analyzing the instrument at inception, the issuer concludes that the instrument contains two component obligations that the issuer must consider in determining whether ASC 480-10-25-14 applies:

1. A conditional obligation to deliver a fixed number of shares if the holder exercises the warrant.
2. A conditional obligation to issue a variable number of shares if the holder puts the instrument back to the issuer.

The first obligation does not cause the instrument to be within the scope of ASC 480-10-25-14 because it does not involve the delivery of a variable number of shares. However, the second obligation would be classified as a liability under ASC 480-10-25-14(a) if it were freestanding since it involves the delivery of a variable number of shares worth a fixed monetary amount. Accordingly, the issuer must assess whether the second obligation is predominant (relative to the first) and, if it is, must classify the entire instrument as a liability under ASC 480-10-25-14(a).

In this scenario, the actual settlement outcome will depend on the warrant’s exercise price and the price of the issuer’s equity shares on the settlement date because those factors will affect whether the holder elects to exercise the warrant or put it back to the issuer for a variable number of shares. In assessing whether the component obligation to deliver a variable number of shares worth a fixed monetary amount is predominant at inception, the issuer considers factors such as the relationship between the current stock price and the warrant strike price, expected stock price growth, expected stock price volatility, and the time to expiration of the warrant. If the stock price is significantly lower than the strike price, the stock price volatility is very low, and the warrant term is short, the likelihood increases that the issuer will determine that the obligation to issue a variable number of shares if the holder puts the instrument back to the issuer is predominant relative to the obligation to deliver a fixed number of shares if the holder exercises the warrant. If the obligation to deliver a variable number of shares worth a fixed monetary amount is judged not to be predominant relative to the obligation to deliver a fixed number of shares, the entire instrument is outside the scope of ASC 480-10 and is evaluated under other GAAP, including ASC 815-40.

### 6.2.4.3 Warrant With Share-Settleable Make-Whole Put

**ASC 480-10**

| 55-47 | Entity E issues a warrant to Holder allowing Holder to purchase 1 equity share at a strike price of $10. The warrant has an embedded liquidity make-whole put that entitles Holder to receive from Entity E the net amount of any difference between the share price on the date the warrants are exercised and the sales price the holder receives when the shares are later sold. The make-whole provision is not legally detachable. Entity E can settle by issuing a variable number of shares. For example, if on the date Holder exercises the warrant, the share price is $15 and the share price subsequently decreases to $12 at the date Holder sells the shares, Holder would receive $3 worth of equity shares from Entity E. |
ASC 480-10-55-47 and 55-48 illustrate the issuer’s assessment of predominance in connection with a freestanding financial instrument that contains multiple component obligations. The financial instrument contains (1) a warrant on own equity that allows the holder to purchase a fixed number of the issuer’s shares at a fixed price and (2) a net-share-settled make-whole provision that gives the holder the right to compensation for any loss it incurs if it subsequently sells the shares it receives upon the exercise of the warrants at a price lower than the stock price on the warrant exercise date.

This instrument is not subject to ASC 480-10-25-4 because it does not meet the definition of a mandatorily redeemable financial instrument (e.g., it is not an outstanding share). It is also not subject to ASC 480-10-25-8 because it neither requires nor may require the issuer to transfer assets.

In analyzing this instrument at inception to determine whether ASC 480-10-25-14 applies, the issuer concludes that the instrument contains two component obligations that must be considered:

1. A conditional obligation to deliver a fixed number of shares if the holder exercises the warrant.
2. A conditional obligation to issue a variable number of shares if the holder sells the shares it receives upon exercise of the warrants at a price lower than the stock price on the warrant exercise date.

The first conditional obligation does not cause the instrument to be within the scope of ASC 480-10-25-14 because it does not involve the delivery of a variable number of shares. However, the second conditional obligation would be classified as a liability under ASC 480-10-25-14(c) if it were freestanding since it involves the delivery of a variable number of shares with a monetary value that is inversely related to the issuer’s stock price. Accordingly, the issuer must assess whether the second obligation is predominant (relative to the first). If it is, the issuer must classify the entire instrument as a liability under ASC 480-10-25-14(c). If the second obligation is not predominant, the entire instrument is outside the scope of ASC 480-10 and is evaluated under other GAAP, including ASC 815-40. (The guidance in ASC 815-40-25-30 suggests that a make-whole provision would not cause a contract to be classified as an asset or a liability under ASC 815-40 if the provision can be net share settled and the maximum number of shares that could be required to be delivered under the contract, including the make-whole provision, is both fixed and less than the number of available and authorized shares. See Section 5.3.6 of Deloitte’s A Roadmap to Accounting for Contracts on an Entity’s Own Equity.)
6.2.4.4  Variable-Share Forward Sales Contracts

**ASC 480-10**

| 55-50 | Entity D enters into a contract to issue shares of Entity D's stock to Counterparty in exchange for $50 on a specified date. If Entity D’s share price is equal to or less than $50 on the settlement date, Entity D will issue 1 share to Counterparty. If the share price is greater than $50 but equal to or less than $60, Entity D will issue $50 worth of fractional shares to Counterparty. Finally, if the share price is greater than $60, Entity D will issue .833 shares. At inception, the share price is $49. Entity D has an obligation to issue a number of shares that can vary; therefore, paragraph 480-10-25-14 may apply. However, unless it is determined that the monetary value of the obligation to issue a variable number of shares is predominantly based on a fixed monetary amount known at inception (as it is in the $50 to $60 share price range), the financial instrument is not in the scope of this Subtopic.

Variable-share forward (VSF) contracts are frequently issued as a component of a unit offering that consists of a separable (1) debt security and (2) the VSF. A VSF can bear various acronyms, depending on the underwriter, including PRIDES, FELINE PRIDES, PEPS, and DECS. The contract has different settlement outcomes depending on the price of the issuer's common stock as of the date it settles.

**Example 6-5**

The terms of a VSF are as follows:

- The per-share fair value of the issuer's common stock at the inception of the contract is $100.
- On a stipulated fixed date in the future, the counterparty is required to pay the share issuer $100 in exchange for a variable number of shares of the issuer's common stock.
- The variable number of shares is based on the fair value of the issuer's common stock on the date the contract settles, as shown in the table below.
- The counterparty cannot compel the issuer to settle on a net cash basis, and the contract complies with the requirements of ASC 815-40-25-10 to be accounted for as an equity instrument (thus, the VSF is accounted for as an equity instrument unless it must be classified outside of equity under ASC 480-10).

Share settlement amounts are as follows:

<table>
<thead>
<tr>
<th>Company Stock Price at Contract Settlement Date</th>
<th>Number of Common Shares Forward Counterparty Receives</th>
<th>Observations</th>
</tr>
</thead>
<tbody>
<tr>
<td>Below $100</td>
<td>One share of stock</td>
<td>The counterparty is exposed to declines in the price of the issuer's stock below $100</td>
</tr>
<tr>
<td>Above $100 but below $120</td>
<td>A number of shares equal in value to $100</td>
<td>The counterparty neither benefits nor loses as the price of the common stock changes</td>
</tr>
<tr>
<td>$120 and above</td>
<td>0.8333 shares</td>
<td>The counterparty participates in a portion of the appreciation of the issuer’s stock above $120*</td>
</tr>
</tbody>
</table>

* For example, assume that the stock price closes at $135 per share on the date the contract settles. The counterparty will receive 0.8333 shares, worth $112.50, in exchange for $100. The counterparty only partially participated in the $15 appreciation above the upper limit of the original range.
As the table indicates, the VSF is a hybrid instrument whose components consist of (from the issuer’s perspective) (1) a purchased put option on its own shares, (2) an agreement to issue shares at fair value, and (3) a written call option on its own shares.

Under ASC 480-10-25-14(a), contracts that require the issuance of a variable number of shares worth a fixed dollar amount are accounted for as assets or liabilities. Under certain scenarios, a VSF requires this type of settlement (in the example above, if the price of one share of the issuer’s common stock is between $100 and $120 on the contract settlement date, the issuer receives a fixed amount of cash ($100) and delivers a variable number of shares that have a monetary value equal to $100).

When the VSF settles within the range, the company will issue a variable number of shares equal to a fixed monetary amount. An instrument that consists entirely of this characteristic is a liability. If an instrument embodies such an obligation (as does the VSF described in this example), it is an asset or a liability according to ASC 480-10 when the possibility of settling within the range is predominant (see ASC 480-10-55-51).

There are two possible outcomes for a VSF that has terms similar to those in Example 6-5: (1) it can be settled in a manner consistent with equity treatment (above or below the specified range) or (2) it can be settled in a manner consistent with ASC 480-10 asset or liability treatment (within the specified range). Accordingly, if at the inception of the contract it is more likely than not that the VSF will settle within the specified range, the VSF should be accounted for as an asset or a liability.

Factors that an issuer should consider in evaluating the likelihood of a VSF’s outcomes include:

- The terms of the VSF, including its maturity date and the formula for adjustments to the range.
- The volatility of the underlying stock.
- The relationship between the price of the common stock on the date the VSF is entered into and the low and high end of the original range.
- Historical and expected dividend levels.

When evaluating the likelihood of a VSF’s outcomes, an issuer may want to engage a third-party valuation specialist to help with quantitative determinations.

Other financial instruments may incorporate features that are similar to those of a VSF, such as a mandatorily convertible preferred stock in which the conversion feature is settled in (1) a fixed number of common shares if the price of the issuer’s common share on the settlement date is above a ceiling price per share or below a floor price per share or (2) a variable number of shares equal to the face amount of the convertible preferred stock if the price of the issuer’s common share on the settlement date is between the ceiling and the floor price per share. To evaluate whether such instruments are liabilities or equity under ASC 480-10, the issuer should apply the same guidance as that on VSFs. Accordingly, if it is more likely than not that the mandatorily convertible preferred stock will convert within the variable-share range, it should be classified as a liability under ASC 480-10-25-14.
6.2.5 Financial Instruments With Contingent Obligation

6.2.5.1 Outstanding Shares

ASC 480-10 only applies to outstanding shares that embody unconditional obligations that fall within the scope of either ASC 480-10-25-4 or ASC 480-10-25-14. Accordingly, an outstanding share that embodies an obligation that is contingent on the occurrence or nonoccurrence of an uncertain future event would not be within the scope of ASC 480-10.

An outstanding share may contain both (1) a conditional obligation to deliver a variable number of shares whose monetary value is based on one of the factors in ASC 480-10-25-14 (i.e., a fixed monetary amount, variations in something other than the fair value of the issuer's equity shares, or variations inversely related to changes in the fair value of the issuer's equity shares) and (2) a conditional obligation to repurchase the share for cash or other assets. Even though those conditional obligations would individually be outside the scope of ASC 480-10, the outstanding share would be classified as a liability under ASC 480-10 if the obligations in combination represent an unconditional obligation to repurchase the shares by either transferring assets or issuing a variable number of shares in accordance with one of the factors in ASC 480-10-25-14 (see ASC 480-10-55-28 for analogous guidance). For example, an outstanding share would be classified as a liability if the obligations are contingent upon the occurrence or nonoccurrence of the same event (e.g., an obligation to repurchase an outstanding share for cash if an IPO occurs and an obligation to repurchase the share in exchange for a variable number of shares worth a fixed monetary amount if an IPO does not occur). Alternatively, a preferred share with a stated redemption date on which it will be settled in a fixed monetary amount of cash may include an option for the issuer to settle the share instead by delivering a variable number of common shares equal in value to the fixed monetary amount. That preferred share would be classified as a liability under ASC 480-10 since the obligations in combination represent an unconditional obligation to repurchase the shares by either transferring assets or issuing a variable number of shares worth a fixed monetary amount.

Note, however, that for the outstanding share to be classified as a liability under ASC 480, each individual obligation would need to meet the criteria for liability classification under ASC 480-10-25-4 or ASC 480-10-25-14 on the basis of an assumption that it was individually unconditional. That is, an outstanding share with multiple embedded obligations would not be classified as a liability even if the obligations in combination represent an unconditional obligation to repurchase the shares by either transferring assets or issuing a variable number of shares in a circumstance in which the variable-share obligation does not meet the criteria for liability classification in ASC 480-10-25-14.

Example 6-5A

Entity A has issued preferred stock for $1,000 that has a stated redemption date of 10 years, at which time A must redeem the stock for cash or other assets. The preferred stock contains an automatic conversion feature under which the preferred stock is exchanged for A’s shares of common stock upon an IPO. The conversion rate has both a fixed and variable component; upon any conversion, A must deliver a fixed number of shares, subject to a floor on the fair value of the shares delivered that is equal to $1,000 as of the date of conversion. Thus, if the fair value of the fixed number of shares that is required to be delivered upon a conversion is less than $1,000, A must deliver an additional number of shares so that the aggregate fair value of the shares delivered equals $1,000. Under ASC 480, A must determine at inception whether it is more likely than not that it would deliver a variable number of shares worth a fixed monetary amount of $1,000 if a conversion were to occur at any time before the stated redemption date. In other words, A would assess whether its obligation to deliver a variable number of shares worth a fixed monetary amount is predominant (see Section 6.1.1.3), assuming that an automatic conversion occurred because of an IPO. Entity A would classify the preferred stock as a liability under ASC 480 only if the obligation to deliver shares worth a fixed monetary amount was predominant, assuming that an IPO were to occur.
6.2.5.2  Instruments Other Than Outstanding Shares

**ASC 480-10**

**55-49** If exercisability of a feature into a fixed or variable number of shares is contingent on both the occurrence or nonoccurrence of a specified event and the issuer's share price, a financial instrument settleable in a number of shares that can vary should be analyzed following the same method as for the examples in paragraphs 480-10-55-45 and 480-10-55-50 to consider all possibilities. In some cases, it may be determined that the instrument may not be within the scope of paragraph 480-10-25-14 and thus not a liability under this Subtopic. That determination depends on whether the obligation to deliver a variable number of shares, with a monetary value based on either a fixed monetary amount known at inception or an inverse relationship with the share price, is predominant at inception.

**55-52** Entity F has a share-settleable puttable warrant that provides that the put feature is exercisable only if Entity F fails to accomplish an operational plan (for example, failure to complete a building within two years). If at inception the possibility that both the building will not be completed in two years and the put will be exercised is judged to be predominant, the put warrant would be recognized as a liability under paragraph 480-10-25-14(a).

If a financial instrument other than an outstanding share contains more than one obligation, and one of those obligations is contingent on the occurrence or nonoccurrence of a specified event as well as the issuer's stock price, the analysis of whether ASC 480-10-25-14 applies is similar to that for other instruments that embody multiple obligations (see Section 6.2.4). In assessing whether a contingent obligation to deliver a variable number of shares whose monetary value is based on one of the factors in ASC 480-10-25-14 is predominant, the issuer would consider the contingency's likelihood of being met by assessing it separately from any other factors that may affect the settlement outcome. If the issuer determines that ASC 480-10 does not apply, the contract would be evaluated under ASC 815-40.

6.2.6  Obligations With Settlement Alternatives

Some obligations give one of the parties the choice of whether the obligation will be settled by the issuer's transfer of assets or by its issuance of shares. In these circumstances, the issuer should determine whether ASC 480-10-24-4, ASC 480-10-25-8, or ASC 480-10-25-14 takes precedence in the assessment of whether the contract must be accounted for outside of equity.

6.2.6.1  Issuer Choice

If a financial instrument in the form of a share embodies an unconditional redemption obligation, and the issuer has a choice of settling the obligation by either transferring assets or delivering a variable number of nonredeemable shares of equal value, the instrument should be assessed as a variable-share obligation under ASC 480-10-25-14 rather than as a mandatorily redeemable financial instrument under ASC 480-10-25-4. Such an instrument does not meet the definition of a mandatorily redeemable financial instrument because the issuer has no unconditional obligation to transfer assets.
Example 6-6

An outstanding share contains an unconditional obligation that requires the issuer to redeem the share for a fixed monetary amount (e.g., $100,000) on a specified date. The issuer has the option to settle the obligation by either transferring cash or delivering a variable number of equity shares equal in value to the fixed monetary amount on the settlement date. The share would be evaluated under ASC 480-10-25-14 rather than ASC 815-40-25-4 because the issuer does not have an unconditional obligation to transfer assets. In this example, the instrument is a liability under ASC 480 even though it does not represent a mandatorily redeemable financial instrument. If, however, the obligation involving the delivery of a variable number of shares was not solely or predominantly based on a fixed monetary amount, on variations in something other than the fair value of the issuer’s equity shares, or on variations inversely related to changes in the fair value of the issuer’s equity shares, classification of the instrument as a liability under ASC 480 would not be required.

If a financial instrument other than an outstanding share embodies a conditional or unconditional obligation to repurchase shares (or is indexed to such an obligation), and the issuer has a choice of settling the obligation by either transferring assets or delivering a variable number of nonredeemable equity shares of equal value, the instrument should be assessed as a variable-share obligation under ASC 480-10-25-14 rather than as an obligation to repurchase shares by transferring assets under ASC 480-10-25-8. However, the instrument would still be a liability under ASC 480-10-25-14 because the monetary value of the shares delivered on settlement is based on variations that are inversely related to changes in the fair value of the issuer’s equity shares.

Paragraph B48 of the Background Information and Basis for Conclusions of FASB Statement 150 states:

Certain financial instruments embody obligations that permit the issuer 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 those obligations should be treated like obligations that require settlement by issuance of equity shares. That is, the Board concluded that this Statement should require liability classification of obligations that provide the issuer with the discretion to determine how the obligations will be settled if, and only if, the conditions in [ASC 480-10-25-14] related to changes in monetary value are met.

If a financial instrument embodying an obligation to repurchase shares gives the issuer a choice of settling the obligation by transferring either assets or a fixed number of nonredeemable equity shares, the instrument is outside the scope of ASC 480-10 because it embodies neither an obligation to transfer assets nor an obligation to deliver a variable number of shares.

6.2.6.2 Counterparty Choice

If a financial instrument in the form of a share embodies an unconditional redemption obligation, and the holder has a choice of requiring the issuer to settle the redemption obligation by transferring either assets or a variable number of shares of equal value, the instrument should be assessed as a variable-share obligation under ASC 480-10-25-14 rather than as a mandatorily redeemable financial instrument because the issuer does not have an unconditional obligation to transfer assets. In accordance with ASC 480-10-55-28, such a share would be classified as a liability under ASC 480-10 if the issuer has an unconditional obligation that may require the issuance of a variable number of shares on the basis of one of the factors in ASC 480-10-25-14.

If the share instead gave the holder a choice of requiring the issuer to repurchase the share by transferring either assets or a fixed number of equity shares, the share would fall outside the scope of ASC 480-10 because it embodies neither an unconditional obligation to transfer assets nor an obligation to deliver a variable number of shares.
If a financial instrument other than an outstanding share embodies a conditional or unconditional obligation to repurchase shares (or is indexed to such an obligation), and the holder has the choice of requiring the issuer to settle the redemption obligation by transferring either assets or a variable number of shares of equal value, the issuer should assess the contract under ASC 480-10-25-8. Such a contract would not be analyzed as a variable-share obligation under ASC 480-10-25-14 because the issuer could be forced to settle it by transferring assets depending on the holder’s settlement election. If the financial instrument instead gave the holder a choice of assets or a fixed number of shares, the instrument would still be assessed under ASC 480-10-25-8 because it embodies an obligation that may require the entity to transfer assets.

### 6.2.6.3 Summary

The following table summarizes the analysis under ASC 480-10 of financial instruments embodying obligations to repurchase shares that give either the issuer or the holder a choice of settlement in assets or nonredeemable equity shares.

<table>
<thead>
<tr>
<th>Settlement Alternatives — Transfer of Assets or Variable Number of Nonredeemable Equity Shares</th>
<th>Issuer Choice</th>
<th>Counterparty Choice</th>
</tr>
</thead>
<tbody>
<tr>
<td>Outstanding share</td>
<td>Evaluate as variable-share obligation under ASC 480-10-25-14</td>
<td>Evaluate as variable-share obligation under ASC 480-10-25-14</td>
</tr>
<tr>
<td>Financial instrument other than an outstanding share</td>
<td>Evaluate as variable-share obligation under ASC 480-10-25-14</td>
<td>Evaluate as an obligation to repurchase shares by transferring assets under ASC 480-10-25-8</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Settlement Alternatives — Transfer of Assets or Fixed Number of Nonredeemable Equity Shares</th>
<th>Issuer Choice</th>
<th>Counterparty Choice</th>
</tr>
</thead>
<tbody>
<tr>
<td>Outstanding share</td>
<td>Outside scope of ASC 480-10</td>
<td>Outside scope of ASC 480-10-25</td>
</tr>
<tr>
<td>Financial instrument other than an outstanding share</td>
<td>Outside scope of ASC 480-10</td>
<td>Evaluate as an obligation to repurchase shares by transferring assets under ASC 480-10-25-8</td>
</tr>
</tbody>
</table>

### 6.2.6.4 Illustration

#### ASC 480-10

55-27 Some instruments do not require the issuer to transfer assets to settle the obligation but, instead, unconditionally require the issuer to settle the obligation either by transferring assets or by issuing a variable number of its equity shares. Because those instruments do not require the issuer to settle by transfer of assets, those instruments are not within the scope of paragraphs 480-10-25-4 through 25-6. However, those instruments may be classified as liabilities under paragraph 480-10-25-14.

55-28 For example, an entity may issue 1 million shares of cumulative preferred stock for cash equal to the stock’s liquidation preference of $25 per share. The entity is required either to redeem the shares on the fifth anniversary of issuance for the issuance price plus any accrued but unpaid dividends in cash or to settle by issuing sufficient shares of its common stock to be worth $25 per share. Preferred stockholders are entitled to a mandatory dividend, payable quarterly at a rate of 6 percent per annum based on the $25 per share liquidation preference ($1.50 per share annually). The dividend is cumulative and is payable in cash or in a sufficient number of additional shares of the preferred stock based on the liquidation preference of $25 per share. That obligation does not represent an unconditional obligation to transfer assets and, therefore, is not a mandatorily redeemable financial instrument subject to paragraph 480-10-25-4. But it is still a liability, under paragraph 480-10-25-14(a), because the preferred shares embody an unconditional obligation that the issuer may settle by issuing a variable number of its equity shares with a monetary value that is fixed and known at inception. Because the preferred shares are liabilities, payments to holders are reported as interest cost, and accrued but not-yet-paid payments are part of the liability for the shares.
6.2.7 Financial Instruments That Embody Both Rights and Obligations

**ASC 480-10**

- 55-26 A net written or net purchased option or a zero-cost collar similar to the examples in paragraphs 480-10-55-18 through 55-20 that must or may be net share settled is classified as a liability (or asset) under paragraph 480-10-25-14(c), because the monetary value of the issuer’s obligation to deliver a variable number of shares under the written put option varies inversely in relation to changes in the fair value of the issuer’s share price. The purchased call option element of that freestanding instrument does not embody an obligation to deliver a variable number of shares and does not affect the classification of the entire instrument when applying that paragraph. In addition, a freestanding purchased call option is not within the scope of this Subtopic because it does not embody an obligation.

In assessing whether ASC 480-10-25-14 applies, an issuer considers only terms and features that represent obligations (e.g., forward obligations and written options). Issuer rights that could not require the transfer of assets or equity shares do not affect the accounting analysis. Accordingly, an issuer does not assess predominance among the potential settlement outcomes for a share-settled instrument that embodies only one obligation, even if the instrument has other potential settlement outcomes that could result in the issuer’s receipt of assets or equity shares because of issuer rights.

For a freestanding financial instrument such as a net-share-settled collar that contains both a purchased call option that could result in the issuer’s receipt of assets or equity shares and a written put option that could result in the issuer’s delivery of assets or equity shares, the purchased call option component does not affect the analysis under ASC 480-10-25-14. Instead, the written put option component causes the entire instrument to be classified outside of equity under ASC 480-10-25-14. Such accounting applies even if the fair value of the purchased option component equals or exceeds the written option component so that the collar represents a zero-cost collar or a net-purchased option on the issuer’s own stock.

6.3 Accounting

**ASC 480-10**

- 30-7 All other financial instruments recognized under the guidance in Section 480-10-25 shall be measured initially at fair value.

- 35-1 Financial instruments within the scope of Topic 815 shall be measured subsequently as required by the provisions of that Topic.

- 35-4A Contingent consideration issued in a business combination that is classified as a liability in accordance with the requirements of this Topic shall be subsequently measured at fair value in accordance with 805-30-35-1.

- 35-5 All other financial instruments recognized under the guidance in Section 480-10-25 shall be measured subsequently at fair value with changes in fair value recognized in earnings, unless either this Subtopic or another Subtopic specifies another measurement attribute.

- 55-17 In contrast to forward purchase contracts that require physical settlement in exchange for cash, forward purchase contracts that require or permit net cash settlement, require or permit net share settlement, or require physical settlement in exchange for specified quantities of assets other than cash are measured initially and subsequently at fair value, as provided in paragraphs 480-10-30-2, 480-10-30-7, 480-10-35-1, and 480-10-35-5 (as applicable), and classified as assets or liabilities depending on the fair value of the contracts on the reporting date.
A financial instrument that must be accounted for as an asset or a liability under ASC 480-10-25-14 is initially and subsequently measured at fair value, with changes in fair value recognized in earnings unless other GAAP permit or require a different accounting treatment. Instruments for which a different accounting treatment may apply include:

- A derivative instrument within the scope of ASC 815 that the entity designates as a hedging instrument in a cash flow hedge or net investment hedge and for which changes in fair value are recognized in other comprehensive income under ASC 815-30-35 or ASC 815-35-35 (see Section 2.3).
- A contingent consideration arrangement in a business combination when a change in its fair value represents a measurement-period adjustment under ASC 805-30-35 (see Section 2.6).
- Share-settled debt that is accounted for at amortized cost under the interest method in ASC 835-30 (see below).

We believe that unless the fair value option in ASC 825-10 is elected, share-settled debt whose monetary value represents a fixed or predominantly fixed monetary amount should be accounted for at amortized cost in accordance with the interest method in ASC 835-30. As noted in paragraph B13 of the Background Information and Basis for Conclusions of FASB Statement 150, “a financial instrument that requires settlement by issuance of $100,000 worth of equity shares establishes something more akin to a debtor-creditor relationship than to an ownership relationship.” Further, the last sentence of ASC 480-10-55-22 (i.e., upon “issuance of the shares to settle the obligation, equity is increased by the amount of the liability and no gain or loss is recognized for the difference between the average and the ending market price”) implicitly acknowledges that a fixed-monetary-value share-settled debt arrangement is not required to be measured at fair value through earnings. The paragraph provides guidance on whether a gain or loss should be recognized related to the difference between the average and ending market price upon the settlement of a share-settled debt arrangement for which the number of shares that will be delivered is determined on the basis of an average stock price as opposed to the ending stock price. Had the instrument in ASC 480-10-55-22 been measured on an ongoing basis at fair value (i.e., on the basis of a current stock price), there should have been no difference to address at settlement after the issuer had updated its prior fair value estimate.

Example 6-7

In October 20X0, Issuer T issued an obligation to deliver a variable number of its equity shares to Entity K, which can elect to require settlement of the obligation at any time starting in January 20X1. The obligation is not in the form of an outstanding share. Upon settlement, T will issue a variable number of shares of its common stock that has a fair value equal to $20 million. The fair value of common stock will be determined on the basis of the weighted average price of the common stock for the 20 consecutive trading days preceding settlement. The obligation is classified as a liability under ASC 480-10-25-14 because the monetary value of its settlement amount is predominantly fixed and the obligation is not in the form of an outstanding share. Company T determines that it would be appropriate to account for the obligation as share-settled debt at amortized cost since the obligation is repayable on demand at a predominantly fixed monetary amount.

On January 15, 20X1, K exercised its option to demand settlement. Company T issued 225,000 shares of common stock, which had a fair value of approximately $25 million measured on the basis of the current stock price on the settlement date. The excess of the fair value of the common stock over the $20 million carrying amount of the liability was the result of an increase in the common stock price during the averaging period. That is, the weighted average stock price for the 20 days in the averaging period was less than the current stock price at settlement. In a manner consistent with ASC 480-10-55-22, T should not recognize a loss for the excess of the current fair value of the common shares delivered at settlement over the $20 million carrying amount of the liability for the obligation.

In this Roadmap, the term “share-settled debt” is used to describe a share-settled obligation that is not in the legal form of debt but has the same economic payoff profile as debt. Financial instruments that are in the legal form of debt are outside the scope of ASC 480-10 (see Section 2.2.4).
6.4 Reassessment

Under ASC 480-10-25-14, an entity assesses whether an obligation has a monetary value that is based either solely or predominantly on a fixed monetary amount, on variations in something other than the fair value of the issuer's equity shares, or on variations inversely related to changes in the fair value of the issuer's equity shares. Such assessment is performed only at inception or upon a modification that is treated as a new instrument for accounting purposes (e.g., as a result of a modification or exchange that is accounted for as an extinguishment of the existing instrument; see ASC 470-50). There is no subsequent reassessment of whether the monetary value is based solely or predominantly on one of those factors. Further, as discussed in Section 3.2.1, the issuer does not reassess whether a feature is nonsubstantive or minimal after inception.
Chapter 7 — Certain Option Combinations

This chapter discusses the special accounting requirements in ASC 480-10 related to certain option combinations involving noncontrolling interests (see Section 7.1) and the illustrations in ASC 480-10 of the application of its requirements to certain option combinations (see Section 7.2).

7.1 Certain Transactions Involving Noncontrolling Interests

<table>
<thead>
<tr>
<th>ASC 480-10</th>
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</thead>
</table>
| **55-53** A controlling majority owner (parent) holds 80 percent of a subsidiary's equity shares. The remaining 20 percent (the noncontrolling interest) is owned by an unrelated entity (the noncontrolling interest holder). Simultaneous with the acquisition of the noncontrolling interest, the noncontrolling interest holder and the parent enter into a derivative instrument that is indexed to the subsidiary's equity shares. The terms of the derivative instrument may be any of the following:
  a. The parent has a fixed-price forward contract to buy the other 20 percent at a stated future date. (Derivative 1)
  b. The parent has a call option to buy the other 20 percent at a fixed price at a stated future date, and the noncontrolling interest holder has a put option to sell the other 20 percent to the parent under those same terms, that is, the fixed price of the call is equal to the fixed price of the put option. (Derivative 2)
  c. The parent and the noncontrolling interest holder enter into a total return swap. The parent will pay to the counterparty (initially the noncontrolling interest holder) an amount computed based on the London Interbank Offered Rate (LIBOR), plus an agreed spread, plus, at the termination date, any net depreciation of the fair value of the 20 percent interest since inception of the swap. The counterparty will pay to the parent an amount equal to dividends paid on the 20 percent interest and, at the termination date, any net appreciation of the fair value of the 20 percent interest since inception of the swap. At the termination date, the net change in the fair value of the 20 percent interest may be determined through an appraisal or the sale of the stock. (Derivative 3)
| **55-54** If the terms correspond with Derivative 1, the forward purchase contract that requires physical settlement by repurchase of a fixed number of shares (the noncontrolling interest) in exchange for cash is recognized as a liability, initially measured at the present value of the contract amount; the noncontrolling interest is correspondingly reduced. Subsequently, accrual to the contract amount and any amounts paid or to be paid to holders of those contracts are reflected as interest cost. In effect, the parent accounts for the transaction as a financing of the noncontrolling interest and, consequently, consolidates 100 percent of the subsidiary.
| **55-55** Depending on how Derivative 2 was issued, one of three different accounting methods applies. If Derivative 2 was issued as a single freestanding instrument, under this Subtopic it would be accounted for in its entirety as a liability (or an asset in some circumstances), initially and subsequently measured at fair value. If the written put option and the purchased call option in Derivative 2 were issued as freestanding instruments, the written put option would be accounted for under this Subtopic as a liability measured at fair value, and the purchased call option would be accounted for under Subtopic 815-40. Under both of those situations, the noncontrolling interest is accounted for separately from the derivative instrument under applicable guidance. However, if the written put option and purchased call option are embedded in the shares (noncontrolling interest) and the shares are not mandatorily redeemable, the freestanding instrument shall be accounted for as discussed in paragraph 480-10-55-59 with the parent consolidating 100 percent of the subsidiary. |
Depending on how Derivative 2 was issued, one of three different accounting methods applies. If Derivative 2 was issued as a single freestanding instrument, under this Subtopic it would be accounted for in its entirety as a liability (or an asset in some circumstances), initially and subsequently measured at fair value. If the written put option and the purchased call option in Derivative 2 were issued as freestanding instruments, the written put option would be accounted for under this Subtopic as a liability measured at fair value, and the purchased call option would be accounted for under Subtopic 815-40. Under both of those situations, the noncontrolling interest is accounted for separately from the derivative instrument under applicable guidance. However, if the written put option and purchased call option are embedded in the shares (noncontrolling interest) and the shares are not otherwise classified as liabilities under the guidance in this Subtopic, the instrument shall be accounted for as discussed in paragraph 480-10-55-59 with the parent consolidating 100 percent of the subsidiary.

If the terms correspond with Derivative 3, the total return swap is indexed to an obligation to repurchase the issuer's shares and may require the issuer to settle the obligation by transferring assets. Therefore it is in the scope of this Subtopic and is required to be accounted for as a liability (or asset in some circumstances), initially, and subsequently measured at fair value. The noncontrolling interest is accounted for separately from the total return swap.

In applying paragraphs 480-10-25-4 through 25-14 to determine classification, a freestanding financial instrument within this Subtopic's scope is precluded from being combined with another freestanding financial instrument, unless combination is required under the provisions of Topic 815; therefore, unless under the particular facts and circumstances that Topic provides otherwise, freestanding derivative instruments in the scope of this Subtopic would not be combined with the noncontrolling interest.

This guidance is limited to circumstances in which the parent owns a majority of the subsidiary's outstanding common stock and consolidates that subsidiary at inception of the derivative instrument. This guidance is limited to the specific derivative instruments described.

If the derivative instrument in Derivative 2 is freestanding of the noncontrolling interest, it should be combined with the noncontrolling interest and accounted for as a financing. That is, the combination of option contracts should be viewed on a combined basis with the noncontrolling interest and accounted for as a financing of the parent's purchase of the noncontrolling interest.

If the derivative instrument in Derivative 2 is embedded in the shares (noncontrolling interest) and the shares are not otherwise classified as liabilities under the guidance in this Subtopic, the combination of options should be viewed on a combined basis with the noncontrolling interest and accounted for as a financing of the parent's purchase of the noncontrolling interest.

Under that approach, the parent would consolidate 100 percent of the subsidiary and would attribute the stated yield earned under the combined derivative instrument and noncontrolling interest position to interest expense (that is, the financing would be accreted to the strike price of the forward or option over the period until settlement). No gain or loss would be recognized on the sale of the noncontrolling interest by the parent to the noncontrolling interest holder at the inception of the derivative instrument.
55-61 The risks and rewards of owning the noncontrolling interest have been retained by the parent during the period of the derivative instrument, notwithstanding the legal ownership of the noncontrolling interest by the counterparty. Combining the two transactions in this circumstance reflects the substance of the transactions; that the counterparty is financing the noncontrolling interest. Upon such combination, the resulting instrument is not a derivative instrument subject to Subtopic 815-10.

55-62 This accounting applies even if the exercise prices of the put and call options are not equal, as long as those exercise prices are not significantly different.

### ASC 480-10 — Glossary

**Noncontrolling Interest**
The portion of equity (net assets) in a subsidiary not attributable, directly or indirectly, to a parent. A noncontrolling interest is sometimes called a minority interest.

### 7.1.1 Scenarios
ASC 480-10-55-53 through 55-62 contain multiple scenarios illustrating the accounting for certain transactions that involve noncontrolling interests.

Other than in one scenario, the guidance in ASC 480-10-55-53 through 55-62 merely illustrates how to apply ASC 480-10 and ASC 815-40. However, in the scenario in which an option combination is embedded in the noncontrolling interest, ASC 480-10-55 contains unique requirements that differ from other requirements in ASC 480-10 or ASC 815-40 (see Section 7.1.2).

The following table provides an overview of the scenarios in ASC 480-10-55-53 through 55-62. In each scenario, the parent holds 80 percent of the subsidiary’s equity shares and consolidates the subsidiary, and a third party holds the remaining 20 percent of the subsidiary’s equity shares (the noncontrolling interest). However, the parent is exposed to the risks and rewards associated with the noncontrolling interest through a forward, an option combination, or a total return swap on the noncontrolling interest that may require the issuer to pay cash.

<table>
<thead>
<tr>
<th>Scenario</th>
<th>Parent’s Accounting</th>
</tr>
</thead>
</table>
| **Derivative 1** — The parent has a fixed-price forward contract to buy the other 20 percent on a stated future date (ASC 480-10-55-53(a) and 55-54). | • The forward is accounted for as a liability in accordance with the requirements for a physically settled forward purchase contract under ASC 480-10-25-8 (see Section 5.3.1).  
• The subsidiary is 100 percent consolidated.  
• No noncontrolling interest. |
| **Derivative 2** — The parent has a call option to buy the other 20 percent at a fixed price on a stated future date, and the noncontrolling interest holder has a put option to sell the other 20 percent to the parent under those same terms (ASC 480-10-55-53(b) and ASC 480-10-55-55). | The accounting depends on how Derivative 2 was structured (see below). |
### (Table continued)

<table>
<thead>
<tr>
<th>Scenario</th>
<th>Parent’s Accounting</th>
</tr>
</thead>
</table>
| Derivative 2 is issued as a single freestanding instrument (ASC 480-10-55-53(b) and ASC 480-10-55-55). | After the adoption of ASU 2018-09:  
  - The option combination is accounted for as an asset or a liability at fair value under ASC 480-10-25-8 (see Section 5.3.2).  
  - The subsidiary is 80 percent consolidated.  
  - The noncontrolling interest is 20 percent.  
  - See also Section 7.1.2.2.  
  We believe that before the adoption of ASU 2018-09, an issuer could elect to account for the option combination and the noncontrolling interest in either of the following ways:  
  - On a combined basis in a manner consistent with the guidance on options in the form of Derivative 2 that are embedded in the noncontrolling interest (see Section 7.1.2.1).  
  - As separate instruments in accordance with ASU 2018-09 (see Section 7.1.2.2). |
| The written put option and the purchased call option in Derivative 2 are issued as separate freestanding instruments (ASC 480-10-55-53(b) and ASC 480-10-55-55). |  
  - The put option is accounted for as a liability at fair value under ASC 480-10-25-8 (see Section 5.3.2).  
  - The call option is evaluated under ASC 815-40 (i.e., it is accounted for as equity if it meets the equity classification conditions in ASC 815-40).  
  - The subsidiary is 80 percent consolidated.  
  - The noncontrolling interest is 20 percent.  
  - See also Section 7.1.2.2. |
| The written put option and the purchased call option in Derivative 2 are embedded in the shares, and the shares are not mandatorily redeemable (ASC 480-10-55-53(b), ASC 480-10-55-55, and ASC 480-10-55-59 through 55-62). |  
  - The transaction is accounted for as a financing (i.e., as if the parent had already purchased the 20 percent noncontrolling interest by using borrowed funds) under ASC 480-10-55-53(b), ASC 480-10-55-55, and ASC 480-10-55-59. The liability for the financing is accreted to the option strike price.  
  - The subsidiary is 100 percent consolidated.  
  - No noncontrolling interest.  
  - See Section 7.1.2.1 for further discussion. |
| Derivative 3 — The parent and the noncontrolling interest holder enter into a total return swap on the other 20 percent (ASC 480-10-55-53(b) and ASC 480-10-55-56). |  
  - The total return swap is accounted for as an asset or a liability at fair value under ASC 480-10-25-8 (see Section 5.3.2).  
  - The subsidiary is 80 percent consolidated.  
  - The noncontrolling interest is 20 percent. |
7.1.2 “Derivative 2”

7.1.2.1 Options Embedded in Noncontrolling Interest

The scenario described in ASC 480-10-55-53(b), ASC 480-10-55-55, and ASC 480-10-55-59 through 55-62 is as follows:

- The parent holds 80 percent of the subsidiary’s equity shares and consolidates the subsidiary.
- The remaining 20 percent of the subsidiary’s equity shares (the noncontrolling interest) are held by a third party.
- Simultaneously with the third party’s acquisition of the noncontrolling interest, the parent and the holder of the noncontrolling interest enter into the following option combination, which is labelled “Derivative 2” in ASC 480-10-55-53(b):
  - The parent has a call option to purchase the noncontrolling interest at a fixed price on a stated future date.
  - The noncontrolling interest holder has a put option to sell the noncontrolling interest to the parent under the same terms. (ASC 480-10-55-62 suggests that the exercise prices do not need to be equal as long as they are not significantly different.)
- The options are embedded in the shares representing the noncontrolling interest (i.e., they are not considered separate freestanding instruments).
- The noncontrolling interest shares do not meet the definition of a mandatorily redeemable financial instrument.

ASC 480-10-55-55 and ASC 480-10-55-59 through 55-62 require the embedded options and the noncontrolling interest in this scenario to be accounted for on a combined basis as a financing of the parent’s purchase of the noncontrolling interest. That is, the transaction is accounted for as a liability in a manner similar to a mandatorily redeemable financial instrument or a physically settled forward purchase contract on the issuer’s equity shares under ASC 480-10 even though redemption of the shares is conditional on the exercise of one or both of the options. Effectively, therefore, the guidance in ASC 480-10-55-55 and ASC 480-10-55-59 through 55-62 overrides that in ASC 480-10-55-38 through 55-40 under which shares that embed a written put option and a purchased call option with the same terms are not considered mandatorily redeemable (see Section 4.2.1).

We believe that the guidance in ASC 480-10-55-55 and ASC 480-10-55-59 through 55-62 applies irrespective of whether the noncontrolling interest is in the form of common stock or preferred stock. Further, it applies even if the relative ownership interests of the parent and the holder of the noncontrolling interest differ from the levels assumed in the scenario described in ASC 480-10 (i.e., 80 percent and 20 percent) provided that the parent owns a majority of the subsidiary’s outstanding common stock and consolidates the subsidiary at the inception of the arrangement (see ASC 480-10-55-58).

The liability accounting required by ASC 480-10-55-59 through 55-62 applies only to the combination of a call option and a put option on a noncontrolling interest when the options (1) are exercisable on the same future date and (2) have either the same fixed price or, as discussed in ASC 480-10-55-62, exercise prices that are not significantly different. Entities may be required to use significant judgment to determine whether the call and put options have the same fixed price. For example, if the call and put options each have an exercise price with the same fixed amount and the same adjustment for an interest component such as LIBOR, the call and put options would be considered to have the same fixed price.
We believe that the liability classification guidance in ASC 480-10-55-59 through 55-62 does not apply if (1) the option exercise prices are based on a formula (e.g., EBITDA) that is not simply an indexation to interest rates or (2) the options are contingent on the satisfaction of certain conditions. ASC 480-10-55-61 discusses the FASB's rationale for the liability accounting required under ASC 480-10-55-59 through 55-62 and states, in part:

The risks and rewards of owning the noncontrolling interest have been retained by the parent during the period of the derivative instrument, notwithstanding the legal ownership of the noncontrolling interest by the counterparty. Combining the two transactions in this circumstance reflects the substance of the transactions; that the counterparty is financing the noncontrolling interest.

For options that have an exercise price based on EBITDA, for example, the substance of the transaction does not represent the parent's financing of the purchase of the noncontrolling interest because the purchase price continues to vary on the basis of the subsidiary's operating performance.

If the liability classification in ASC 480-10-55-59 through 55-62 does not apply solely because the option exercise prices are based on a formula that is not simply an indexation to interest rates, the noncontrolling interest is not considered a mandatorily redeemable financial instrument under ASC 480-10-25-4 (see Chapter 4) and is not subject to liability classification under the other provisions of ASC 480-10. Accordingly, the parent would classify the noncontrolling interest as an equity instrument. However, if the parent is an SEC registrant, the noncontrolling interest would be subject to classification and measurement in temporary equity in accordance with ASC 480-10-599-3A (see Chapter 9).

7.1.2.2 Freestanding Options

In July 2018, the FASB issued ASU 2018-09, which clarifies a parent's accounting for freestanding put and call options on noncontrolling interests and aligns ASC 480-10-55-55 and 55-59 with the pre-Codification guidance in Statement 150 as well as ASC 480-10-25-15.

7.1.2.2.1 Analysis After an Entity's Adoption of ASU 2018-09

If a parent and the holder of a noncontrolling interest enter into put and call options on the noncontrolling interest, and either the option combination or each option is considered to be a freestanding financial instrument (see Section 3.3) that is separate from the noncontrolling interest, the noncontrolling interest and the options would not be accounted for on a combined basis as a financing of the parent's purchase of the noncontrolling interest. Instead, the accounting for the options depends on whether they represent a single freestanding financial instrument (in which case the option combination is accounted for as an asset or a liability under ASC 480-10-25-8) or two separate freestanding financial instruments (in which case the put option is accounted for as a liability under ASC 480-10-25-8, and the call option is evaluated under ASC 815-40). Either way, the accounting differs from that on noncontrolling interests with embedded options in ASC 480-10-55-59 through 55-62 because the noncontrolling interest would be reflected in equity by the parent.

7.1.2.2.2 Analysis Before an Entity's Adoption of ASU 2018-09

Before the adoption of ASU 2018-09, the implementation guidance in the first sentence of ASC 480-10-55-59 suggests that “Derivative 2” (i.e., the options described in ASC 480-10-55-53(b)) should be combined with the noncontrolling interest and accounted for as a financing even if it is “freestanding of the noncontrolling interest.” That guidance conflicts with the prohibition in ASC 480-10-25-15 and ASC 480-10-55-57 against combining freestanding financial instruments unless combination is required under ASC 815. Further, it does not accurately represent U.S. GAAP as of the date it was codified (July 1, 2009). The guidance in ASC 480-10-55-59 through 55-61 was carried forward from the consensus in EITF Issue 00-4. However, paragraph 18 in the “Status” section of EITF Issue 00-4 states that “FASB Statement
150 [later codified in ASC 480-10] nullifies the consensuses reached in this Issue unless the derivative . . . is not freestanding of the noncontrolling interest.”

We believe that before the adoption of ASU 2018-09, an entity is not required to account for the options on a combined basis with the noncontrolling interest under ASC 480-10-55-59 if either the option combination or each option is considered to be a freestanding financial instrument that is separate from the noncontrolling interest under ASC 480-10 (see Section 3.3). The accounting instead depends on whether the options represent a single freestanding financial instrument (in which case the option combination is accounted for as an asset or liability under ASC 480-10-25-8) or two separate freestanding financial instruments (in which case the put option is accounted for as a liability under ASC 480-10-25-8, and the call option is evaluated under ASC 815-40). Either way, the accounting differs from that specified in ASC 480-10-55-59 through 55-62 before adoption of ASU 2018-09 because the noncontrolling interest would be reflected in equity by the parent. Alternatively, we believe that on the basis of a literal application of ASC 480-10-55-59 (before adoption of ASU 2018-09), an issuer could elect to account for the option combination and the noncontrolling interest on a combined basis in a manner consistent with the guidance on options in the form of Derivative 2 that are embedded in the noncontrolling interest (see Section 7.1.2.1).

7.1.2.2.3 Transition Related to ASU 2018-09

<table>
<thead>
<tr>
<th>ASC 105-10</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>65-4</strong> The following represents the transition and effective date information related to Accounting Standards Update No. 2018-09, Codification Improvements:</td>
</tr>
<tr>
<td>a. A public business entity, a not-for-profit entity that has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market, and an employee benefit plan that files or furnishes financial statements with or to the U.S. Securities and Exchange Commission shall apply the pending content that links to this paragraph for annual periods beginning after December 15, 2018, including interim periods within those annual periods.</td>
</tr>
<tr>
<td>b. All other entities shall apply the pending content that links to this paragraph for annual periods beginning after December 15, 2019, and interim periods within annual periods beginning after December 15, 2020.</td>
</tr>
<tr>
<td>c. An entity shall recognize and present separately the cumulative effect of the change in accounting principle of the pending content that links to this paragraph as an adjustment to the opening balance of retained earnings (or other appropriate components of equity or net assets in the statement of financial position) as of the beginning of the period in which it is first applied. The cumulative-effect adjustment is the difference between the amounts recognized in the statement of financial position before initial application of the pending content that links to this paragraph and the amounts recognized in the statement of financial position at initial application of the pending content that links to this paragraph.</td>
</tr>
<tr>
<td>d. An entity may elect to apply the pending content that links to this paragraph retrospectively.</td>
</tr>
<tr>
<td>e. Early application of the pending content that links to this paragraph is permitted for any fiscal year or interim period for which the entity's financial statements have not yet been issued (public business entities) or for which financial statements are available to be issued (all other entities).</td>
</tr>
<tr>
<td>f. An entity shall disclose the nature of a change in accounting principle to the pending content that links to this paragraph and the reason for the change.</td>
</tr>
</tbody>
</table>

For public business entities and certain other entities identified in ASC 105-10-65-4(a), the amendments to ASC 480-10-55-55 and 55-59 are effective for annual periods beginning after December 15, 2018, including interim periods within those annual periods. For all other entities, the amendments are effective for annual periods beginning after December 15, 2019, and interim periods within annual periods beginning after December 15, 2020.
Upon transition, entities may elect to apply the amendments in either of the following ways:

- Recognize the cumulative effect of the change (i.e., the difference between amounts recognized in the statement of financial position before and at initial application) as an adjustment to the opening balance of retained earnings as of the beginning of the period in which the change is first applied.
- Apply the amendments retrospectively for each prior reporting period presented.

Public business entities are permitted to early apply the amendments for any fiscal year or interim period for which they have not yet issued financial statements. Other entities are permitted to early apply the amendments for any fiscal year or interim period for which they have not yet made financial statements available to be issued.

### 7.2 Illustrations of the Application of ASC 480-10 to Certain Option Combinations

The application of the scope provisions and the accounting requirements in ASC 480-10 depends on how an issuer's contractual rights and obligations are aggregated or disaggregated into units of account (see Section 3.3). The guidance in ASC 480-10-55-19 and 55-20 and in ASC 480-10-55-34 through 55-37 illustrates the application of ASC 480-10 to sets of options that involve the same counterparty and are executed contemporaneously. Each freestanding financial instrument is assessed separately under ASC 480-10, whereas a freestanding financial instrument that includes multiple components is analyzed in its entirety.

<table>
<thead>
<tr>
<th>ASC 480-10</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Combination of Written Put Option and Purchased Call Option Issued as a Freestanding Instrument</strong></td>
</tr>
<tr>
<td><strong>55-18</strong> If a freestanding financial instrument consists solely of a written put option to repurchase the issuer's equity shares and another option, that freestanding financial instrument in its entirety is subjected to paragraphs 480-10-25-4 through 25-14 to determine if it meets the requirements to be classified as a liability.</td>
</tr>
<tr>
<td><strong>55-19</strong> For example, an entity may enter into a contract that requires it to purchase 100 shares of its own stock on a specified date for $20 if the stock price falls below $20 and entitles the entity to purchase 100 shares on that date for $21 if the stock price is greater than $21. That contract shall be analyzed as the combination of a written put option and a purchased call option and not as a forward contract. The written put option on 100 shares has a strike price of $20, and the purchased call option on 100 shares has a strike price of $21. If at issuance the fair value of the written put option exceeds the fair value of the purchased call option, the issuer receives cash and the contract is a net written option — a liability. If required to be physically settled, that contract is a liability under the provisions in paragraphs 480-10-25-8 through 25-12 because it embodies an obligation that may require repurchase of the issuer's equity shares and settlement by a transfer of assets. If the issuer must or can net cash settle the contract, the contract is a liability under the provisions of those paragraphs because it embodies an obligation that is indexed to an obligation to repurchase the issuer's equity shares and may require settlement by a transfer of assets. If the issuer must or can net share settle the contract, the contract is a liability under the provisions in paragraph 480-10-25-14(c), because the monetary value of the obligation varies inversely in relation to changes in the fair value of the issuer's equity shares.</td>
</tr>
<tr>
<td><strong>55-20</strong> If, in this example, the fair value of the purchased call option at issuance exceeds the fair value of the written put option, the issuer pays out cash and the contract is a net purchased option, to be initially classified as an asset under either paragraphs 480-10-25-8 through 25-12 or 480-10-25-14(c). If the fair values of the two options are equal and opposite at issuance, the financial instrument has an initial fair value of zero, and is commonly called a zero-cost collar. Thereafter, if the fair value of the instrument changes, the instrument is classified as an asset or a liability and measured subsequently at fair value.</td>
</tr>
</tbody>
</table>
Three Freestanding Instruments

55-34 An issuer has the following three freestanding instruments with the same counterparty, entered into contemporaneously:
   a. A written put option on its equity shares
   b. A purchased call option on its equity shares
   c. Outstanding shares of stock.

55-35 Under this Subtopic those three contracts would be separately evaluated. The written put option is reported as a liability under either paragraphs 480-10-25-8 through 25-12 or 480-10-25-14(c) (depending on the form of settlement) and is measured at fair value. The purchased call option does not embody an obligation and, therefore, is not within the scope of this Subtopic. The outstanding shares of stock also are not within the scope of this Subtopic, because the shares do not embody an obligation for the issuer. Under paragraph 480-10-25-15, neither the purchased call option nor the shares of stock are to be combined with the written put option in applying paragraphs 480-10-25-4 through 25-14 unless otherwise required by Topic 815. If that Topic required the freestanding written put option and purchased call option to be combined and viewed as a unit, the unit would be accounted for as a combination of options, following the guidance in paragraphs 480-10-55-18 through 55-20.

Two Freestanding Instruments

55-36 An issuer has the following two freestanding instruments with the same counterparty entered into contemporaneously:
   a. A contract that combines a written put option at one strike price and a purchased call option at another strike price on its equity shares
   b. Outstanding shares of stock.

55-37 As required by paragraph 480-10-25-1, paragraphs 480-10-25-4 through 25-14 are applied to the entire freestanding instrument that comprises both a put option and a call option. Because the put option element of the contract embodies an obligation to repurchase the issuer’s equity shares, the freestanding instrument that comprises a put option and a call option is reported as a liability (or asset) under either paragraphs 480-10-25-8 through 25-12 or 480-10-25-14(c) (depending on the form of settlement) and is measured at fair value. Under paragraphs 480-10-15-3 through 15-4 and 480-10-25-1, that freestanding financial instrument is within the scope of this Subtopic regardless of whether at current prices it is a net written, net purchased, or zero-cost collar option and regardless of the form of settlement. The outstanding shares of stock are not within the scope of this Subtopic and, under paragraph 480-10-25-15, are not combined with the freestanding written put and purchased call option. (Some outstanding shares of stock are within the scope of this Subtopic, for example, mandatorily redeemable shares or shares subject to a physically settled forward purchase contract in exchange for cash.)

ASC 480-10-55-19 and 55-20, and ASC 480-10-55-35 and 55-36 contain two similar examples of a freestanding financial instrument that consists of a combination of a written put option and a purchased call option on own stock. The accounting analysis of this option combination under ASC 480-10 depends on whether the issuer could be required to settle its obligation under the written put option component by transferring assets or may settle it by transferring a variable number of equity shares. If the issuer could be required to settle the obligation by transferring assets (either in a physical settlement or net in cash), the instrument is classified outside of equity under ASC 480-10-25-8 because it is not an outstanding share and it embodies an obligation to repurchase the issuer’s equity shares or is indexed to such an obligation (see Chapter 5). If the issuer must or can elect to settle the obligation by delivering a variable number of shares, the instrument is classified outside of equity under ASC 480-10-25-14(c) because (1) it is a financial instrument other than an outstanding share that embodies a conditional obligation that the issuer must or may settle by issuing a variable number of shares and (2) its monetary
value is inversely related to the issuer’s stock price (see Chapter 6). In either case, the instrument is classified outside of equity because of the written put option component. The purchased call option does not affect the analysis of the appropriate classification of the instrument because the call option does not represent an obligation of the issuer.

Although the classification analysis in these two examples focuses on the written put option component, the option combination is accounted for in its entirety since it represents a single freestanding financial instrument. For example, in the fair value measurement of the instrument, both the written put option and the purchased call option components are considered. Note, however, that the purchased call option component of the combination would have been outside the scope of ASC 480-10 had it been issued as a freestanding instrument that is separate from the written put option, as illustrated in ASC 480-10-55-34 and 55-35, since it (1) would have represented a unit of account that is separate from the written put option and (2) embodies no obligation of the issuer. Similarly, outstanding shares of stock that are freestanding financial instruments and separate from the put and call options are analyzed independently of the options, as illustrated in ASC 480-10-55-34 through 55-37.
Chapter 8 — Presentation and Disclosure

This chapter discusses the presentation and disclosure of instruments that are classified outside of equity under ASC 480-10-25 (see Sections 8.1 and 8.2). ASC 480-10 contains special presentation and disclosure requirements for entities that have issued mandatorily redeemable shares but have no equity-classified shares outstanding (see Section 8.3). Further, ASC 480-10 requires certain adjustments to EPS calculations (see Section 8.4).

8.1 Presentation

ASC 480-10

| 45-1 | Items within the scope of this Subtopic shall be presented as liabilities (or assets in some circumstances). Those items shall not be presented between the liabilities section and the equity section of the statement of financial position. |

Instruments that do not qualify as equity under ASC 480-10-25 must be presented as either assets or liabilities. Unlike securities with redemption features outside the control of the issuer (e.g., puttable shares) that are subject to ASC 480-10-599-3A (see Chapter 9), such instruments cannot be presented in a mezzanine section between liabilities and equity.

Mandatorily redeemable financial instruments, which are one of the three classes of freestanding financial instruments that must be classified outside of equity under ASC 480-10, are always classified as liabilities. Freestanding financial instruments in the other two classes are either assets or liabilities depending on whether their fair value is positive or negative. For example, a forward contract or collar on equity shares may be in either a gain or loss position for the issuer.

An issuer that has no equity-classified instruments outstanding presents liability-classified shares that are subject to mandatory redemption, and related payments and accruals, separately from other liabilities in the issuer’s financial statements (see Section 8.3).

8.2 Disclosure

ASC 480-10

| 50-1 | Entities that issue financial instruments recognized under the guidance in Section 480-10-25 shall disclose both of the following: |
| a. The nature and terms of the financial instruments |
| b. The rights and obligations embodied in those instruments, including both: |
| 1. Settlement alternatives, if any, in the contract |
| 2. The entity that controls the settlement alternatives. |
Additionally, for all outstanding financial instruments recognized under the guidance in Section 480-10-25 and for each settlement alternative, issuers shall disclose all of the following:

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

b. How changes in the fair value of the issuer's equity shares would affect those settlement amounts (for example, "the issuer is obligated to issue an additional X shares or pay an additional Y dollars in cash for each $1 decrease in the fair value of one share")

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

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

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

f. For a forward contract or an option indexed to the issuer's equity shares, all of the following:
   1. The forward price or option strike price
   2. The number of issuer's shares to which the contract is indexed
   3. The settlement date or dates of the contract, as applicable.

Paragraph 505-10-50-3 requires additional disclosures for actual issuances and settlements that occurred during the accounting period.

The disclosure requirements in ASC 480-10 supplement those in ASC 505-10-50 related to an entity's capital structure and those in other GAAP related to an entity's liability and equity instruments. Notably, ASC 505-10-50-3 requires disclosure of the pertinent rights and privileges of securities outstanding, and ASC 505-10-50-11 requires disclosure of the amount of redemption requirements associated with stock that is redeemable at fixed or determinable prices on fixed or determinable dates in each of the five years after the date of the latest statement of financial position presented.

Paragraph B70 of the Background Information and Basis for Conclusions of FASB Statement 150 indicates that in developing the disclosure requirements now contained in ASC 480-10, the Board concluded that "additional information would be helpful to users in evaluating an entity's economic exposure to financial instruments that could be settled in an entity's shares." The Board modelled most of these incremental disclosure requirements on those now contained in ASC 815-40 for contracts on an entity's own equity. The following table compares the disclosure requirements for contracts subject to ASC 480-10 with the comparable disclosure requirements for contracts subject to ASC 815-40:

<table>
<thead>
<tr>
<th>ASC 480-10-50-1</th>
<th>ASC 815-40-50-5</th>
</tr>
</thead>
</table>
| "Entities that issue financial instruments recognized under the guidance in Section 480-10-25 shall disclose both of the following:" | "b. If the terms of the contract provide settlement alternatives, those settlement alternatives shall be disclosed under Section 505-10-50, including . . .:
   1. Who controls the settlement alternatives" |
| a. The nature and terms of the financial instruments | |
| b. The rights and obligations embodied in those instruments, including both: | |
| 1. Settlement alternatives, if any, in the contract | |
| 2. The entity that controls the settlement alternatives." | |
|
(Table continued)

<table>
<thead>
<tr>
<th>ASC 480-10-50-2</th>
<th>ASC 815-40-50-5</th>
</tr>
</thead>
<tbody>
<tr>
<td>“[F]or each settlement alternative . . . :”</td>
<td>“d. A contract’s current fair value for each settlement alternative (denominated, as relevant, in monetary amounts or quantities of shares) . . .”</td>
</tr>
<tr>
<td>- a. The amount that would be paid, or the number of shares that would be issued and their fair value, determined under the conditions specified in the contract if the settlement were to occur at the reporting date.”</td>
<td>- d. [How] changes in the price of the issuer’s equity instruments affect those settlement amounts (for example, the issuer is obligated to issue an additional X shares or pay an additional Y dollars in cash for each $1 decrease in stock price) shall be disclosed under Section 505-10-50. (For some issuers, a tabular format may provide the most concise and informative presentation of these data.)”</td>
</tr>
<tr>
<td>- b. How changes in the fair value of the issuer’s equity shares would affect those settlement amounts (for example, ‘the issuer is obligated to issue an additional X shares or pay an additional Y dollars in cash for each $1 decrease in the fair value of one share”).”</td>
<td>- d. How changes in the price of the issuer’s equity instruments affect those settlement amounts (for example, the issuer is obligated to issue an additional X shares or pay an additional Y dollars in cash for each $1 decrease in stock price) shall be disclosed under Section 505-10-50. (For some issuers, a tabular format may provide the most concise and informative presentation of these data.)”</td>
</tr>
<tr>
<td>- “c. The maximum amount that the issuer could be required to pay to redeem the instrument by physical settlement, if applicable.”</td>
<td>No directly comparable requirement.</td>
</tr>
<tr>
<td>- “d. The maximum number of shares that could be required to be issued, if applicable.”</td>
<td>- b. If the terms of the contract provide settlement alternatives, those settlement alternatives shall be disclosed under Section 505-10-50, including . . .</td>
</tr>
<tr>
<td>- 2. The maximum number of shares that could be required to be issued to net share settle a contract, if applicable. Paragraph 505-10-50-3 requires additional disclosures for actual issuances and settlements that occurred during the accounting period.”</td>
<td></td>
</tr>
<tr>
<td>“e. That a contract does not limit the amount that the issuer could be required to pay or the number of shares that the issuer could be required to issue, if applicable.”</td>
<td>“c. If a contract does not have a fixed or determinable maximum number of shares that may be required to be issued, the fact that a potentially infinite number of shares could be required to be issued to settle the contract shall be disclosed under Section 505-10-50.”</td>
</tr>
<tr>
<td>“f. For a forward contract or an option indexed to the issuer’s equity shares, all of the following:”</td>
<td>“a. In the case of an option or forward contract indexed to the issuer’s equity, the pertinent information to be disclosed under Section 505-10-50 about the contract includes all of the following:”</td>
</tr>
<tr>
<td>1. The forward price or option strike price</td>
<td>1. The forward rate</td>
</tr>
<tr>
<td>2. The number of issuer’s shares to which the contract is indexed</td>
<td>2. The option strike price</td>
</tr>
<tr>
<td>3. The settlement date or dates of the contract, as applicable.”</td>
<td>3. The number of issuer’s shares to which the contract is indexed</td>
</tr>
<tr>
<td>4. The settlement date or dates of the contract</td>
<td>5. The issuer’s accounting for the contract (that is, as an asset, liability, or equity).”</td>
</tr>
</tbody>
</table>
8.3 Entities That Have No Equity-Classified Shares

8.3.1 Separate Presentation and Disclosure

ASC 480-10

45-2 Entities that have no equity instruments outstanding but have financial instruments issued in the form of shares, all of which are mandatorily redeemable financial instruments required to be classified as liabilities, shall describe those instruments as shares subject to mandatory redemption in statements of financial position to distinguish those instruments from other liabilities. Similarly, payments to holders of such instruments and related accruals shall be presented separately from payments to and interest due to other creditors in statements of cash flows and income.

50-4 Some entities have no equity instruments outstanding but have financial instruments in the form of shares, all of which are mandatorily redeemable financial instruments required to be classified as liabilities. Those entities shall disclose the components of the liability that would otherwise be related to shareholders’ interest and other comprehensive income (if any) subject to the redemption feature (for example, par value and other paid-in amounts of mandatorily redeemable instruments shall be disclosed separately from the amount of retained earnings or accumulated deficit).

If an entity determines that none of its financial instruments qualify as equity under ASC 480-10 because all of its shares meet the definition of a mandatorily redeemable financial instrument in ASC 480-10, special presentation and disclosure requirements apply. The liability-classified shares are presented separately from other liabilities and described as “shares subject to mandatory redemption” in the statement of financial position. Further, payments and accruals on such instruments are presented separately in the statement of cash flows and the statement of financial performance. Moreover, an entity discloses the components of the liability that would otherwise be related to shareholders’ interest and other comprehensive income (e.g., par value, additional paid-in capital (APIC), retained earnings or accumulated deficit, and accumulated other comprehensive income attributable to those shares).

Paragraph B60 of the Background Information and Basis for Conclusions of FASB Statement 150 states, in part:

For entities that have financial instruments in the form of shares that are all mandatorily redeemable, the Board decided that, in addition to separate presentation, a related disclosure is needed that displays the nature and composition of the mandatorily redeemable instruments. For example, such an entity would disclose the event triggering the redemption, the number of shares issued and outstanding, the value associated with those financial instruments, and any retained earnings or accumulated other comprehensive income that would be distributed on redemption . . . . The Board concluded that for those entities that have financial instruments in the form of shares that are all mandatorily redeemable, disclosure will assist financial statement users in assessing the amount and timing of redemptions.
In ASC 480-10-55-64 below, the FASB provides an example of stock that must be redeemed upon the death of the holder.

**Example 1: Mandatorily Redeemable Financial Instruments — Stock to Be Redeemed Upon Death of the Holder**

This Example illustrates the application of the guidance in this Subtopic to stock to be redeemed upon the death of the holder. An entity may issue shares of stock that are required to be redeemed upon the death of the holder for a proportionate share of the book value of the entity. The death of the holder is an event that is certain to occur. Therefore, the stock is classified as a liability. (An insurance contract that would cover the cost of the redemption does not affect the classification of the stock as a liability.) If the stock represents the only shares in the entity, the entity reports those instruments in the liabilities section of its statement of financial position and describes them as shares subject to mandatory redemption so as to distinguish the instruments from other financial statement liabilities. The issuer presents interest cost and payments to holders of such instruments separately, apart from interest and payments to other creditors, in statements of income and cash flows. The entity also discloses that the instruments are mandatorily redeemable upon the death of the holders. The following presentation is an example of the required presentation and disclosure for entities that have no equity instruments outstanding but have shares, all of which are mandatorily redeemable financial instruments classified as liabilities.

### Statement of Financial Position:

<table>
<thead>
<tr>
<th>Description</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total assets</td>
<td>$ 1,800,000</td>
</tr>
<tr>
<td>Liabilities other than shares</td>
<td>$ 1,000,000</td>
</tr>
<tr>
<td>Shares subject to mandatory redemption(\text{a})</td>
<td>800,000</td>
</tr>
<tr>
<td>Total liabilities</td>
<td>$ 1,800,000</td>
</tr>
</tbody>
</table>

### Notes to Financial Statements:

(a) Shares, all subject to mandatory redemption upon death of the holders, consist of:

- Common stock — $100 par value, 10,000 shares authorized, $ 500,000
- 5,000 shares issued and outstanding, $ 320,000
- Retained earnings attributable to those shares, $(20,000)
- Accumulated other comprehensive income attributable to those shares, $ (20,000)

Total: $ 800,000

### 8.3.2 Difference Between Redemption Price and Book Value

**ASC 480-10**

Some entities have outstanding shares, all of which are subject to mandatory redemption on the occurrence of events that are certain to occur. The redemption price may be a fixed amount or may vary based on specified conditions. If all of an entity's shares are subject to mandatory redemption and the entity is not subject to the deferral in paragraphs 480-10-15-7A through 15-7F, an excess of the redemption price of the shares over the entity's equity balance shall be reported as an excess of liabilities over assets (a deficit), even though the mandatorily redeemable shares are reported as a liability. If the redemption price of the mandatorily redeemable shares is less than the book value of those shares, the entity should report the excess of that book value over the liability reported for the mandatorily redeemable shares as an excess of assets over liabilities (equity).
The measurement of a mandatorily redeemable financial instrument under ASC 480-10-35-3 is based not on the holder's interest in the net book value of the entity but on the amount to be paid on settlement of the instrument (i.e., the redemption value). Therefore, the carrying amount may differ from the net book value attributable to an instrument, in which case ASC 480-10-45 requires the excess or deficit to be presented separately. If the carrying amount of mandatorily redeemable financial instruments exceeds their net book value, the excess is reported as an “excess of liabilities over assets (a deficit).” If the net book value exceeds the carrying amount, the surplus is reported as “excess of assets over liabilities (equity).”

When all of an entity's shares are mandatorily redeemable financial instruments and contractually must be redeemed at their book value, the entity generally would report no net income after deducting interest cost on those shares. When all of an entity's shares are mandatorily redeemable financial instruments and contractually must be redeemed at an amount other than their net book value, however, changes in the carrying amount of the liability-classified mandatorily redeemable financial instruments could be greater or less than net income before interest cost on those shares is deducted.

FASB Staff Position FAS 150-2 (superseded as a result of the Codification) contains two examples of an entity's transition to FASB Statement 150 and its post-transition accounting when all shares are mandatorily redeemable and the redemption value differs from the entity's book value. Except for the entries related to transition, those examples continue to be relevant and are reproduced below (the transition entries have been removed).

### FASB Staff Position FAS 150-2

**Illustrations of Accounting for Mandatorily Redeemable Shares With a Redemption Value That Differs From the Company's Book Value [footnote omitted]**

**Example 1**

Assume . . . that the fair value (which equals the redemption value) of the mandatorily redeemable shares is $20 million and the book value of those shares is $15 million, of which $10 million is paid-in capital. [In this case,] the company would recognize a liability of $20 million . . . . Subsequently, net income attributable to the mandatorily redeemable shares is $1 million for the year 20XX and the fair value of those shares at the reporting date of December 31, 20XX, is $21.2 million. Also assume that the company did not pay any cash dividends.

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

<table>
<thead>
<tr>
<th>Statements of Financial Position</th>
<th>January 1, 20XX</th>
<th>December 31, 20XX</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total assets</td>
<td>$25,000,000</td>
<td>$26,000,000</td>
</tr>
<tr>
<td>Liabilities other than shares</td>
<td>$10,000,000</td>
<td>$10,000,000</td>
</tr>
<tr>
<td>Shares subject to mandatory redemption*</td>
<td>$20,000,000</td>
<td>$21,200,000</td>
</tr>
<tr>
<td>Total liabilities</td>
<td>$30,000,000</td>
<td>$31,200,000</td>
</tr>
<tr>
<td>Excess of liabilities over assets (deficit)</td>
<td>$(5,000,000)</td>
<td>$(5,200,000)</td>
</tr>
<tr>
<td>Total</td>
<td>$25,000,000</td>
<td>$26,000,000</td>
</tr>
</tbody>
</table>
FASB Staff Position FAS 150-2 (continued)

Notes to Financial Statements

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

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Common stock — $100 par value, 200,000 shares authorized, 100,000 shares issued and outstanding</td>
<td>$10,000,000</td>
</tr>
<tr>
<td>Retained earnings attributable to those shares</td>
<td>5,000,000</td>
</tr>
<tr>
<td>Excess of redemption amount over common stock and retained earnings attributable to those shares</td>
<td>5,000,000</td>
</tr>
<tr>
<td></td>
<td>$20,000,000</td>
</tr>
</tbody>
</table>

Partial Statement of Income (For the Year Ended December 31, 20XX)

Income before interest on mandatorily redeemable shares | $1,000,000
Less: Interest on mandatorily redeemable shares (change in redemption amount) | 1,200,000
Income (loss) . . . | $(200,000)

Example 2
Assume the same facts as in Example 1 except that the shares are to be redeemed at an amount ($11 million) that is less than their book value . . .

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

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

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total assets</td>
<td>$25,000,000</td>
</tr>
<tr>
<td>Liabilities other than shares</td>
<td>$10,000,000</td>
</tr>
<tr>
<td>Shares subject to mandatory redemption*</td>
<td>11,000,000</td>
</tr>
<tr>
<td>Total liabilities</td>
<td>$21,000,000</td>
</tr>
<tr>
<td>Excess of assets over liabilities (equity)</td>
<td>$4,000,000</td>
</tr>
<tr>
<td>Total</td>
<td>$25,000,000</td>
</tr>
</tbody>
</table>

Notes to Financial Statements

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

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Common stock — $100 par value, 200,000 shares authorized, 100,000 shares issued and outstanding</td>
<td>$10,000,000</td>
</tr>
<tr>
<td>Retained earnings attributable to those shares</td>
<td>5,000,000</td>
</tr>
<tr>
<td>Excess of common stock and retained earnings attributable to those shares over redemption amount</td>
<td>(4,000,000)</td>
</tr>
<tr>
<td></td>
<td>$11,000,000</td>
</tr>
</tbody>
</table>
8.4 Earnings per Share

ASC 480-10 does not comprehensively address how to determine EPS for instruments within its scope. Instead, an entity applies ASC 260 except as specified in ASC 480-10-45-4. ASC 480-10-45-4 requires an entity to make certain adjustments to the EPS calculation performed under ASC 260 for (1) mandatorily redeemable financial instruments and (2) forward contracts that require physical settlement by repurchase of a fixed number of equity shares of common stock in exchange for cash (see Section 8.4.1). For other contracts within the scope of ASC 480-10, an entity applies ASC 260, including to other forward contracts and written put options on common stock (see Section 8.4.2) and share-settled debt (see Section 8.4.3).

Connecting the Dots

For a detailed discussion of the computation of EPS, see Deloitte’s A Roadmap to the Presentation and Disclosure of Earnings per Share.

8.4.1 Mandatorily Redeemable Financial Instruments and Physically Settled Forward Contracts to Repurchase Common Stock

ASC 480-10-45-4 requires an entity to make the following adjustments to the EPS calculation for (1) mandatorily redeemable financial instruments and (2) forward contracts that require physical settlement by repurchase of a fixed number of the issuer’s equity shares of common stock in exchange for cash:

- **Denominator (i.e., the number of shares outstanding)** — In calculating both basic and diluted EPS, the entity excludes from the denominator shares of common stock that will be repurchased (i.e., it treats those shares as retired).
- **Numerator (i.e., the amount of earnings available to common stockholders)** — The entity uses a two-class method to adjust the numerator for any amounts attributable to such shares that have not been accounted for as interest cost. Under the two-class method, the entity reduces the numerator for the amount of undistributed earnings that are allocable to the shares subject to repurchase.

Paragraph B68 of the Background Information and Basis for Conclusions of FASB Statement 150 states, in part:

The Board decided that the number of outstanding shares associated with physically settled forward purchase contracts measured at the present value of the contract amount should be removed from the denominator in computing basic and diluted earnings per share in the same way as required for mandatorily redeemable shares classified as liabilities. The Board reasoned that, because the accounting for physically settled forward contracts reduces equity, even though the shares are still outstanding, they are effectively accounted for as if retired. Like mandatorily redeemable shares accounted for as liabilities, shares subject to physically settled forward contracts should not be treated as outstanding in earnings per share calculations. The Board noted that amounts paid to holders are interest costs reflected in earnings available to common shareholders, the numerator in calculating earnings per share.
Connecting the Dots

Questions often arise related to whether it is appropriate to reduce the denominator in the calculation of basic EPS when an entity has a forward contract to repurchase a variable number of shares that must be physically settled. Although the EPS guidance in ASC 480-10-45-4 refers to contracts in which a fixed number of shares must be physically settled, it is generally appropriate to reduce the denominator by the minimum number of shares of common stock that will be repurchased, but only if the contract specifies a contractual minimum. In these circumstances, the entity should apply a method akin to the two-class method for the number of shares removed from the denominator if those shares are entitled to dividends during the period of the forward contract and the holder is not obligated to return those dividends to the entity.

According to ASC 260-10-45-60 and ASC 260-10-45-60B, the two-class method is an earnings-allocation formula under which:

- Net income is “reduced by the amount of dividends declared in the current period for each class of stock and by the contractual amount of dividends . . . that must be paid for the current period (for example, unpaid cumulative dividends).”
- The “remaining earnings [are] allocated to common stock and participating securities to the extent that each security may share in earnings as if all of the earnings for the period had been distributed.”
- The “total earnings allocated to each security [are] divided by the number of outstanding shares of the security to which the earnings are allocated to determine the EPS for the security.”

While the outstanding common shares are excluded from the denominator in the calculations of EPS, if the counterparty that owns the common shares has a contractual right to participate in dividends declared by the entity before the common shares are retired, the entity must treat the excluded common shares as participating securities under ASC 260. Under the two-class method, an entity adjusts the numerator for any dividends declared or paid and undistributed earnings, but only to the extent that these amounts have not been accounted for as interest cost.

Because ASC 480-10-45-3 requires entities to reflect in interest cost any amounts paid or to be paid to holders of the contracts in excess of the initial measurement amount, the numerator is not adjusted for such amounts under the two-class method. For example, accrued cumulative dividends would be recognized as interest cost even if not declared as long as the holder is entitled to such dividends during the life of the contract or at settlement. Generally, therefore, no distributed earnings will be allocated to these participating securities because the dividends will have been recognized in earnings as interest cost; reflecting the distributed earnings under the two-class method would result in “double-counting” the impact on EPS. However, undistributed earnings must be allocated to these participating securities in accordance with ASC 260-10-45-60 through 45-70.

Other amounts attributable to the shares under the two-class method, however, might not have been recognized as interest cost. For example, the holder of a mandatorily redeemable financial instrument may have a participation right in 10 percent of dividends paid on common shares if or when they are declared. An amount may therefore be allocable to the share subject to repurchase because all earnings for the period are assumed to have been distributed under the two-class method. However, this amount may not have been recognized as interest cost under ASC 480-10 if the holder is not entitled to it during the life of the contract or at settlement unless the issuer elects to declare a dividend on common stock. As discussed in Section 3.2.4.3.1 of Deloitte’s A Roadmap to the Presentation and Disclosure of Earnings per Share, the impact on EPS of treating the common shares as participating securities will often be the same as including the common shares in the denominator in the EPS calculations when an entity has...
undistributed earnings. If, however, a forward purchase contract on a fixed number of common shares contains fixed adjustments to the forward price that are based on anticipated dividends, the guidance in Section 5.3.3.5.2 of Deloitte’s *A Roadmap to the Presentation and Disclosure of Earnings per Share* applies and the forward purchase contract is not a participating security.

**Example 8-1**

**Calculating EPS When Repurchasing Shares in a Forward Contract**

Company A, a public business entity, has 1,000 outstanding common shares. On January 1, A enters into a forward contract that must be physically settled on December 31 by the repurchase of 100 shares in exchange for the fixed amount of $500. The forward contract does not provide for any subsequent adjustment of the repurchase price on the basis of the amount of actual dividends paid. Like other common shares, the 100 shares to be repurchased under the forward contract continue to be entitled to receive any dividends declared on common shares until the repurchase date. However, A declares no dividends during the year.

In calculating basic EPS for the year, A excludes from the denominator the 100 shares that are to be repurchased in accordance with ASC 480-10-45-4. Company A’s earnings for the year are $20,000 (excluding interest cost accrued on the forward contract under ASC 480-10-35-8. In the absence of the forward contract, basic EPS for the year would have been $20 ($20,000 ÷ 1,000).

ASC 480-10-45-4 also requires that A deduct from income available to common stockholders any amounts (including participation rights in undistributed earnings) attributable to shares that are to be repurchased.

This is consistent with the two-class method described in ASC 260 (except to the extent that such amounts have already been recognized as interest cost under ASC 480-10-35-3). Because the forward contract in this situation does not return to A the actual dividends paid on the 100 shares to be repurchased, A deducts $2,000 from the EPS numerator to reflect the participation rights in undistributed earnings attributable to the 100 shares being repurchased ($20,000 × [100 ÷ 1,000]). Accordingly, the EPS numerator is $18,000 ($20,000 – $2,000). Because the EPS denominator is 900, basic EPS for the period is still $20 ($18,000 ÷ 900).

The SEC staff has indicated that if an equity-classified preferred stock is subsequently reclassified as a liability (e.g., a preferred share that was conditionally redeemable becomes mandatorily redeemable), the reclassification should be treated as a redemption of equity by issuance of a debt instrument in the calculation of EPS (see ASC 260-10-S99-2 and Section 3.2.2.8 of Deloitte’s *A Roadmap to the Presentation and Disclosure of Earnings per Share*). Further, ASC 480-10-30-2 requires an entity to initially measure the instrument at fair value upon reclassification, with an offset to equity and no gain or loss recognized. For EPS purposes, however, the numerator is adjusted for any change in the carrying amount. For example, if the new carrying amount under ASC 480-10 exceeds the carrying amount previously recorded in equity, that difference reduces the EPS numerator (i.e., the change is treated as a distribution to the holder of the instrument).

### 8.4.2 Other Forward Purchase Contracts and Written Put Options on Common Stock

#### ASC 260-10

**Written Put Options and the Reverse Treasury Stock Method**

**45-35** Contracts that require that the reporting entity repurchase its own stock, such as written put options and forward purchase contracts other than forward purchase contracts accounted for under paragraphs 480-10-30-3 through 30-5 and 480-10-35-3, shall be reflected in the computation of diluted EPS if the effect is dilutive. If those contracts are in the money during the reporting period (the exercise price is above the average market price for that period), the potential dilutive effect on EPS shall be computed using the reverse treasury stock method. . . .
The reverse treasury stock method applies in the computation of diluted EPS to contracts that require an entity to repurchase its common stock. Such contracts include the following:

- **Written put options (common stock)** — Options written by an entity under which the counterparty has the right, but not the obligation, to sell a specified quantity or amount of common stock to the entity at a fixed or otherwise determinable price.

- **Forward purchase contracts (common stock)** — Contracts that require the entity to purchase a specified quantity or amount of common stock from the counterparty at a future date at a fixed or otherwise determinable price.

An entity should not apply the reverse treasury stock method to a contract listed above in the following three situations:

- The contract represents a forward contract to repurchase common stock that is within the scope of ASC 480-10-30-3 through 30-5 and ASC 480-10-35-3 (see Section 8.4.1).

- The contract must be net settled in cash (i.e., no common shares are purchased upon settlement).

- The contract may be settled in cash or stock at the election of the entity, and the entity has overcome the presumption of share settlement.

The reverse treasury stock method represents a method of determining the dilutive effect of a contract that obligates an entity to purchase its common shares. Under this method, it is assumed that the entity raises the proceeds necessary to satisfy its obligation under the share purchase contract by issuing its common shares to market participants at the average market price during the period. The excess of the common shares assumed issued over the common shares purchased under the contract represents the incremental common shares under the reverse treasury stock method.

Like the treasury stock method (as discussed in Section 4.2.2.1 of Deloitte’s A Roadmap to the Presentation and Disclosure of Earnings per Share), the reverse treasury stock method is only applied to written put options that are in-the-money from the perspective of the counterparty. This determination is based on a comparison of the exercise price with the average market price of the entity’s common stock. We do not believe that the reverse treasury stock method should be applied to an out-of-the-money written put option that would be dilutive to EPS because of the adjustment made to the numerator to reverse the mark-to-market amount recognized on the contract during the reporting period. However, because forward purchase contracts must be settled regardless of whether they are in-the-money or out-of-the-money, the reverse treasury stock method should be applied to forward contracts if such contracts are dilutive. An entity would determine whether a forward purchase contract is dilutive to EPS on the basis of the aggregate effect of the numerator adjustment and the incremental common shares to be included in the denominator under the reverse treasury stock method.

Although contracts subject to the reverse treasury stock method must be classified as liabilities (or assets in some circumstances) for accounting purposes, it is still assumed that the contract is classified as an equity instrument under this method of calculating diluted EPS. Therefore, in addition to the incremental shares that are added to the denominator under the reverse treasury stock method, an adjustment to the numerator is also required. The numerator adjustment should reflect the change in net income that would have occurred during the reporting period if the contract had been classified in equity. Since contracts subject to the reverse treasury stock method are typically subsequently measured at fair value, with changes in fair value recognized in earnings, and contracts classified as equity instruments are typically not subsequently remeasured, the adjustment to the numerator will reflect a reversal of the mark-to-market adjustment recognized on the contract during the reporting period, net of any associated income tax effects. However, the numerator adjustment should not be
made, and the incremental shares should not be added to the denominator, if either (1) the contract is a written put option and is out-of-the-money on the basis of a comparison of the exercise price with the average market price or (2) the aggregate effect of the two adjustments is antidilutive on the basis of the antidilution sequencing requirements in ASC 260. See Section 4.7 of Deloitte’s *A Roadmap to the Presentation and Disclosure of Earnings per Share* for further discussion of the diluted EPS accounting for contracts subject to the reverse treasury stock method.

See Section 4.3.2 of Deloitte’s *A Roadmap to the Presentation and Disclosure of Earnings per Share* for further discussion of the application of the reverse treasury stock method to potential common shares within its scope that are not participating securities. For example, special issues arise when:

- The number of common shares to be repurchased is variable (see Section 4.3.2.1.1 of Deloitte’s *A Roadmap to the Presentation and Disclosure of Earnings per Share*),
- The exercise price or the forward price is variable (see Section 4.3.2.1.2.1 of Deloitte’s *A Roadmap to the Presentation and Disclosure of Earnings per Share*).
- The contract is issued, exercised, forfeited, or canceled, or it expires, during a financial reporting period (see Section 4.3.2.1.3.1 of Deloitte’s *A Roadmap to the Presentation and Disclosure of Earnings per Share*).
- The contract permits net share settlement (see Section 4.3.2.2.2 of Deloitte’s *A Roadmap to the Presentation and Disclosure of Earnings per Share*).
- The contract has multiple settlement alternatives (see Sections 4.3.2.2.3 and 4.6 of Deloitte’s *A Roadmap to the Presentation and Disclosure of Earnings per Share*).

If a potential common share is a participating security, an entity is required to apply the more dilutive of the reverse treasury stock method or the two-class method of calculating diluted EPS (see Section 5.5.4 of Deloitte’s *A Roadmap to the Presentation and Disclosure of Earnings per Share*).

If a contract can be settled in common stock or cash at the option of the issuer, it is presumed that it will be settled in common stock. ASC 260-10-45-46 and ASC 260-10-55-36 imply that the presumption may be overcome if past experience or a stated policy provides a reasonable basis for an entity to conclude that the contract will be paid partially or wholly in cash unless the counterparty controls the means of settlement (see Section 4.3.2.2.1 of Deloitte’s *A Roadmap to the Presentation and Disclosure of Earnings per Share*).

The reverse treasury stock method is not applied if the contract must be cash settled (i.e., no common shares are purchased on settlement) or the contract may be settled in cash or stock at the election of the entity, and the entity has overcome the presumption of share settlement. Any dilutive impact of the contract is reflected through the mark-to-market adjustment recognized in earnings on the contract through the application of other GAAP. Since share settlement is not assumed in the calculation of diluted EPS, and because the contract has already been marked to market through net earnings in accordance with the subsequent-measurement guidance in ASC 480, no additional adjustments are needed in the calculation of diluted EPS. The reverse treasury stock method is applied in all other circumstances if its application is dilutive. Other circumstances may include those in which (1) the contract must be share settled, (2) the counterparty is permitted to require the entity to settle the contract in cash or by purchasing common shares, or (3) the entity is permitted to settle the contract in cash or by purchasing common shares and does not overcome the presumption of share settlement.
8.4.3 Certain Variable-Share Obligations

A financial instrument that embodies an unconditional obligation that the issuing entity must settle by issuing a variable number of common shares equal to a fixed monetary amount must be classified as a liability under ASC 480-10-25-14 (see Chapter 6). Although such a share-settled “debt” instrument does not provide the holder with any potential “upside” from increases in the issuing entity's common stock, it meets the definition of a convertible security; therefore, the if-converted method of calculating diluted EPS must be applied to such an instrument (see Section 4.4 of Deloitte's A Roadmap to the Presentation and Disclosure of Earnings per Share). In applying the if-converted method, an entity should include in the denominator the number of common shares that would be issuable on the basis of the end-of-period stock price in accordance with the contingently issuable share method, as discussed in ASC 260-10-45-52.

If the number of common shares issuable upon conversion is linked to a specified rate, price, index, or other variable, the convertible security is considered to contain a variable conversion price. Since there is no specific guidance in ASC 260 on how to determine the conversion price under the if-converted method when it varies on the basis of a specified rate, price, index, or other variable, an entity may reasonably interpret ASC 260 in one of two ways in such circumstances:

- **View A: The number of common shares issuable upon conversion reflects the conversion price at the end of the reporting period** — This view is consistent with the guidance on contingently issuable shares in ASC 260-10-45-48 and ASC 260-10-45-52. Under that guidance, it is assumed that the contingency (in this case, the conversion price) is resolved as of the end of the reporting period. Thus, an entity calculates the conversion price on the basis of the current rate, price, index, or other variable as of the reporting date (or the average rate, price, index, or other variable, assuming conversion on the last day of the reporting period if the contract stipulates an averaging formula). See Section 4.5 of Deloitte's A Roadmap to the Presentation and Disclosure of Earnings per Share for additional discussion of the contingently issuable share method.

- **View B: The number of common shares issuable upon conversion is based on the lowest conversion price (highest conversion rate) available to the counterparty during any day within the reporting period** — This view is consistent with ASC 260-10-45-21, which requires that diluted EPS be calculated on the basis of “the most advantageous conversion rate or exercise price from the standpoint of the security holder.” As of each reporting date, the entity should evaluate all the conversion prices applicable for the entire time during the reporting period in which the convertible security was outstanding and should use the conversion price that is least advantageous to the entity and produces the highest number of common shares for the investor. The entity should not project future conversion prices since they will vary on the basis of changes in the rate, price, index, or other variable.

These two approaches are acceptable regardless of whether the entity or counterparty controls the timing of conversion (since neither party ultimately controls the rate, price, index, or other variable that affects the conversion price). The approach selected is considered an accounting policy election that must be applied consistently and disclosed.

If the convertible security is classified as a liability and recognized at fair value, with changes in fair value reported in earnings, which may be required because of the variable terms of the contract, an entity must also adjust the numerator in calculating diluted EPS, as discussed in Section 4.4.2.2.3 of Deloitte's A Roadmap to the Presentation and Disclosure of Earnings per Share.

We do not believe that it is acceptable to determine the conversion price on the basis of either (1) the conversion price at the beginning of the reporting period or (2) the average conversion price during the financial reporting period. There is no basis in ASC 260 for the use of either of these two approaches.
Chapter 9 — The SEC’s Guidance on Temporary Equity

Issuers of certain equity-classified instruments that are redeemable for cash or other assets in circumstances not under their sole control must, in financial statements filed with the SEC under Regulation S-X, (1) present such instruments in a caption that is separate from both liabilities and stockholders’ equity on the face of the balance sheet and (2) apply specific measurement and disclosure guidance to them. Instruments presented in this manner are described as temporary (or “mezzanine”) equity instruments.

Under the SEC’s temporary-equity guidance, equity instruments that contain terms that could force the issuer to redeem the instruments for cash or other assets are presented separately from conventional equity capital, which does not contain such terms. Temporary-equity presentation highlights that the proceeds received from equity instruments within the scope of the guidance may have to be repaid and thus may not be available to the issuer as a permanent source of equity financing.

Terms and features that could trigger temporary-equity classification are not limited to those that are explicitly described as cash-settled redemption or put features. For example, call, conversion, and liquidation features that could force the issuer to redeem an equity instrument for cash or assets might necessitate such classification. Accordingly, the SEC staff has advised issuers to “carefully consider all contractual provisions of a security before determining how it should be classified in the financial statements.”

9.1 Sources of Guidance

9.1.1 Overview

The SEC has issued various types of guidance on the separate presentation and disclosure of certain redeemable equity instruments, including:

- Rules and policies:
  - Regulation S-X, Rule 5-02.27.
  - Accounting Series Release No. 268 (ASR 268).
  - Codification of Financial Reporting Policies, Section 211 (CFRP 211; also known as CFRR 211 or FRR 211).
- Staff Accounting Bulletins (SABs):
  - SAB Topic 3.C.
  - SAB Topic 14.E.

1 From remarks by then SEC Professional Accounting Fellow Dominick J. Ragone III before the 2000 AICPA Conference on Current SEC Developments.
Staff announcements and observer comments at EITF meetings:
- *Classification and Measurement of Redeemable Securities* (announcement).
- *Sponsor’s Balance Sheet Classification of Capital Stock With a Put Option Held by an Employee Stock Ownership Plan* (observer comment).

Further, when applying the SEC’s temporary-equity guidance, registrants should consider remarks made by the SEC staff in public speeches, meetings with members of the accounting profession (including the CAQ's SEC Regulations Committee and its International Practices Task Force), and informal discussions about how the staff expects registrants to apply the guidance.

For ease of reference, the FASB has included in the Codification certain portions of the SEC’s rules and guidance (e.g., excerpts from Regulation S-X and SABs). If any discrepancies exist (e.g., because of updates to the SEC’s guidance that the FASB has not yet reflected in the Codification), registrants should apply the text issued by the SEC rather than the version in the Codification. However, note that since the SEC does not separately publish staff announcements or observer comments made at EITF meetings, the Codification is the primary repository for that text.

### 9.1.2 SEC Rules and Policies

#### 9.1.2.1 Regulation S-X

Regulation S-X, Rule 5-02 (reproduced in ASC 210-10-S99-1), contains requirements related to what should appear on the face of the balance sheet and be disclosed in related notes in financial statements filed with the SEC by all persons except those specifically exempted. Rule 5-02.27 specifies the basic balance sheet presentation and footnote disclosure requirements related to temporary-equity-classified redeemable preferred stocks. It requires an entity to present redeemable preferred stocks separately from components of permanent equity on the face of the balance sheet (see Section 9.8.1).

In presenting redeemable preferred stock separately under Regulation S-X, registrants should consider the SEC’s additional guidance on this topic, in particular the SEC staff announcement in ASC 480-10-S99-3A, and the GAAP requirements related to what should be presented as liabilities or equity. For instance, while Regulation S-X, ASR 268, CFRP 211, and SAB Topic 3.C focus on redeemable preferred stock, ASC 480-10-S99-3A clarifies that the SEC staff also expects registrants to apply the SEC’s temporary-equity guidance to other types of redeemable equity-classified instruments (such as common stock and noncontrolling interests; see Section 9.3.1). Further, while Regulation S-X, ASR 268, and CFRP 211 suggest that the temporary-equity guidance applies to stocks subject to mandatory redemption requirements, the FASB has subsequently issued guidance that requires certain financial instruments to be classified as liabilities even if they are in the form of outstanding shares of stock (see Chapters 4 and 6). Accordingly, the SEC’s temporary-equity guidance does not apply to outstanding shares that must be classified as liabilities under GAAP.

#### 9.1.2.2 ASR 268

ASR 268 contains the amendments to Regulation S-X that the SEC adopted on July 27, 1979, when it first established separate presentation and disclosure requirements for redeemable preferred stocks. In addition, the supplementary information in ASR 268 discusses the SEC’s decision to require separate presentation and disclosure of redeemable preferred stocks. While the complete, original text of ASR 268 is not reproduced in the Codification, ASC 210-10-S99-1 contains excerpts from Regulation S-X that were amended by ASR 268. Further, ASC 480-10-S99-1 contains selected portions of the supplementary information in ASR 268 that the SEC incorporated into CFRP 211.
9.1.2.3 CFRP 211

The SEC codified selected portions of ASR 268 in CFRP 211 (also known as CFRR 211 or FRR 211). Reproduced in ASC 480-10-S99-1, CFRP 211 provides information about the SEC's decision to require separate presentation and disclosure of redeemable preferred stocks in accordance with Regulation S-X. CFRP 211 does not contain the actual amendments to Regulation S-X, however, and omits portions of the supplementary information that was originally included in ASR 268, such as a brief discussion of comments the SEC received on the proposed rule that resulted in ASR 268 and the SEC's observations about the FASB's standard-setting activity at the time.

9.1.3 SABs

9.1.3.1 SAB Topic 3.C

SAB Topic 3.C (reproduced in ASC 480-10-S99-2) contains the SEC staff's views on how redeemable preferred stock should be measured and how changes in the carrying amount should be treated in EPS and ratio calculations. The SEC staff announcement in ASC 480-10-S99-3A contains additional detailed guidance on these topics.

9.1.3.2 SAB Topic 14.E

SAB Topic 14.E (reproduced in ASC 718-10-S99-1) contains the SEC's views on the application of the temporary-equity guidance to share-based payment arrangements with employees. This Roadmap touches briefly on these topics (see Sections 9.3.9, 9.4.9, and 9.5.12). For a more detailed discussion, see Deloitte's *A Roadmap to Accounting for Share-Based Payment Awards*.

9.1.4 SEC Announcements and Observer Comments Made at EITF Meetings

9.1.4.1 SEC Staff Announcement: Classification and Measurement of Redeemable Securities

<table>
<thead>
<tr>
<th>ASC 480-10 — SEC Materials — SEC Staff Guidance</th>
</tr>
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<tbody>
<tr>
<td><strong>S99-3A</strong> This SEC staff announcement provides the SEC staff's views regarding the application of Accounting Series Release No. 268, <em>Presentation in Financial Statements of “Redeemable Preferred Stocks.”</em> FN1</td>
</tr>
<tr>
<td><strong>FN1</strong> ASR 268 (SEC Financial Reporting Codification, Section No. 211, <em>Redeemable Preferred Stocks</em>) is incorporated into SEC Regulation S-X, Articles 5-02.27, 7-03.21, and 9-03.19. Hereafter, reference is made only to ASR 268.</td>
</tr>
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</table>

The SEC staff announcement in ASC 480-10-S99-3A provides a comprehensive overview of the SEC staff's views on the application of the redeemable-equity requirements in Regulation S-X and related guidance. Some practitioners continue to refer to this announcement as EITF Topic D-98 because that document contained an earlier version of the announcement. However, they should no longer rely on the text of EITF Topic D-98 because the SEC has since revised the original announcement.
9.1.4.2 SEC Observer Comments — Sponsor's Balance Sheet Classification of Capital Stock With a Put Option Held by an Employee Stock Ownership Plan

The SEC staff observer comments in ASC 480-10-S99-4 discuss the application of the SEC's temporary-equity guidance to equity instruments issued by a sponsor to an ESOP in situations in which the instruments can be put to the sponsor for cash or other assets (see Sections 9.3.8 and 9.5.11). These observer comments are also contained in EITF Issue 89-11, which was superseded by the Codification.

9.2 Scope — Entities

9.2.1 SEC Registrants

The SEC's temporary-equity guidance applies to SEC registrants' financial statements that are prepared in accordance with Regulation S-X (e.g., in annual reports on Form 10-K and registration statements on Form S-1). Regulation S-X, Rules 5-02.27 (reproduced in ASC 210-10-S99-1), 7-03.20 (reproduced in ASC 944-210-S99-1(20)), and 9-03.18 (reproduced in ASC 942-210-S99-1(18)), contain guidance on balance sheet presentation related to redeemable preferred stocks for SEC registrants that are subject to those rules.

9.2.2 Nonpublic Entities

While the SEC's temporary-equity guidance (including the SEC staff announcement in ASC 480-10-S99-3A) is not required to be applied to financial statements that are not filed with the SEC, an entity that is not filing financial statements with the SEC may elect to apply it anyway (e.g., if it contemplates becoming an SEC registrant in the future). Thus, paragraph 17.24 of AICPA Audit and Accounting Guide Depository and Lending Institutions: Banks and Savings Institutions, Credit Unions, Finance Companies, and Mortgage Companies (AAG-DEP), July 1, 2018, states, in part:

Regulation S-X, [Rule 5-02.27.] states that mandatory redeemable preferred stock is not to be included in amounts reported as stockholders' equity. Although nonpublic companies are not required to follow Regulation S-X, it would be appropriate for them to do so in most cases.

In some circumstances, the SEC's temporary-equity guidance must be applied to equity instruments issued by entities that are not SEC registrants:

- If a private company were a subsidiary of an SEC registrant, the SEC's guidance would be applied to the redeemable preferred stock issued by the subsidiary in the consolidated financial statements of the SEC registrant. However, the private company would not be required to apply the guidance in its stand-alone financial statements if they are not filed with the SEC.

- A private company or a subsidiary of an SEC registrant may be required to apply SEC guidance in its financial statements that are included, or incorporated by reference, in an SEC registrant's filing (e.g., when an SEC registrant is required to file a guarantor subsidiary's financial statements under Regulation S-X, Rule 3-10).

A nonpublic entity that becomes an SEC registrant (e.g., an entity that files an IPO registration statement) is required to comply with the SEC's guidance. Often, redeemable convertible preferred stock is fully converted into common stock upon consummation of an IPO and is no longer outstanding after the IPO. Nevertheless, an entity must still apply the SEC's temporary-equity guidance, if applicable, to the redeemable convertible preferred stock in the entity's financial statements before the IPO takes effect when the entity files an IPO registration statement with the SEC.
For a nonpublic entity not previously subject to ASC 480-10-S99-3A, a change to the classification or measurement of an equity instrument as a result of initially adopting ASC 480-10-S99-3A (e.g., in financial statements to be included in a registration statement filed with the SEC) is treated as a change in accounting policy (see ASC 250-10), not as the correction of an error. Accordingly, the nonpublic entity may need to retrospectively revise its prior-period financial statements to meet the SEC’s requirements.

9.3 **Scope — Instruments**

9.3.1 **Equity Instruments**

<table>
<thead>
<tr>
<th>ASC 480-10 — SEC Materials — SEC Staff Guidance</th>
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</thead>
<tbody>
<tr>
<td><strong>SEC Staff Announcement: Classification and Measurement of Redeemable Securities</strong></td>
</tr>
<tr>
<td><strong>S99-3A(3)</strong> Although ASR 268 specifically describes and discusses preferred securities, the SEC staff believes that ASR 268 also provides analogous guidance for other redeemable equity instruments including, for example, common stock, derivative instruments, noncontrolling interests, securities held by an employee stock ownership plan, and share-based payment arrangements with employees. The SEC staff’s views regarding the applicability of ASR 268 in certain situations is described below. [Footnotes and additional text omitted]</td>
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Although Regulation S-X, Rule 5-02.27, as well as ASR 268, CFRP 211, and SAB Topic 3.C focus on redeemable preferred stock, ASC 480-10-S99-3A(3) clarifies that the SEC’s temporary-equity guidance applies broadly to equity-classified instruments (including separated equity components) that meet the classification criteria for temporary equity (see Section 9.4) irrespective of whether they are in the form of preferred stock. Accordingly, the temporary-equity guidance applies to the issuer’s presentation of the following types of instruments if they meet the requirements for temporary-equity classification:

- Common stock.
- Preferred stock.
- Equity-classified components of convertible debt.
- Noncontrolling interests.
- Share-based payment arrangements.
- Equity securities issued by a sponsor to an ESOP.

9.3.2 **Assets and Liabilities**

<table>
<thead>
<tr>
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<tr>
<td><strong>SEC Staff Announcement: Classification and Measurement of Redeemable Securities</strong></td>
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<tr>
<td><strong>S99-3A(3)(a)</strong> Freestanding financial instruments classified as assets or liabilities. Freestanding financial instruments that are classified as assets or liabilities pursuant to Subtopic 480-10 or other applicable GAAP (including those that contain separated derivative assets or derivative liabilities) are not subject to ASR 268. An equity instrument subject to potential redemption under a freestanding written put option is not subject to ASR 268 (since the put option liability is considered a separate unit of account). However, as discussed in paragraph 3(b), when an embedded written put option has been separated from a hybrid financial instrument with an equity host contract, the host equity instrument is subject to ASR 268.</td>
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</table>

FN5 An equity instrument subject to potential redemption under a freestanding written put option is not subject to ASR 268 (since the put option liability is considered a separate unit of account). However, as discussed in paragraph 3(b), when an embedded written put option has been separated from a hybrid financial instrument with an equity host contract, the host equity instrument is subject to ASR 268.
The temporary-equity guidance does not apply to amounts presented as assets or liabilities under GAAP. Accordingly, the following instruments are not within the scope of that guidance even if they are in the form of equity contracts and contain redemption features not solely within the control of the issuer:

- Financial instruments (e.g., mandatorily redeemable financial instruments and written put options on the entity's own stock) that are classified as assets or liabilities under ASC 480-10 (see Chapters 4, 5, and 6).

- Contracts on the entity's own equity (e.g., warrants, options, or forwards that involve the purchase or sale of the issuer's equity shares) that are accounted for as assets or liabilities under ASC 815-40 because they are not considered indexed to the entity's own stock under ASC 815-40-15 or because the issuer could be forced to settle them in cash in accordance with ASC 815-40-25. (See Deloitte's A Roadmap to Accounting for Contracts on an Entity's Own Equity for a detailed discussion of this guidance.)

However, equity components that have been separated from convertible debt under ASC 470-20 or other GAAP are subject to the temporary-equity guidance if they meet the special requirements for temporary-equity classification that apply to such equity components (see Section 9.3.5).

An entity is not permitted to elect to present as a liability an instrument that is subject to the temporary-equity guidance (and thereby avoid application of the guidance) if the instrument does not qualify as a liability under ASC 480-10 or other GAAP, except for certain grandfathered instruments that (1) were classified and accounted for as a liability in fiscal quarters beginning before September 15, 2007, and (2) have not been subsequently modified or subject to a remeasurement (new basis) event (see Section 9.8.1).

### 9.3.3 Freestanding Equity-Classified Contracts (Other Than Outstanding Shares)

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<tr>
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<tbody>
<tr>
<td>SEC Staff Announcement: Classification and Measurement of Redeemable Securities</td>
</tr>
<tr>
<td><strong>S99-3A(3)(b)</strong> Freestanding derivative instruments classified in stockholders' equity. Freestanding derivative instruments that are classified in stockholders' equity pursuant to Subtopic 815-40 are not subject to ASR 268.(^{FN6}) Equity-classified freestanding financial instruments that were previously classified outside of permanent equity under Subtopic 815-40 are now classified as assets or liabilities pursuant to Subtopic 480-10. . . .</td>
</tr>
<tr>
<td>(^{FN6}) A freestanding derivative instrument would not meet the conditions in Subtopic 815-40 to be classified as an equity instrument if it was subject to redemption for cash or other assets on a specified date or upon the occurrence of an event that is not within the control of the issuer.</td>
</tr>
</tbody>
</table>

If a freestanding contract on an entity's own equity (such as a warrant, option, or forward that involves the purchase or sale of the issuer's equity instruments) other than an outstanding share includes a redemption requirement that would have resulted in temporary-equity classification under ASC 480-10-S99-3A (see Section 9.4), the contract will not qualify as equity under GAAP. ASC 480-10 and ASC 815-40 generally preclude equity classification for a contract (other than an outstanding share) that the issuer might be forced to settle in cash or other assets. Accordingly, to qualify as equity under ASC 480-10 and ASC 815-40, a contract other than an outstanding share cannot contain a redemption feature that would have resulted in temporary-equity classification under ASC 480-10-S99-3A. Therefore, the temporary-equity guidance generally does not apply to freestanding contracts on the entity's own equity that are accounted for as equity under ASC 815-40.


9.3.4 Hybrid Equity Instruments and Embedded Derivatives

Hybrid equity instruments (i.e., equity instruments that embody both a host contract and an embedded feature, such as preferred stock with an embedded redemption, put, call, or conversion feature) are subject to evaluation under the temporary-equity guidance in ASC 480-10-S99-3A.

If the embedded feature is not bifurcated under ASC 815-15 (e.g., a redemption feature embedded in an equity security would not require bifurcation under ASC 815-15 if the net settlement characteristic in the definition of a derivative in ASC 815-10-15-83 is not met), the issuer considers all the terms and features of the entire hybrid instrument in (1) evaluating whether the temporary-equity guidance applies to the entire hybrid instrument and (if it does) (2) classifying and measuring the instrument.

We believe that if the embedded feature is bifurcated from the host contract as a derivative instrument under ASC 815-15, the issuer should consider all of the terms and features of the entire hybrid financial instrument in evaluating whether the temporary-equity guidance applies to the host contract. As stated in footnote 5 of ASC 480-10-S99-3A(3)(a), “when an embedded written put option has been separated from a hybrid financial instrument with an equity host contract, the host equity instrument is subject to ASR 268.”

The temporary-equity guidance does not apply to hybrid instruments that are accounted for in their entirety as liabilities. It also does not apply to an outstanding equity share if it is determined that any and all redemption features associated with the share are freestanding financial instruments that are separate from the share (see Chapter 3).

9.3.5 Convertible Debt Instruments Separated Into Liability and Equity Components

Convertible debt instruments that contain a separately classified equity component. Other applicable GAAP may require a convertible debt instrument to be separated into a liability component and an equity component.\textsuperscript{FN8} . . .

\textsuperscript{FN8} See Subtopics 470-20 and 470-50; and Paragraph 815-15-35-4.
Under GAAP, an issuer is required to separate certain convertible debt instruments into liability and equity components provided that the equity conversion feature is not required to be bifurcated as an embedded derivative under ASC 815-15. The equity-classified component of a convertible debt instrument that has been separated into liability and equity components should be evaluated under the temporary-equity guidance (see Sections 9.4.8 and 9.5.7 for a discussion of specific considerations related to applying the temporary-equity guidance to such equity components).

Separation of equity components is required under GAAP for the following types of convertible debt unless the equity conversion feature must be bifurcated as an embedded derivative under ASC 815-15:

- Convertible debt subject to the cash conversion guidance in ASC 470-20. That guidance applies to the issuer’s accounting for certain convertible debt instruments that by their stated terms may be settled in cash (including partial cash settlement) or other assets upon conversion. The issuer allocates to the liability component an amount of the proceeds equal to the fair value of a similar liability that does not have an associated equity component, and it allocates the remaining amount of the proceeds to the equity component.
- Convertible debt that contains a beneficial conversion feature (BCF) at issuance (see ASC 470-20-25-5). The BCF is “recognized separately at issuance by allocating a portion of the proceeds equal to the intrinsic value of that feature to [APIC].”
- Convertible debt for which a contingent BCF has been triggered (see ASC 470-20-25-6). The issuer recognizes a contingent BCF when the contingency is resolved (e.g., an IPO) by debiting the debt (typically a debt discount) and crediting equity (APIC) for the amount of the BCF.
- Convertible debt issued at a substantial premium (see ASC 470-20-25-13). There is a presumption that such premium should be separately presented in equity.
- Convertible debt instruments that are modified or exchanged in a transaction that does not qualify as an extinguishment for accounting purposes and involves an increase in the fair value of the embedded conversion option (see ASC 470-50-40-15). The “increase in the fair value of the embedded conversion option (calculated as the difference between the fair value of the embedded conversion option immediately before and after the modification or exchange)” reduces the carrying amount of the debt instrument with an offsetting entry to equity (APIC).
- Convertible debt with an embedded conversion option that no longer meets the bifurcation criteria in ASC 815-15-25-1. The issuer reclassifies to equity the carrying amount of the derivative liability (i.e., the fair value of the conversion option as of the date of reclassification; see ASC 815-15-35-4) and continues to amortize any remaining debt discount that was created by the original bifurcation).

Similarly, convertible preferred stock that is classified as a liability under ASC 480-10 (see Chapters 4 and 6) may contain an equity component that must be separated. For instance, a convertible preferred share that has a stated redemption date and requires the issuer to settle the face amount in cash upon conversion potentially would need to be separated into liability and equity components under the cash conversion guidance in ASC 470-20 (see ASC 470-20-15-6 and ASC 470-20-55-70) provided that the conversion option is not required to be bifurcated as an embedded derivative under ASC 815-15. In a manner similar to its assessment of equity components in convertible debt, the issuer should evaluate whether any separated equity component in liability-classified shares of stock should be accounted for under the SEC’s temporary-equity guidance.
9.3.6 Equity Instruments Subject to Registration Payment Arrangements

ASC 480-10 — SEC Materials — SEC Staff Guidance

SEC Staff Announcement: Classification and Measurement of Redeemable Securities

S99-3A(3)(c) Equity instruments subject to registration payment arrangements. The determination of whether an equity instrument subject to a registration payment arrangement (as defined in [the ASC master glossary]) is subject to ASR 268 should be made without regard to the existence of the registration payment arrangement (that is, the registration payment arrangement is a separate unit of account). However, in determining the applicability of ASR 268 to an equity instrument with any other related arrangement, a conclusion that the related arrangement is a separate unit of account should not be based on an analogy to Paragraph 815-10-25-16.

ASC 815-10

25-16 Paragraphs 825-20-25-2 and 825-20-30-2 require that a financial instrument subject to a registration payment arrangement be recognized and measured in accordance with other applicable GAAP (for example, this Subtopic) without regard to the contingent obligation to transfer consideration pursuant to the registration payment arrangement. That is, those paragraphs require that an entity recognize and measure a registration payment arrangement as a separate unit of account from the financial instrument(s) subject to that arrangement.

ASC Master Glossary

Registration Payment Arrangement

An arrangement with both of the following characteristics:

a. It specifies that the issuer will endeavor to do either of the following:
   1. File a registration statement for the resale of specified financial instruments and/or for the resale of equity shares that are issuable upon exercise or conversion of specified financial instruments and for that registration statement to be declared effective by the U.S. Securities and Exchange Commission (SEC) (or other applicable securities regulator if the registration statement will be filed in a foreign jurisdiction) within a specified grace period
   2. Maintain the effectiveness of the registration statement for a specified period of time (or in perpetuity).

b. It requires the issuer to transfer consideration to the counterparty if the registration statement for the resale of the financial instrument or instruments subject to the arrangement is not declared effective or if effectiveness of the registration statement is not maintained. That consideration may be payable in a lump sum or it may be payable periodically, and the form of the consideration may vary. For example, the consideration may be in the form of cash, equity instruments, or adjustments to the terms of the financial instrument or instruments that are subject to the registration payment arrangement (such as an increased interest rate on a debt instrument).
ASC 825-20

15-4 The guidance in this Subtopic does not apply to any of the following:

a. Arrangements that require registration or listing of convertible debt instruments or convertible preferred stock if the form of consideration that would be transferred to the counterparty is an adjustment to the conversion ratio. (Subtopic 470-20 provides guidance on accounting for convertible instruments with contingently adjustable conversion ratios.)

b. Arrangements in which the amount of consideration transferred is determined by reference to either of the following:
   1. An observable market other than the market for the issuer's stock
   2. An observable index.

For example, if the consideration to be transferred if the issuer is unable to obtain an effective registration statement is determined by reference to the price of a commodity. See Subtopic 815-15 for related guidance.

c. Arrangements in which the financial instrument or instruments subject to the arrangement are settled when the consideration is transferred (for example, a warrant that is contingently puttable if an effective registration statement for the resale of the equity shares that are issuable upon exercise of the warrant is not declared effective by the SEC within a specified grace period).

25-1 An entity shall recognize a registration payment arrangement as a separate unit of account from the financial instrument(s) subject to that arrangement.

25-2 The financial instrument(s) subject to the registration payment arrangement shall be recognized in accordance with other applicable generally accepted accounting principles (GAAP) (for example, Subtopics 815-10; 815-40; and 835-30) without regard to the contingent obligation to transfer consideration pursuant to the registration payment arrangement.

30-1 An entity shall measure a registration payment arrangement as a separate unit of account from the financial instrument(s) subject to that arrangement.

30-2 The financial instrument(s) subject to the registration payment arrangement shall be measured in accordance with other applicable generally accepted accounting principles (GAAP) (for example, Subtopics 815-10; 815-40; and 835-30) without regard to the contingent obligation to transfer consideration pursuant to the registration payment arrangement.

In connection with issuances of equity shares, convertible instruments, and equity-linked contracts, issuers may agree to pay amounts in the event they are unable to deliver registered shares or maintain an effective registration (see Section 2.7). The SEC's temporary-equity guidance does not apply to registration payment arrangements within the scope of ASC 825-20. Such arrangements are accounted for separately from any related financial instrument (such as a share or contract on own equity) even if they are included in the contractual terms of that instrument (see ASC 825-20-25-1 as well as ASC 825-20-30-1 and 30-2). Accordingly, an issuer does not consider such arrangements in evaluating whether the related instrument should be classified in temporary equity under ASC 480-10-S99-3A even if the registration payment arrangement is included in the contractual terms of the share or contract on own equity itself. Instead, the issuer would account for those provisions separately as a registration payment arrangement in accordance with ASC 825-20 provided that the arrangement meets the ASC master glossary definition thereof. In other words, the mere fact that the issuer might be required to pay a cash penalty under a registration payment arrangement related to an outstanding equity share does not trigger temporary-equity classification for that equity share, because the registration payment arrangement is treated as a separate unit of account.
Under ASC 825-20-15-4, an arrangement would not qualify for the scope exception for registration payment arrangements if any of the following applies:

- The form of consideration transferred is a contingently adjustable conversion ratio in a convertible instrument.
- The payment is adjusted by reference to either an observable market other than the issuer’s stock (e.g., a commodity price) or an observable index.
- The payment is made when the contract subject to the arrangement is settled (i.e., a registration payment arrangement is not treated as a separate unit of account if the issuer is required to repurchase the related share upon a failed registration).

Accordingly, such provisions would be considered in the analysis of the financial instrument that contains them unless they represent separate units of account. The SEC staff believes that it would be inappropriate to analogize to ASC 815-10-25-16 or ASC 825-20 in the evaluation of whether an arrangement outside the scope of ASC 825-20 is a separate unit of account (see ASC 480-10-S99-3A(3)(c)).

### 9.3.7 Noncontrolling Interests

**ASC 480-10 — Glossary**

**Noncontrolling Interest**
The portion of equity (net assets) in a subsidiary not attributable, directly or indirectly, to a parent. A noncontrolling interest is sometimes called a minority interest.

**ASC 480-10 — SEC Materials — SEC Staff Guidance**

SEC Staff Announcement: Classification and Measurement of Redeemable Securities

S99-3A(3) Although ASR 268 specifically describes and discusses preferred securities, the SEC staff believes that ASR 268 also provides analogous guidance for other redeemable equity instruments including, for example, . . . noncontrolling interests\(^{FN2}\). . . .

\(^{FN2}\) The Master Glossary defines *noncontrolling interest* as “The portion of equity (net assets) in a subsidiary not attributable, directly or indirectly, to a parent. A noncontrolling interest is sometimes called a minority interest.” ASR 268 applies to redeemable noncontrolling interests (provided the redemption feature is not considered a freestanding option within the scope of Subtopic 480-10). Where relevant, specific classification and measurement guidance pertaining to redeemable noncontrolling interests has been included in this SEC staff announcement.

In accordance with ASC 810-10-45-15, the ownership interests in a subsidiary that are held by owners other than the parent are a noncontrolling interest (for further discussion of this guidance, see Deloitte’s *A Roadmap to Accounting for Noncontrolling Interests*). An entity should evaluate the noncontrolling interest in a subsidiary (i.e., the portion of equity or net assets not attributable to the parent) to determine whether to account for it as temporary equity. ASC 480-10-S99-3A contains special measurement and EPS guidance that applies to noncontrolling interests that must be classified as temporary equity (see Sections 9.5.10 and 9.6.3). Note, however, that an entity that applies ASC 480-10-S99-3A is not relieved of its requirements under the accounting and disclosure guidance in ASC 810-10.
If a subsidiary issues shares to a third party, and those shares meet the definition of a mandatorily redeemable financial instrument in ASC 480-10, those shares are classified as liabilities rather than as temporary equity unless the shares are exempt from some or all of the guidance in ASC 480-10 (see Section 4.1.5) as follows:

- If the shares are exempt from the classification and measurement requirements in ASC 480-10, the temporary-equity guidance (including classification and measurement) in ASC 480-10-S99-3A applies to the shares.
- If the shares are exempt from ASC 480-10’s requirements for measurement but not classification, ASC 480-10-S99-3A’s requirements for measurement but not classification apply to the shares. Accordingly, even though the shares are classified as liabilities under ASC 480-10, an entity applies ASC 480-10-S99-3A’s measurement provisions to adjust their carrying amount. (This accounting applies to certain mandatorily redeemable noncontrolling interests issued before November 5, 2003, in accordance with ASC 480-10-15-7E(b), as added by ASU 2017-11.)

In prepared remarks at the 2003 AICPA Conference on Current SEC Developments, then Professional Accounting Fellow Gregory Faucette stated the following:

Entities with instruments that qualify for the [exception in ASC 480-10-15-7A through 15-7F] should refer to [ASC 480-10-S99-3A] for guidance related to classification and/or measurement, as applicable, for those securities that . . . will not be fully accounted for in accordance with [ASC 480-10]. In other words, if both the classification and measurement guidance in [ASC 480-10] has been deferred for an instrument, look to [ASC 480-10-S99-3A] for both classification and measurement guidance. If only the measurement guidance in [ASC 480-10] has been deferred for an instrument, look to [ASC 480-10-S99-3A] for continued measurement guidance.

The temporary-equity guidance does not apply to a noncontrolling interest that is subject to a redemption feature in a freestanding financial instrument that is separate from the noncontrolling interest, such as a freestanding written put option. In practice, entities consider the FASB’s definition of a freestanding financial instrument and other related guidance (see Section 3.3) in evaluating whether a redemption feature for accounting purposes should be considered freestanding or part of the same unit of account as the noncontrolling interest.

9.3.8 Securities Held by an Employee Stock Ownership Plan

**ASC 718-10 — Glossary**

**Employee Stock Ownership Plan**
An employee stock ownership plan is an employee benefit plan that is described by the Employee Retirement Income Security Act of 1974 and the Internal Revenue Code of 1986 as a stock bonus plan, or combination stock bonus and money purchase pension plan, designed to invest primarily in employer stock. Also called an employee share ownership plan.

**ASC 480-10 — SEC Materials — SEC Staff Guidance**

SEC Staff Announcement: Classification and Measurement of Redeemable Securities

S99-3A(3) Although ASR 268 specifically describes and discusses preferred securities, the SEC staff believes that ASR 268 also provides analogous guidance for other redeemable equity instruments including, for example, . . . securities held by an employee stock ownership plan\(^{FN3}\) . . .

\(^{FN3}\) ASR 268 applies to equity securities held by an employee stock ownership plan (whether or not allocated) that, by their terms, can be put to the registrant (sponsor) for cash or other assets. Where relevant, specific classification and measurement guidance pertaining to employee stock ownership plans has been included in this SEC staff announcement.
Under U.S. federal income tax regulations, employer securities (such as convertible preferred stock) that are held by participants in a qualifying ESOP and are not readily tradable on an established market must contain an option that permits the participant to put the security to the employer. The temporary-equity guidance applies in the sponsor’s financial statements to equity instruments that are held by an ESOP and can be put to the sponsor for cash or other assets. ASC 480-10-S99-3A and S99-4 contain special guidance on the sponsor’s accounting for equity securities held by ESOPs (see Sections 9.4.10 and 9.5.11).

9.3.9 Share-Based Payment Arrangements With Employees

**ASC 480-10 — SEC Materials — SEC Staff Guidance**

SEC Staff Announcement: Classification and Measurement of Redeemable Securities

S99-3A(3) Although ASR 268 specifically describes and discusses preferred securities, the SEC staff believes that ASR 268 also provides analogous guidance for other redeemable equity instruments including, for example, . . . share-based payment arrangements with employees.

FN4 As indicated in Section 718-10-S99, ASR 268 applies to redeemable equity-classified instruments granted in conjunction with share-based payment arrangements with employees. Where relevant, specific classification and measurement guidance pertaining to share-based payment arrangements with employees has been included in this SEC staff announcement.

**SEC Staff Accounting Bulletins**


**Question 1:** While the instruments are subject to FASB ASC Topic 718, is ASR 268 and related guidance applicable to instruments issued under share-based payment arrangements that are classified as equity instruments under FASB ASC Topic 718?

**Interpretive Response:** Yes. The staff believes that registrants must evaluate whether the terms of instruments granted in conjunction with share-based payment arrangements with employees that are not classified as liabilities under FASB ASC Topic 718 result in the need to present certain amounts outside of permanent equity (also referred to as being presented in “temporary equity”) in accordance with ASR 268 and related guidance. [Footnote omitted]

When an instrument ceases to be subject to FASB ASC Topic 718 and becomes subject to the recognition and measurement requirements of other applicable GAAP, the staff believes that the company should reassess the classification of the instrument as a liability or equity at that time and consequently may need to reconsider the applicability of ASR 268.

FN83 FASB ASC paragraph 718-10-35-13, states that an instrument ceases to be subject to this Topic when “the rights conveyed by the instrument to the holder are no longer dependent on the holder being an employee of the entity (that is, no longer dependent on providing service).”

As discussed in more detail in Deloitte’s *A Roadmap to Accounting for Share-Based Payment Awards*, equity-classified share-based payment arrangements (e.g., employee stock options and stock awards with redemption features) that are accounted for in accordance with ASC 718 should be evaluated under the SEC’s temporary-equity guidance. In prepared remarks before the 2005 AICPA Conference on Current SEC and PCAOB Developments, then SEC Professional Accounting Fellow Shan Benedict (Nemeth) stated the following:

Based on the guidance regarding classification provided in [ASC 718], most awards with redemption features that are outside of the control of the issuer are required to be classified as liabilities. However for those that are not, Section E of SAB 107 [i.e., SAB Topic 14.E] clarifies that registrants should evaluate whether the terms of the award result in the need to classify an amount outside of permanent equity in accordance with ASR 268. This classification and measurement guidance is applicable to an award whether it is vested or unvested.
Further, in his prepared remarks before the 2006 AICPA Conference on Current SEC and PCAOB Developments, then SEC Professional Accounting Fellow Joseph Ucuzoglu stated:

The staff has observed the increasing use by both public companies and pre-IPO companies of special classes of stock that are granted only to employees. Public companies often create special classes of stock to more closely align the compensation of an employee with the operating performance of a portion of the business with which he or she has oversight responsibility. . . . Similarly, pre-IPO companies often create special classes of stock to provide employees with an opportunity to participate in any appreciation realized through a future initial public offering or sale of the company, with limited opportunity for gain if no liquidity event occurs. [It] is important to note that even when such instruments are considered a substantive class of equity for accounting purposes, the terms of these instruments often result in a requirement to classify the instruments outside of permanent equity in the balance sheet pursuant to [ASC 480-10-S99-3A].

ASC 480-10-S99-3A specifies how the SEC's temporary-equity guidance applies to share-based payment arrangements (see Sections 9.4.9 and 9.5.12). If an instrument ceases to be within the scope of ASC 718, the issuer should reassess whether the temporary-equity guidance applies. The issuer would conclude that the temporary-equity guidance:

- No longer applies if a share-based payment arrangement that was classified as temporary equity must be reclassified as a liability under ASC 480-10 because it is no longer within the scope of ASC 718 (see Section 2.4).
- Begins to apply when ASC 718 ceases to apply if a share-based payment arrangement that was previously within the scope of ASC 718 would have been classified as temporary equity had it not met one of the specific classification exceptions applicable to share-based payment arrangements within the scope of ASC 718 (see Section 9.4.9).

9.4 Classification

9.4.1 Characteristics That Trigger Temporary-Equity Classification

<table>
<thead>
<tr>
<th>ASC 480-10 — SEC Materials — SEC Staff Guidance</th>
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</thead>
<tbody>
<tr>
<td>SEC Staff Announcement: Classification and Measurement of Redeemable Securities</td>
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<tr>
<td><strong>S99-3A(2)</strong> ASR 268 requires preferred securities that are redeemable for cash or other assets to be classified outside of permanent equity if they are redeemable (1) at a fixed or determinable price on a fixed or determinable date, (2) at the option of the holder, or (3) upon the occurrence of an event that is not solely within the control of the issuer. As noted in ASR 268, the Commission reasoned that “[t]here is a significant difference between a security with mandatory redemption requirements or whose redemption is outside the control of the issuer and conventional equity capital. The Commission believes that it is necessary to highlight the future cash obligations attached to this type of security so as to distinguish it from permanent capital.”</td>
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<td><strong>S99-3A(4)</strong> ASR 268 requires equity instruments with redemption features that are not solely within the control of the issuer to be classified outside of permanent equity (often referred to as classification in &quot;temporary equity&quot;). . . .</td>
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<td><strong>S99-3A(5)</strong> Determining whether an equity instrument is redeemable at the option of the holder or upon the occurrence of an event that is solely within the control of the issuer can be complex. The SEC staff believes that all of the individual facts and circumstances surrounding events that could trigger redemption should be evaluated separately and that the possibility that any triggering event that is not solely within the control of the issuer could occur — without regard to probability — would require the instrument to be classified in temporary equity. Paragraphs 6–11 provide examples of the application of ASR 268.</td>
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Unless an exception applies, an equity-classified instrument must be presented as temporary equity if the issuer could be required to redeem it for cash or other assets in any circumstance not under the issuer's sole control. Informally, the SEC staff has indicated that this guidance should be “strictly and rigidly applied.”
Example 9-1

Company U, an SEC registrant, issued, for $33 million, a 6.5 percent convertible preferred stock with an embedded put option. The put option requires U to repurchase the shares for $33 million upon exercise of the put option. Because U's repurchase of the shares is conditioned upon exercise of the put option, the shares do not meet the definition of a mandatorily redeemable financial instrument in ASC 480-10 (see Chapter 4). Further, the issuer has determined that the put option is not required to be bifurcated as a derivative instrument under ASC 815-15. Because the redemption of the shares of preferred stock is outside the issuer's control, these shares must be classified as temporary rather than permanent equity. Note that classification of the convertible preferred stock in temporary equity would also have been required even if the put option had been separated as an embedded derivative under ASC 815-15.

According to ASC 480-10-S99-3A(2), which contains interpretations of the requirements of Regulation S-X, Rule 5-02.27(a) (as amended by ASR 268), an equity-classified instrument is presented as temporary equity if it is redeemable for cash or other assets in any of the following circumstances:

- “[A]t a fixed or determinable price on a fixed or determinable date” (e.g., convertible preferred shares that are mandatorily redeemable for cash on a specified date in the future if not previously converted by the holder).
- “[A]t the option of the holder” (e.g., preferred shares that the holder can elect to redeem for cash, assets, or the issuer's debt securities).
- “[U]pon the occurrence of an event that is not solely within the control of the issuer” (e.g., preferred shares that become redeemable for cash upon a change in control, the violation of financial statement covenant, a change in law, or the occurrence of a deemed liquidation event).

Further, instruments that are redeemable for cash or other assets in any of the circumstances described above are classified as temporary equity:

- “[R]egardless of their other attributes such as voting rights, dividend rights or conversion features” (see CFRP 211.02).
- “[W]ithout regard to probability” (see ASC 480-10-S99-3A(5)). As noted by the SEC staff at the 1991 AICPA Conference on Current SEC Developments, temporary-equity classification is required even if the likelihood of redemption is “insignificant, unlikely, or remote.” (Although an instrument's likelihood of becoming redeemable does not affect its classification, such likelihood may affect its subsequent measurement; see Section 9.5.2.)
- Even if redemption is outside the control of the holder. It is sufficient that redemption “not [be] solely within the control of the issuer” (see ASC 480-10-S99-3A(5)).

In a letter dated April 12, 1990, and addressed to the SEC staff, Donald Moulin, then chairman of the AICPA SEC Regulations Committee, provided the following observations about common misconceptions in the application of the SEC's temporary-equity guidance:

Our practice experience indicates that the following are the two aspects of ASR No. 268 that are most commonly misunderstood:

- The probability that the event triggering redemption (or the holder's right to demand redemption) will occur is not a factor in deciding whether redeemable equity treatment is required under ASR No. 268; and
- The condition or event that will trigger redemption (or the holder's right to demand redemption) does not have to be within the control of the holder, but merely outside the control of the issuer.
A feature does not need to be explicitly described as a cash-settled-redemption or put-option feature to potentially trigger temporary-equity classification. For example, a redemption feature that causes temporary-equity classification may be established through contractual terms that are described as a call option (see Section 9.4.4), conversion feature (see Sections 9.4.6, 9.4.7, and 9.4.8), or liquidation provision (see Section 9.4.5). Further, a feature does not necessarily need to explicitly provide for settlement in cash or other assets. If an issuer could be forced to settle all or part of a share-settled feature (e.g., a conversion feature) in cash or other assets, temporary-equity classification may be required (see Section 9.4.6).

When an entity issues shares or other equity instruments without complying with applicable registration or qualification requirements (e.g., under federal securities laws or certain state laws), the holder may have a legal right to rescind its purchase of those equity instruments. If a legal determination has been made that the holder has in fact the right to rescind its purchase, redemption will be outside the issuer’s control. The SEC staff has indicated that equity instruments subject to rescission rights should be presented in temporary equity. The SEC’s Division of Corporation Finance: Frequently Requested Accounting and Financial Reporting Interpretations and Guidance (March 31, 2001) states, in part:

The staff considers [the temporary equity] guidance to be applicable to all equity securities (not only preferred stock) the cash redemption of which is outside the control of the issuer, including stock subject to rescission rights.

ASC 480-10-S99-3A contains a number of exceptions that permit an issuer to disregard certain types of redemption features in evaluating whether the related equity instrument (or component) should be classified as temporary equity. These include the following obligations and features:

- Redemption features that are contingent on an event that is under the sole control of the issuer (see Section 9.4.2).
- Redemption obligations upon the death or disability of the holder if the redemption amount will be funded from the proceeds of an insurance policy that meets certain criteria (see Section 9.4.3).
- Redemption obligations upon an ordinary liquidation event (see Section 9.4.5).
- Redemption obligations upon a deemed liquidation event “if all of the holders of equally and more subordinated equity instruments of the entity would always be entitled to also receive the same form of consideration (for example, cash or shares) upon the occurrence of the event that gives rise to the redemption (that is, all subordinate classes would also be entitled to redeem)” (see Section 9.4.5).
- Redemption obligations associated with the equity component of certain convertible debt that is not currently redeemable or convertible for cash or other assets on the balance sheet date (see Section 9.4.8).
- Certain features in share-based payment arrangements (see Section 9.4.9).
9.4.2 Evaluation of Whether an Event Is Under the Sole Control of the Issuer

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<tr>
<th>ASC 480-10 — SEC Materials — SEC Staff Guidance</th>
</tr>
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<tr>
<td>S99-3A(9) [Examples in which temporary equity classification is appropriate] Example 4. An equity instrument may contain provisions that allow the holder to redeem the instrument for cash or other assets upon the occurrence of events that are not solely within the issuer's control. Such events may include:</td>
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<td>• The failure to have a registration statement declared effective by the SEC by a designated date</td>
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<td>• The failure to maintain compliance with debt covenants</td>
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<tr>
<td>• The failure to achieve specified earnings targets</td>
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<tr>
<td>• A reduction in the issuer's credit rating.</td>
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<tr>
<td>Since these events are not solely within the control of the issuer, the equity instrument is required to be classified in temporary equity.</td>
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If the terms of an equity instrument require or may require the issuer to redeem the instrument for cash or other assets upon the occurrence of an event that is not solely within the issuer's control, it is classified as temporary equity, irrespective of the likelihood that the event will occur. Conversely, a term that requires or may require redemption upon an event that is solely within the issuer's control (e.g., a holder put right that becomes exercisable only if the issuer elects to undertake an IPO) does not result in temporary-equity classification, since the issuer has the discretion to avoid redemption by preventing the event from occurring. In prepared remarks before the 2009 AICPA Conference on Current SEC and PCAOB Developments, then SEC Professional Accounting Fellow Brian Fields stated the following:

A key question . . . is whether the company can avoid settling the instrument in cash or other assets even in contingent scenarios that may be improbable. [An] equity share is generally presented as mezzanine temporary equity if it could require cash settlement for reasons beyond the company's control.

Moreover, at the 2000 AICPA Conference on Current SEC Developments, then SEC Professional Accounting Fellow Dominick J. Ragone III said, in part:

The [SEC] staff believes that securities with redemption features that are "outside of the control of the issuer" include those securities that are redeemable either based on mandatory or certain events (for example, the death or retirement of the holder) or on uncertain events (for example, change in control of the company, violation of specified financial covenants, or the attainment of specific earnings or a stock market price).

Accordingly, temporary-equity classification is required if an equity instrument must be redeemed or becomes redeemable at the election of the holder upon an event not solely within the issuer's control. The table below provides examples of events that may be considered solely within and not solely within the issuer's control when an instrument becomes redeemable upon the occurrence of the event. Note, however, that the determination of whether an event is within the issuer's control may differ from that indicated in the table depending on the facts and circumstances. An event that would ordinarily be deemed solely within the issuer's control may not qualify as such if either (1) the holder controls the issuer's decision to cause the event to occur through board representation or other rights (see Section 9.4.4) or (2) the issuer is firmly committed to undertaking an action that will cause the event to occur.
<table>
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<tr>
<th>Solely Within the Issuer’s Control</th>
<th>Not Solely Within the Issuer’s Control</th>
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<tr>
<td>• The issuer’s decision to redeem, put, call, or convert a financial instrument</td>
<td>• The counterparty’s decision to redeem, put, call, or convert a financial instrument</td>
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<tr>
<td>• Specified corporate transactions or events (e.g., a sale of substantially all of the assets)</td>
<td>• The issuer’s failure to have a registration statement declared effective by the SEC</td>
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<td>that the issuer’s management or board of directors may decide to undertake</td>
<td>• The issuer’s effective registration statement lapses</td>
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<td>• A change in the issuer’s business strategy</td>
<td>• An IPO’s not being completed by a certain date (the successful completion of an IPO depends in part on factors outside the issuer’s control, such as an effective registration statement)</td>
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<td>• The issuer’s declaration of an extraordinary dividend</td>
<td>• The issuer’s failure to submit SEC filings on time (ASC 815-40-25-29)</td>
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<td>• The occurrence of an IPO (usually an issuer is able to prevent an IPO from occurring but is unable to control whether it can successfully complete one)</td>
<td>• The issuer’s failure to maintain compliance with specified financial covenants</td>
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<tr>
<td>• The issuer’s achievement of a project milestone (usually, an issuer is able to prevent a milestone from being reached but is unable to control whether it can successfully meet one)</td>
<td>• The issuer’s failure to achieve specified revenue or earnings targets</td>
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<tr>
<td>• The issuer’s future decision to issue new equity securities</td>
<td>• The issuer’s failure to achieve a project milestone</td>
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<tr>
<td>• Redemption upon mutual agreement by the parties</td>
<td>• The issuer’s failure to pay specified dividends</td>
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<td>• The attainment of a specific stock market price</td>
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<td>• A change in the issuer’s credit rating</td>
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<td>• The delisting of the issuer’s securities</td>
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In determining whether redemption may be required because of circumstances outside the issuer’s control, the issuer should consider the interaction between different contractual provisions. For example, one of the terms of an outstanding perpetual equity share may permit the issuer to call the instrument for a stated amount of cash at any time. By itself, such a term typically would not cause the instrument to be classified in temporary equity (unless the holder controls the issuer’s decision; see Section 9.4.4) since the issuer could not be forced to exercise the call. Further, the holder may have no right to put the instrument to the issuer for cash unless the issuer elects not to exercise its call option by a specified date in the future. Typically, a put right that is contingent on a discretionary decision of the issuer would not result in temporary-equity classification since the issuer could prevent the put right from becoming exercisable. In such a scenario, however, the instrument would be classified in temporary equity because the only event that prevents the holder from being able to redeem
the instrument is the issuer’s election to redeem it by a certain date. In other words, either it will be redeemed by the issuer or it will become redeemable by the holder by the specified date.

The issuer should also consider any applicable legal requirements that may affect whether redemption is within its control. For example, a provision in an instrument may require the instrument’s redemption upon the issuer’s merger with another entity. Further, state law may require approval of the issuer’s board of directors before any merger can occur. If the holders of the instrument are not able to control the board’s vote through direct representation or other rights, the decision to merge with another entity may be within the issuer’s control.

9.4.3 Redemption Features Triggered by Holder’s Death or Disability

As a general rule, an equity-classified instrument that becomes redeemable for cash or other assets upon the death or disability of the holder must be classified in temporary equity because those events are outside the issuer’s control (see Section 9.4.2). However, the SEC does not require temporary-equity classification if upon death or disability a redemption “will be funded from the proceeds of an insurance policy that is currently in force,” provided that the issuer has the intent and ability to maintain the policy in force. Note that this guidance does not apply to nonconvertible stock that is mandatorily (as opposed to optionally) redeemable for cash or other assets upon the holder’s death because ASC 480-10 requires liability classification for an instrument that is certain to be redeemed. (Unlike disability, death is certain to occur; see Section 4.1.) Further, if a nonconvertible equity instrument becomes mandatorily redeemable upon the disability of the holder, the instrument would need to be reclassified from equity to a liability (see Section 4.4.1).

9.4.4 Special Considerations When the Holder Has the Ability to Control Issuer Decisions

As a general rule, an equity-classified instrument that becomes redeemable for cash or other assets upon the death or disability of the holder must be classified in temporary equity because those events are outside the issuer’s control (see Section 9.4.2). However, the SEC does not require temporary-equity classification if upon death or disability a redemption “will be funded from the proceeds of an insurance policy that is currently in force,” provided that the issuer has the intent and ability to maintain the policy in force. Note that this guidance does not apply to nonconvertible stock that is mandatorily (as opposed to optionally) redeemable for cash or other assets upon the holder’s death because ASC 480-10 requires liability classification for an instrument that is certain to be redeemed. (Unlike disability, death is certain to occur; see Section 4.1.) Further, if a nonconvertible equity instrument becomes mandatorily redeemable upon the disability of the holder, the instrument would need to be reclassified from equity to a liability (see Section 4.4.1).
Examples in which permanent equity classification is appropriate [Example 5] A preferred security may have a provision that the decision by the issuing company to sell all or substantially all of a company's assets and a subsequent distribution to common stockholders triggers redemption of the security. In this case, the security would be appropriately classified in permanent equity if the preferred stockholders cannot trigger or otherwise require the sale of the assets through representation on the board of directors, or through other rights, because the decision to sell all or substantially all of the issuer's assets and the distribution to common stockholders is solely within the issuer's control. In other words, if there could not be a "hostile" asset sale whereby all or substantially all of the issuer's assets are sold, and a dividend or other distribution is declared on the issuer's common stock, without the issuer's approval, then classifying the security in permanent equity would be appropriate.

[Example 6] A preferred security may have a provision that provides for redemption in cash or other assets if the issuing company is merged with or consolidated into another company, and pursuant to state law, approval of the board of directors is required before any merger or consolidation can occur. In that case, assuming the preferred stockholders cannot control the vote of the board of directors through direct representation or through other rights, the security would be appropriately classified in permanent equity because the decision to merge with or consolidate into another company is within the control of the issuer. Again, all of the relevant facts and circumstances should be considered when determining whether the preferred stockholders can control the vote of the board of directors.

Sometimes, equity instruments contain a stated redemption feature that is ostensibly controlled by the issuer, such as a call option or redemption requirement upon the issuer's decision to undertake a specified action (e.g., through an affirmative vote of the majority of its shareholders or board of directors). Even though such a feature may appear to be controlled by the issuer, temporary-equity classification is required if the instrument's holder (or the holders acting together as a class) has the ability to control whether the issuer will redeem the instrument or cause the instrument to become redeemable under the redemption feature through board representation, voting rights, or other rights. Accordingly, an equity instrument that contains any of the following features would be classified in temporary equity:

- A call option permitting the issuer to call the instrument for cash when the holder controls the issuer's decision to call the instrument through board representation or other rights.
- A redemption feature requiring the issuer to redeem the instrument upon a vote by a majority of the holders of the instrument.
- A redemption feature requiring the issuer to redeem the instrument upon the occurrence of a specified corporate transaction (e.g., sale of assets) if the holder controls whether the issuer will undertake the transaction through board representation or other rights.

The determination of whether the holders of an equity instrument (e.g., convertible preferred stock) control the ability to direct corporate actions depends on the facts and circumstances (e.g., relevant provisions of shareholder and other agreements, contracts, and state laws).

Even if the holder of an equity-classified instrument currently has no power to direct the issuer to redeem the instrument, an entity should consider whether the holder would obtain such power if an event not solely within the issuer's control were to occur.
Example 9-2

A perpetual preferred share with a stated perpetual dividend rate payable in cash and a redemption feature may permit the issuer to call the instrument for cash. However, if the holder does not hold voting stock or sit on the board, and the issuer fails to pay the stated dividend on the preferred stock for four consecutive quarters, the holder will obtain the right to appoint a majority of the directors on the board and thereby direct the issuer's decision of whether to call the share. The share would be classified in temporary equity because the issuer does not control whether it always will have sufficient cash to pay the dividend (see Section 9.4.2). If the issuer does not have sufficient cash, the holder will obtain the ability to direct the issuer's decision of whether to call the instrument by taking control of the board.

A board of directors' fiduciary duty under state law to act prudently and in the best interests of the company is not by itself sufficient to cause a redeemable equity instrument to be classified as permanent equity.

Example 9-2A

Company A has issued preferred stock that is redeemable for cash at the option of the holder (Investor B) if A's board of directors agrees to such redemption. Under state law applicable to the preferred stock, the directors have a fiduciary responsibility to the company, which requires that they act prudently and in the best interests of the company. The board includes directors appointed by B as well as independent directors who would need to consent to any cash redemption. However, B is contractually able to replace any directors who object to a cash redemption. There are no specific contractual safeguards to protect other shareholders (e.g., there is no requirement for other shareholders to approve a redemption). In the evaluation of whether the preferred stock should be classified as temporary equity, the existence of fiduciary responsibility under state law does not take precedence over the redemption terms of the contractual agreements. Accordingly, the preferred stock should be classified as temporary equity.

Mr. Fields stated the following at the 2009 AICPA Conference on Current SEC and PCAOB Developments:

[The] SEC staff guidance on redeemable shares . . . notes that there may be situations in which control by the governance structure of an entity, such as the Board of Directors, may be insufficient to demonstrate that a settlement option is within the company's control. These are often situations in which specific shareholders have the ability to seize control of the governance structure and require redemption of their interests in a preferential manner using another feature of the instrument. A typical example is a provision whereby a class of preferred shareholders can take control of the Board upon failure to pay dividends and thereby exercise a preexisting embedded call option on their preferred stock. Unless there were a third provision that makes the call inoperable when the preferred shareholders are in control, the shares would be classified in temporary equity because the combination of the contingent control right and the call could be used in the same manner as a put option by the preferred shareholder. Of course, whenever the analysis becomes this involved a healthy attention to appropriate disclosure is probably in order.

Some entities have multiple classes of outstanding equity instruments with stated redemption features that cannot be triggered without the issuer's involvement (e.g., the issuer's exercise of a call feature or its decision to undertake a specified corporate transaction that would activate a holder put feature). Sometimes, no single class of holders of such instruments controls the issuer's decision to trigger the redemption feature in any individual class of equity instruments. If some or all classes of holders can force the issuer to trigger a redemption feature in any or all classes by acting in concert (e.g., by voting together or giving their consent), the entity should consider whether holders of different classes would be aligned in any action to trigger the redemption feature (e.g., by considering the dividend rights and liquidation preferences of each class). If the holders of more than one class are able to trigger a redemption of one or more classes by acting together and their economic interests related to such redemptions do not conflict, temporary-equity classification is appropriate for all classes of outstanding equity instruments that would become subject to redemption upon such action, since the redemption feature would be considered not solely within the issuer's control.
We believe that in the absence of a stated redemption feature (regardless of whether it is described as a call, put, liquidation, redemption, or conversion feature), an issuer is not required to classify an instrument as temporary equity even though the holder might be able to use its influence to compel the issuer to purchase the instrument (e.g., through board representation or voting rights). Further, we believe that temporary-equity classification is not required, in the separate financial statements of a subsidiary, for a redeemable equity instrument if, upon redemption, the redemption amount will be paid by the parent and not the subsidiary.

9.4.5 Evaluation of Liquidation Provisions

9.4.5.1 Overview

Sometimes, a feature of an equity instrument that makes it redeemable is characterized as a liquidation provision. Even if an equity instrument (e.g., convertible preferred stock) does not contain an explicit redemption feature (i.e., a stated call option or stated put option), an entity must evaluate the instrument’s liquidation provisions to determine whether the instrument should be classified as temporary equity. The liquidation provisions applicable to an instrument may be contained in the contractual agreement or in the entity’s bylaws, shareholder agreements, charter, or certificate of incorporation. Practitioners should consider all of the pertinent agreements that contain liquidation provisions related to the instrument.

ASC 480-10-S99-3A(3)(f) distinguishes between an “ordinary” and a “deemed” liquidation and provides separate requirements for each:

- A provision whose application will result in the redemption or liquidation of an equity instrument upon an event that qualifies as an ordinary liquidation does not result in an instrument’s classification in temporary equity.
- A provision whose application will result in the redemption of an equity instrument upon an event that does not represent an ordinary liquidation (i.e., a deemed liquidation) typically causes the instrument to be classified in temporary equity with one narrow and limited exception (see discussion below).

The Division of Corporation Finance’s Frequently Requested Accounting and Financial Reporting Interpretations and Guidance (March 31, 2001) states, in part:

[Clauses] describing [deemed liquidation] events are commonly included in the “Liquidation” section of the preferred stock indentures. By characterization of the provisions as liquidation provisions, registrants have sought to avoid ASR 268 treatment. However, the staff believes that these types of provisions are equivalent to ordinary redemption clauses that would cause the securities to be classified outside of permanent equity.

9.4.5.2 Ordinary Liquidation Events

<table>
<thead>
<tr>
<th>ASC 480-10 — SEC Materials — SEC Staff Guidance</th>
</tr>
</thead>
<tbody>
<tr>
<td>SEC Staff Announcement: Classification and Measurement of Redeemable Securities</td>
</tr>
<tr>
<td>S99-3A(3)(f) Certain redemptions upon liquidation events. Ordinary liquidation events, which involve the redemption and liquidation of all of an entity’s equity instruments for cash or other assets of the entity, do not result in an equity instrument being subject to ASR 268. In other words, if the payment of cash or other assets is required only from the distribution of net assets upon the final liquidation or termination of an entity (which may be a less-than-wholly-owned consolidated subsidiary), then that potential event need not be considered when applying ASR 268. . . .</td>
</tr>
</tbody>
</table>
Classification in temporary equity is not required if redemption is contingent only upon the occurrence of an ordinary liquidation event. An ordinary liquidation involves the redemption and liquidation of all of an entity’s equity instruments for cash or other assets of the entity and represents the termination, dissolution, and winding up of the entity’s affairs (i.e., the final liquidation of the issuer). ASC 205-30-20 defines a liquidation as follows:

- The process by which an entity converts its assets to cash or other assets and settles its obligations with creditors in anticipation of the entity ceasing all activities. Upon cessation of the entity's activities, any remaining cash or other assets are distributed to the entity's investors or other claimants (albeit sometimes indirectly).
- Liquidation may be compulsory or voluntary. Dissolution of an entity as a result of that entity being acquired by another entity or merged into another entity in its entirety and with the expectation of continuing its business does not qualify as liquidation.

In the evaluation of whether an event qualifies as an ordinary liquidation, the following factors are typically not relevant:

- Whether the holders of the instrument have control over the entity (i.e., whether the holders can force an ordinary liquidation).
- The preference in liquidation.
- The form of consideration that will be received by the holders of the instrument.

However, entities should consider all relevant facts and circumstances in assessing the substance of the instrument’s provisions.

If an equity instrument does not contain any stated redemption features (e.g., call options or put options) or deemed liquidation provisions and therefore is redeemable only upon an ordinary liquidation of the entity, classification in temporary equity is not required even if the holders of the instrument have control over the entity. That is, if, under the stated terms of the instrument and other pertinent agreements (i.e., the entity’s bylaws, shareholder agreements, charter, or certificate of incorporation), the instrument is redeemable only upon an ordinary liquidation, temporary-equity classification is not required even if the holders of the instrument may have the ability to effectuate a liquidation of only the instrument (outside its contractual terms) by virtue of the holder’s control over the entity. Any such redemption of an instrument outside its contractual terms is a modification of the contractual terms that would be recognized only upon its occurrence.

### 9.4.5.3 Deemed Liquidation Events

<table>
<thead>
<tr>
<th>Section</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>ASC 480-10 — SEC Materials — SEC Staff Guidance</strong></td>
<td></td>
</tr>
<tr>
<td>SEC Staff Announcement: Classification and Measurement of Redeemable Securities</td>
<td></td>
</tr>
<tr>
<td><strong>S99-3A(3)(f)</strong></td>
<td>Other transactions are considered deemed liquidation events. For example, the contractual provisions of an equity instrument may require its redemption by the issuer upon the occurrence of a change-in-control that does not result in the liquidation or termination of the issuing entity, a delisting of the issuer’s securities from an exchange, or the violation of a debt covenant. Deemed liquidation events that require (or permit at the holder’s option) the redemption of only one or more particular class of equity instrument for cash or other assets cause those instruments to be subject to ASR 268.</td>
</tr>
<tr>
<td><strong>S99-3A(8)</strong></td>
<td>[Examples in which permanent equity classification is appropriate] Example 3. A preferred security that is not required to be classified as a liability under other applicable GAAP may contain a deemed liquidation clause that provides that the security becomes redeemable if the common stockholders of the issuing company (that is, those immediately prior to a merger or consolidation) hold, immediately after such merger or consolidation, common stock representing less than a majority of the voting power of the outstanding common stock of the surviving corporation. This change-in-control provision would require the preferred security to be classified in temporary equity if a purchaser could acquire a majority of the voting power of the outstanding common stock without company approval, thereby triggering redemption.</td>
</tr>
</tbody>
</table>
An equity instrument that includes a deemed liquidation provision is presented in temporary equity unless the limited exception discussed in Section 9.4.5.4 is met or the events that could trigger a liquidation are solely within the issuer’s control (see Section 9.4.2). A deemed liquidation encompasses the redemption and liquidation of one or more classes of an entity's equity instruments in a transaction that does not result in the final liquidation of the entity (i.e., transactions that do not qualify as ordinary liquidation events; see Section 9.4.5.2).

The table below illustrates some examples of transactions or events that might be identified in a deemed liquidation provision.

<table>
<thead>
<tr>
<th>Transaction or Event</th>
<th>Solely Within the Entity's Control?</th>
</tr>
</thead>
<tbody>
<tr>
<td>A change in control of the entity</td>
<td>No. An entity cannot prevent its equity holders from transferring a controlling interest.</td>
</tr>
<tr>
<td>A merger or consolidation of the entity with or into another entity</td>
<td>It depends. If the applicable state law requires board approval for a merger or consolidation, such an event may be within the entity's control unless the board is controlled by the instrument holder (see Section 9.4.4).</td>
</tr>
<tr>
<td>A sale, lease, or license of all or substantially all of the entity's assets</td>
<td>Yes, unless the Board is controlled by the instrument holder (see Section 9.4.4).</td>
</tr>
<tr>
<td>A delisting of the entity's securities</td>
<td>No. An entity cannot control whether its securities will continue to be listed.</td>
</tr>
<tr>
<td>The entity's violation of a debt covenant</td>
<td>It depends on the nature of the debt covenant (see Section 9.4.2).</td>
</tr>
<tr>
<td>The entity's failure to issue a specified monetary amount of securities (e.g., a securities offering with proceeds in excess of a specified dollar amount)</td>
<td>No, unless investors are already firmly committed to purchase securities for the specified amount.</td>
</tr>
<tr>
<td>The entity's failure to have an IPO registration statement declared effective by a particular date</td>
<td>No. An entity cannot control whether the SEC will declare its registration statement effective.</td>
</tr>
<tr>
<td>The inability to deliver common shares under a conversion provision</td>
<td>It depends on whether share settlement is within the entity's control (see Section 9.4.6).</td>
</tr>
</tbody>
</table>

2 The entity's specific facts and circumstances may affect this determination (see Section 9.4.2)
In certain situations, the relevant liquidation provisions will include the entity's definition of a deemed liquidation. For example, the entity's certificate of incorporation may include a provision such as the following:

**Example 9-3**

**Sample Liquidation Provision**

*Amount Payable in Mergers, etc.* Upon, and in all cases subject to, the closing of (each of the following, a "Deemed Liquidation Event"): (i) any merger or consolidation of the Corporation with or into another corporation or entity (except a merger or consolidation in which the holders of capital stock of the Corporation immediately prior to such merger or consolidation continue to hold at least a majority of the voting power of the capital stock of the surviving or resulting corporation or entity following such merger or consolidation); (ii) any sale, lease, license, or transfer of all or substantially all of the Corporation's assets or sale or exclusive license of all or substantially all of the Corporation's intellectual property (an "Asset Sale"); or (iii) any other transaction pursuant to, or as a result of which, a single person (or group of Affiliated persons), other than holders of Preferred Stock or Common Stock prior to such transaction, acquires or holds capital stock of the Corporation representing a majority of the Corporation's voting power, all consideration payable to the stockholders of the Corporation in connection with any such Deemed Liquidation Event, or all consideration payable to the Corporation and distributable to its stockholders, together with all other available assets of the Corporation (net of obligations owned by the Corporation that are senior to the Preferred Stock), in connection with any such Deemed Liquidation Event, shall be, as applicable, paid by the purchaser to the holders of, or distributed by the Corporation in redemption (out of funds legally available therefor) of, the Preferred Stock, in accordance with the preferences and priorities set forth above, with such preferences and priorities specifically intended to be applicable in any such Deemed Liquidation Event as if such transaction were a Liquidation Event.

In other situations, the relevant liquidation provisions do not include a definition of, and may not explicitly refer to, a deemed liquidation. Irrespective of whether the term “deemed liquidation” is used, however, entities must carefully consider all relevant liquidation provisions to distinguish ordinary liquidation events from deemed liquidation events. The inclusion of any deemed liquidation redemption feature in an instrument triggers temporary-equity classification (unless the exception discussed in Section 9.4.5.4 below is met or the events that could trigger a redemption are solely within the issuer's control, as discussed in Section 9.4.2) even if all the other redemption provisions in the instrument qualify as ordinary liquidation provisions.

### 9.4.5.4 Limited Exception Applicable to Certain Deemed Liquidation Provisions

Although deemed liquidation redemption features typically cause an instrument to be classified as temporary equity, there is a narrow and limited exception under ASC 480-10-S99-3A(3)(f) for equity instruments that are subject to a deemed liquidation provision “if all of the holders of equally and more subordinated equity instruments of the entity would always be entitled to also receive the same form of consideration (for example, cash or shares) upon the occurrence of the event that gives rise to the redemption (that is, all subordinate classes would also be entitled to redeem).”
We believe that given the guidance in ASC 480-10-S99-3A(3)(f) and our understanding of the types of deemed liquidation provisions that are common in practice, the narrow and limited exception to temporary-equity classification as a result of a deemed liquidation typically would not apply to preferred securities unless the following two conditions are met:

- The agreements pertaining to the equity instrument contain a provision explicitly stating that upon a deemed liquidation event, all of the holders of equally and more subordinated equity instruments of the entity are always entitled to receive the same form of consideration (e.g., cash or shares) upon the occurrence of the event that gives rise to the redemption (i.e., all subordinate classes would also be entitled to redemption). It must also be objectively determinable under the agreements' explicit terms that there are no possible circumstances in which the holders of equally or more subordinated equity instruments of the entity may not be entitled to receive, wholly or in proportion, the same form of consideration that the holders of the equity instrument are entitled to receive.

- The provisions related to the same form of consideration that is payable upon the occurrence of a deemed liquidation event are substantive. If, under the terms of the agreements, the holders of the instrument can “override” a provision related to the same form of consideration, the provision regarding the form of consideration that is payable upon a deemed liquidation may not be substantive. In addition, if the amount of consideration payable to the holders of the instrument is leveraged to such an extent that there is no reasonable possibility that consideration will remain after distribution to the holders of the instrument, any explicit provisions regarding the form of consideration may be deemed nonsubstantive.

Since deemed liquidations often involve a change in control (i.e., 50 percent or more of the voting control over an entity is held by new investors, which is typically considered outside the control of the issuing entity), the relevant liquidation provisions will rarely qualify for the narrow and limited exception in ASC 480-10-S99-3A(3)(f). For that exception to apply, the provisions must clearly indicate that the holders of the instrument would be entitled to a form of consideration only on a basis that is proportionate to the consideration that each holder of equally or more subordinated equity instruments is entitled to receive.

In practice, it is common for the liquidation provisions of convertible preferred stock to fall into one of three categories. That is, they often specify one of the following:

- That the holders of the convertible preferred stock are entitled to receive cash (with respect to the liquidation preference, the if-converted value, or both) upon the occurrence of a deemed liquidation event.

- That, upon the occurrence of a deemed liquidation event, all holders of each preferred share class are entitled to receive the same form of consideration, and all holders of each common share class are entitled to receive the same form of consideration, as opposed to specifying that all holders of equity instruments are entitled to receive the same form of consideration.

- The amount of consideration to which the holders of convertible preferred stock are entitled to receive upon the occurrence of a deemed liquidation event but are silent regarding the form of consideration.
In each circumstance, the convertible preferred stock should be classified in temporary equity because the exception in ASC 480-10-S99-3A(3)(f) is inapplicable. It would generally be inappropriate for an entity to conclude, on the basis of an interpretation by legal counsel or consideration of fiduciary obligations (as opposed to an explicit provision addressing the form of consideration to be distributed to equity holders in all possible deemed liquidation events), that a deemed liquidation provision qualifies for the narrow and limited exception in ASC 480-10-S99-3A(3)(f). Rather, in a manner consistent with the SEC staff’s views on the effect of a contract’s silence on an entity’s ability to settle in unregistered shares or defer settlement until registered shares could be delivered (see Section 5.3.2.1 of Deloitte’s A Roadmap to Accounting for Contracts on an Entity’s Own Equity), it is appropriate to apply this exception to temporary-equity classification only when there is language in the pertinent agreements that explicitly provides for the distribution of consideration to equity holders upon the occurrence of a deemed liquidation event in the manner described above.

9.4.5.5 Convertible Preferred Stock With a Liquidation Provision Upon a Change in Control

Example 9-4

Company X, an SEC registrant, has issued convertible preferred stock. As part of the preferred stock agreement, the investors in preferred stock are entitled to a liquidation preference upon any voluntary or involuntary liquidation, dissolution, or winding down of X. The agreement defines liquidation as including mergers, reorganizations, transfers of a majority of the voting rights of outstanding common stock, and other transactions that result in a change in control and would not cause the legal dissolution of X with the redemption and liquidation of all of its outstanding equity securities.

Further, X’s ordinary equity securities do not become redeemable upon a change in control. The investors in the preferred stock do not control the board’s vote, and the board does not have to approve a change of control. Company X has determined that the convertible preferred stock is not required to be accounted for as a liability under ASC 480-10 and that it contains no embedded feature that requires bifurcation as a derivative instrument under ASC 815-15.

In this scenario, the convertible preferred stock would be classified as temporary equity. Under the temporary-equity guidance, X must assess whether the preferred stock is redeemable upon the occurrence of an event that is not solely within its control. Redemption is not solely within X’s control because a purchaser could acquire a majority of the voting power of the outstanding common stock without company approval, thereby giving the preferred shareholders a right to require redemption of their preferred shares. A change in control is considered outside the control of the issuer even if the preferred shareholders do not control the shareholder vote. The liquidation feature does not qualify as an “ordinary liquidation” feature because a change in control will not result in the legal dissolution of X with the redemption and liquidation of all of its outstanding equity securities.

Under the “deemed liquidation exemption” (see Section 9.4.5.4), upon the occurrence of the event that gives rise to the redemption (change in control), if one or more classes of equity security become redeemable, all of the holders of equally and more subordinated equity securities of the entity would need to be entitled to the same form of consideration. Company X’s preferred securities do not qualify for this exemption because its ordinary securities do not become redeemable in the event of a change in control.

Note that a preferred stock agreement’s provision for redemption of the preferred security if the issuing company is merged with another company may not by itself trigger classification of the preferred stock outside of permanent equity. If state law requires approval of the board of directors before any merger can occur, and preferred stockholders cannot control the board’s vote through direct representation or other rights, the decision to merge with another company may be within the control of the issuer.
9.4.6 Features That the Issuer Must or May Settle in Its Equity Shares

The redeemable-equity guidance applies to equity instruments that are redeemable for cash or other assets in circumstances not under the sole control of the issuer. It does not apply to equity-classified instruments that require or permit the issuer to settle a redemption feature in its equity shares as long as (1) those shares qualify as permanent equity and (2) the issuer could not be forced to deliver cash or other assets to settle the feature. (If the obligation is unconditional, liability classification may be required for the share under ASC 480-10-25-14 even if the issuer has the right and is able to settle the redemption obligation in a variable number of its equity shares; see Chapter 6.)

An equity-classified instrument may specify that the issuer must or may settle a redemption feature in its equity shares (e.g., because the contract permits the issuer to settle the feature in either cash or shares of equivalent value). If those shares qualify as permanent equity (see Section 9.4.7), ASC 480-10-S99-3A(6) requires the issuer to evaluate whether it has the ability to settle the instrument in its equity shares in accordance with the equity classification conditions in ASC 815-40-25. If the issuer could ever be forced to cash settle the feature (e.g., because of the lack of a share cap in the contract), the equity instrument should be classified as temporary equity even if the contract ostensibly requires or permits the issuer to settle in its equity shares. (See Section 9.4.9 for guidance on evaluating whether an issuer could be forced to cash settle a share-based payment arrangement within the scope of ASC 718.)

This guidance is also consistent with the tentative conclusion reached by the EITF in paragraph 60 of EITF 00-27 (this paragraph was not codified):

Issue 16(b) — Whether a convertible preferred stock that has a conversion option within the scope of the [BCF guidance in ASC 470-20] should be classified as either permanent or temporary equity using the guidance in [ASC 815-40-25.] The Task Force reached a tentative conclusion that the guidance in [ASC 815-40-25] should be used to evaluate whether the issuer controls the actions or events necessary to issue the number of required shares under the conversion option if that conversion option is exercised by the holder. If the issuer does not control settlement of the conversion option’s exercise by delivering shares, cash settlement of the instrument would be presumed and, if the issuer is an SEC registrant, the convertible preferred stock would be classified as temporary equity.

ASC 815-40-25-10 lists the following conditions that must be met for an issuer to conclude that it cannot be forced to cash settle a contract:

a. Settlement permitted in unregistered shares. The contract permits the entity to settle in unregistered shares.

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

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

d. No required cash payment if entity fails to timely file. There are no required cash payments to the counterparty in the event the entity fails to make timely filings with the Securities and Exchanges Commission (SEC).

e. No cash-settled top-off or make-whole provisions. There are no cash settled top-off or make-whole provisions.

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

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

ASC 815-40-25 contains additional guidance (e.g., on applying the above conditions) that the issuer should consider in determining whether it controls settlement by delivery of its equity shares under ASC 480-10-599-3A(6). See Section 5.3 of Deloitte's A Roadmap to Accounting for Contracts on an Entity's Own Equity for a detailed discussion of this guidance. The issuer should reassess whether it could be forced to cash settle the feature under ASC 815-40 as of each balance sheet date and whenever circumstances change.

Note that the issuer should perform the assessment under ASC 815-40-25 irrespective of whether a share-settled feature contractually is described as a redemption feature or a conversion feature (including a conversion feature that requires the issuer to deliver a fixed number of equity shares upon conversion). For example, a perpetual convertible preferred share may have no explicit redemption feature. Upon the holder's election to convert the preferred stock into common stock, the issuer may be required to deliver a variable number of equity shares that is determined by using a formula. There is no contractual cap on the number of common shares that the issuer could be required to deliver. Because the contract contains no explicit share limit, the issuer must assume that it might be forced to cash settle the conversion feature in accordance with the accounting analysis under ASC 815-40. Accordingly, the preferred stock would be classified in temporary equity. (See Section 5.3.4 of Deloitte's A Roadmap to Accounting for Contracts on an Entity's Own Equity for further discussion.)

Speaking before the 2000 AICPA Conference on Current SEC Developments, Mr. Ragone provided the following example:

A company issues preferred stock that is redeemable for common shares upon receipt by the company of a conversion notice from the holders of the preferred securities. The legal agreements state that if the company is unable to fully convert the preferred shares into common stock, it would be required to redeem the securities for cash. That is, if the company does not have enough shares authorized to convert the preferred securities to common stock, the company would be required to deliver cash. Further assume that as of the preferred stock issuance date, there were not enough shares authorized to convert the preferred stock to common stock and that a shareholder meeting would be required to authorize additional shares. . . .

The staff believes that the requirement to obtain shareholder approval to authorize additional shares is outside of the control of the issuer. The staff therefore would conclude that because the redemption of the preferred security for cash could be triggered by an event that is outside of the control of the issuer, the preferred securities would be required to [be] classified outside of permanent equity.

9.4.7 Features That the Issuer Must or May Settle in Redeemable Instruments

Sometimes an outstanding equity share does not contain any redemption feature that meets the temporary-equity classification criteria except that it is convertible or exchangeable — at the election of the holder or upon the occurrence of an event that is not solely within the control of the issuer or at a fixed or determinable date — into an instrument that contains such a redemption feature (e.g., a
redeemable share or a debt instrument). We believe that if the issuer cannot prevent the conversion or exchange, the currently outstanding equity share should be classified as temporary equity because the conversion or exchange feature makes the instrument redeemable.

For example, a class of nonredeemable preferred shares (Series A) may be convertible, at the holder’s option, into a different class of preferred shares (Series B) that are redeemable in cash, at the holder’s option, upon an event that is outside the issuer’s control. Even though the Series A shares — when viewed in isolation — do not contain an explicit redemption feature, the issuer cannot prevent the holder from converting the Series A shares into Series B shares, which do contain a redemption feature that meets the temporary-equity classification criteria. Accordingly, the Series A shares are classified as temporary equity.

### 9.4.8 Convertible Debt Instruments Separated Into Liability and Equity Components

<table>
<thead>
<tr>
<th>ASC 480-10 — SEC Materials — SEC Staff Guidance</th>
</tr>
</thead>
<tbody>
<tr>
<td>SEC Staff Announcement: Classification and Measurement of Redeemable Securities</td>
</tr>
<tr>
<td>S99-3A(3)(e) Convertible debt instruments that contain a separately classified equity component. Other applicable GAAP may require a convertible debt instrument to be separated into a liability component and an equity component.(^{FN8}) In these situations, the equity-classified component of the convertible debt instrument should be considered redeemable if at the balance sheet date the issuer can be required to settle the convertible debt instrument for cash or other assets (that is, the instrument is currently redeemable or convertible for cash or other assets). For these instruments, an assessment of whether the convertible debt instrument will become redeemable or convertible for cash or other assets at a future date should not be made. For example, a convertible debt instrument that is not redeemable at the balance sheet date but could become redeemable by the holder of the instrument in the future based on the passage of time or upon the occurrence of a contingent event is not considered currently redeemable at the balance sheet date.</td>
</tr>
<tr>
<td>(^{FN8}) See Subtopics 470-20 and 470-50; and Paragraph 815-15-35-4.</td>
</tr>
</tbody>
</table>

The SEC’s temporary-equity guidance applies to the equity-classified component of convertible instruments that are separated into liability and equity components, such as certain convertible instruments that contain beneficial conversion or CCFs (see Section 9.3.5), only if the instruments are currently redeemable as of the balance sheet date. A convertible instrument is currently redeemable if the issuer could be forced to settle all or part of the instrument in cash or other assets upon a redemption or conversion as of the balance sheet date. For instance, an instrument would be considered currently redeemable if it contains a cash-settled embedded put option that permits the holder to redeem the instrument at any time or if the instrument is convertible as of the balance sheet date and the issuer could be required to settle all or part of its obligation in cash upon conversion (e.g., if the issuer has an obligation upon conversion to pay the principal amount in cash and the excess conversion spread in shares).

If a convertible debt instrument is not currently redeemable, the instrument is exempt from the scope of the temporary-equity guidance under ASC 480-10-S99-3A(3)(e) even if the equity component meets the temporary-equity classification criteria (e.g., because the instrument will become redeemable as of a specified date in the future or is redeemable upon the occurrence of an uncertain future event that is not solely within the control of the issuer; see Section 9.4.1).
9.4.9 Share-Based Payment Arrangements With Employees

ASC 480-10 — SEC Materials — SEC Staff Guidance

SEC Staff Announcement: Classification and Measurement of Redeemable Securities

S99-3A(3)(d) Share-based payment awards. Equity-classified share-based payment arrangements with employees are not subject to ASR 268 due solely to either of the following:

- Net cash settlement would be assumed pursuant to Paragraphs 815-40-25-11 through 25-16 solely because of an obligation to deliver registered shares.\[FN7]\n
- A provision in an instrument for the direct or indirect repurchase of shares issued to an employee exists solely to satisfy the employer’s minimum statutory tax withholding requirements (as discussed in Paragraphs 718-10-25-18 through 25-19).

\[FN7]\ See footnote 84 of Section 718-10-S99.

SEC Staff Accounting Bulletins


Certain financial instruments awarded in conjunction with share-based payment arrangements have redemption features that require settlement by cash or other assets upon the occurrence of events that are outside the control of the issuer.\[FN79] FASB ASC Topic 718 provides guidance for determining whether instruments granted in conjunction with share-based payment arrangements should be classified as liability or equity instruments. Under that guidance, most instruments with redemption features that are outside the control of the issuer are required to be classified as liabilities; however, some redeemable instruments will qualify for equity classification.\[FN80] SEC Accounting Series Release No. 268, Presentation in Financial Statements of “Redeemable Preferred Stocks,”\[FN81] (“ASR 268”) and related guidance\[FN82] address the classification and measurement of certain redeemable equity instruments.

\[FN79]\ The terminology outside the control of the issuer is used to refer to any of the three redemption conditions described in Rule 5-02.28 of Regulation S-X that would require classification outside permanent equity. That rule requires preferred securities that are redeemable for cash or other assets to be classified outside of permanent equity if they are redeemable (1) at a fixed or determinable price on a fixed or determinable date, (2) at the option of the holder, or (3) upon the occurrence of an event that is not solely within the control of the issuer.

\[FN80]\ FASB ASC paragraphs 718-10-25-6 through 718-10-25-19.

\[FN81]\ ASR 268, July 27, 1979, Rule 5-02.28 of Regulation S-X.

\[FN82]\ Related guidance includes FASB ASC paragraph 480-10-S99-3A (Distinguishing Liabilities from Equity Topic).

Facts: Under a share-based payment arrangement, Company F grants to an employee shares (or share options) that all vest at the end of four years (cliff vest). The shares (or shares underlying the share options) are redeemable for cash at fair value at the holder’s option, but only after six months from the date of share issuance (as defined in FASB ASC Topic 718). Company F has determined that the shares (or share options) would be classified as equity instruments under the guidance of FASB ASC Topic 718. However, under ASR 268 and related guidance, the instruments would be considered to be redeemable for cash or other assets upon the occurrence of events (e.g., redemption at the option of the holder) that are outside the control of the issuer.

Question 1: While the instruments are subject to FASB ASC Topic 718,\[FN83] is ASR 268 and related guidance applicable to instruments issued under share-based payment arrangements that are classified as equity instruments under FASB ASC Topic 718?

\[FN83]\ FASB ASC paragraph 718-10-35-13, states that an instrument ceases to be subject to this Topic when “the rights conveyed by the instrument to the holder are no longer dependent on the holder being an employee of the entity (that is, no longer dependent on providing service).”
Interpretive Response: Yes. The staff believes that registrants must evaluate whether the terms of instruments granted in conjunction with share-based payment arrangements with employees that are not classified as liabilities under FASB ASC Topic 718 result in the need to present certain amounts outside of permanent equity (also referred to as being presented in “temporary equity”) in accordance with ASR 268 and related guidance.

Instruments granted in conjunction with share-based payment arrangements with employees that do not by their terms require redemption for cash or other assets (at a fixed or determinable price on a fixed or determinable date, at the option of the holder, or upon the occurrence of an event that is not solely within the control of the issuer) would not be assumed by the staff to require net cash settlement for purposes of applying ASR 268 in circumstances in which FASB ASC Section 815-40-25, Derivatives and Hedging — Contracts in Entity’s Own Equity — Recognition, would otherwise require the assumption of net cash settlement. See FASB ASC paragraph 815-40-25-11, which states, in part: “...the events or actions necessary to deliver registered shares are not controlled by an entity and, therefore, except under the circumstances described in FASB ASC paragraph 815-40-25-16, if the contract permits the entity to net share or physically settle the contract only by delivering registered shares, it is assumed that the entity will be required to net cash settle the contract.” See also FASB ASC subparagraph 718-10-25-15(a).

When an instrument ceases to be subject to FASB ASC Topic 718 and becomes subject to the recognition and measurement requirements of other applicable GAAP, the staff believes that the company should reassess the classification of the instrument as a liability or equity at that time and consequently may need to reconsider the applicability of ASR 268.

The SEC has provided certain exceptions from the classification guidance in ASC 480-10-599-3A on determining whether share-based payment arrangements within the scope of ASC 718 should be classified as temporary equity. For such arrangements, temporary-equity classification is not required in the following circumstances:

- “Net cash settlement would be assumed pursuant to [ASC] 815-40-25-11 through 25-16 solely because of an obligation to deliver registered shares.” (As discussed in Section 9.4.6, a feature that requires or permits share settlement is normally treated as a cash-settled feature if the issuer might be forced to settle it in cash in accordance with the guidance in ASC 815-40-25.)

- “A provision in an instrument for the direct or indirect repurchase of shares issued to an employee exists solely to satisfy the employer’s minimum statutory tax withholding requirements (as discussed in [ASC] 718-10-25-18 through 25-19).”

These exceptions cease to apply when an arrangement is no longer within the scope of ASC 718 (see Section 9.3.9).

See Deloitte’s A Roadmap to Accounting for Share-Based Payment Awards for further discussion.

9.4.10 Classification of ESOP Shares Within Temporary Equity

9.4.10.1 Outstanding Shares

ASC 480-10-599-3A(2) requires that equity securities be classified in temporary equity if they are redeemable at the option of the holder or upon the occurrence of an event not solely within the issuer’s control. Thus, shares of common stock or convertible preferred stock held by an ESOP, whether nonleveraged or leveraged, that are redeemable at the option of the participant or upon any event outside the sponsor’s control must be classified within temporary equity.
The shares of stock held by an ESOP may meet the requirements for classification in temporary equity because of various redemption features and terms. As discussed in EITF Issue 89-11, a sponsor of an ESOP is required to provide participants with a put option on their shares of stock when those shares are not readily tradable. EITF Issue 89-11 states, in part:3

Under federal income tax regulations, employer securities (such as convertible preferred stock) that are held by participants in an employee stock ownership plan (ESOP) and that are not readily tradable on an established market must include a put option. The put option is a right to demand that the sponsor redeem shares of employer stock held by the participant for which there is no market for an established cash price. The employer may have the option to issue marketable securities for all or a portion of that option rather than to pay cash. The provisions of the ESOP may permit the ESOP to substitute for the sponsor as buyer of the employer stock; however, in no case can the sponsor require the ESOP to assume the obligation for the put option.

ASC 718-40-25-2 also discusses this put option requirement and other situations in which sponsors must repurchase shares of stock held by participants that withdraw their shares. ASC 718-40-25-2 states:

Regardless of whether an employee stock ownership plan is leveraged or nonleveraged, employers are required to give a put option to participants holding employee stock ownership plan shares that are not readily tradable, which on exercise requires the employer to repurchase the shares at fair value. Public entity sponsors sometimes offer cash redemption options to participants who are eligible to withdraw traded shares from their accounts, which on exercise requires the employer to repurchase the shares at fair value. Employers shall report the satisfaction of such option exercises as purchases of treasury stock.

In addition to the situations described above, shares of stock held by an ESOP may be redeemable as a result of various other features and terms, including, but not limited to, the following:

- Shares of convertible preferred stock held by the ESOP may be redeemable upon the occurrence of a change of control or another deemed liquidation event involving the sponsor.
- The sponsor may not have sufficient authorized and unissued shares of common stock to satisfy the conversion of convertible preferred stock. For example, upon withdrawal, the holder may be entitled to receive a variable number of shares of common stock based on a minimum stated value without any stated cap on the maximum number of shares of common stock that may need to be delivered. In the absence of a stated cap on the number of shares of common stock that must be delivered, the sponsor does not control the ability to deliver shares of common stock to satisfy such settlement requirements.

Connecting the Dots

The plan documents for an ESOP that holds common stock listed on a stock exchange may contain a stated put option that becomes operable only if the sponsor’s shares of common stock are no longer readily tradable (e.g., the shares are delisted from the stock exchange). We believe that, in these situations, temporary equity classification of the shares of common stock held by the ESOP is required because it is not within an entity’s control to maintain the readily tradable status of its common stock. However, when the plan documents for an ESOP that holds common stock listed on a stock exchange do not contain a stated put option in the event that the sponsor’s shares of common stock are no longer readily tradable, additional consideration is necessary. In these situations, the sponsor does not control the ability to maintain the listing of its shares of common stock on a stock exchange. If the sponsor’s shares of common stock are delisted, they would no longer be considered readily tradable and put options would be issued to ESOP participants or their beneficiaries. However, if the sponsor has not yet legally conveyed a put option to the ESOP participants or their beneficiaries and if, upon receipt of a delisting notice or another event that would cause the sponsor’s shares to no longer be readily tradable, the sponsor has the unilateral ability to (1) terminate the ESOP, (2) accelerate

3 Although not codified, the guidance in EITF 89-11 is still relevant.
the vesting of all shares of common stock held by the ESOP, and (3) distribute all the shares of common stock held by the ESOP participants or their beneficiaries before the sponsor’s shares become no longer readily tradable, we do not believe that an entity is required to classify those shares of common stock in temporary equity. That is, if the holder of the shares does not have a current redemption right and the sponsor controls the ability to avoid the holder’s redemption of the shares of common stock back to the sponsor under all circumstances (i.e., the sponsor controls the ability to effect a plan termination, which would avoid its requirement to provide a redemption option to the holders), temporary equity classification of the common stock held by the ESOP is not required. Note that entities must carefully evaluate the facts and circumstances to determine whether ESOP shares must be classified in temporary equity. As part of this evaluation, it may be necessary to legally interpret certain ERISA and IRC provisions related to the requirement to provide put options on shares that are not readily tradable.

When shares of stock held by an ESOP must be classified in temporary equity on the sponsor’s balance sheet, all of the ESOP’s shares of stock that are considered outstanding must be classified in temporary equity. In accordance with ASC 718-40-45-9, all shares held by a nonleveraged ESOP are treated as outstanding, except the suspense account shares of a pension reversion ESOP, which are not treated as outstanding until they are committed to be released for allocation to participant accounts (see Section 7.2.2.1 of Deloitte’s A Roadmap to the Presentation and Disclosure of Earnings per Share). In accordance with ASC 718-40-45-3, shares held by a leveraged ESOP that have been either allocated or committed to be released (on the basis of the debt service payments) should be considered outstanding (see Section 7.2.3.1 of Deloitte’s A Roadmap to the Presentation and Disclosure of Earnings per Share).

**Connecting the Dots**

For both nonleveraged and leveraged ESOPs, the vested status of shares of stock held by the ESOP is not relevant to the classification of such shares within temporary equity.

### 9.4.10.2 Classification of Unearned ESOP Shares of Leveraged ESOP

When the outstanding shares of stock of a leveraged ESOP must be classified in temporary equity, it is also appropriate to classify all or a portion of the related contra-equity account for unearned ESOP shares in temporary equity. Although not codified, EITF Issue 89-11 states, in part:

> The Task Force reached a consensus that when ASR 268 (as presented in Section 211 of the “Codification of Financial Reporting Policies”) requires some or all of the value of the securities to be classified outside of permanent equity, a proportional amount of the debit in the equity section of the sponsor’s balance sheet (sometimes described as loan to ESOP or deferred compensation), if any, should be similarly classified.
9.5 Measurement

9.5.1 Initial Measurement

SEC Staff Accounting Bulletins

SAB Topic 3.C, Redeemable Preferred Stock [Reproduced in ASC 480-10-599-2]

**Facts:** Rule 5-02.27 of Regulation S-X states that redeemable preferred stocks are not to be included in amounts reported as stockholders' equity, and that their redemption amounts are to be shown on the face of the balance sheet. However, the Commission's rules and regulations do not address the carrying amount at which redeemable preferred stock should be reported, or how changes in its carrying amount should be treated in calculations of earnings per share and the ratio of earnings to combined fixed charges and preferred stock dividends.

**Question 1:** How should the carrying amount of redeemable preferred stock be determined?

**Interpretive Response:** The initial carrying amount of redeemable preferred stock should be its fair value at date of issue.

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**ASC 480-10 — SEC Materials — SEC Staff Guidance**

SEC Staff Announcement: Classification and Measurement of Redeemable Securities

S99-3A(12) *Initial measurement.* The SEC staff believes the initial carrying amount of a redeemable equity instrument that is subject to ASR 268 should be its issuance date fair value, except as follows: FN12

**FN12** SAB Topic 3C, Redeemable Preferred Stock, states that the initial carrying amount of redeemable preferred stock should be its fair value at date of issue. The SEC staff believes this guidance should also be applied to other similar redeemable equity instruments. Consistent with Paragraph 820-10-30-3, the transaction price will generally represent the initial fair value of the equity instrument when the issuance occurs in an arm's-length transaction with an unrelated party and there are no other unstated rights or privileges.

When an equity instrument subject to the temporary-equity guidance is first recognized, it is initially measured at its fair value at issuance unless an exception applies. This measurement requirement applies irrespective of whether the redemption value is higher or lower than fair value. ASC 820 contains guidance on measuring fair value. In many cases, the transaction price (the proceeds received at issuance) will equal the initial fair value (see ASC 820-10-30-2 through 30-6). ASC 820-10-30-3A discusses circumstances in which the transaction price might not equal fair value at initial recognition (e.g., related-party transactions and forced transactions).

For example, an entity may issue a preferred stock instrument for net proceeds of $1,000, which equals its issuance-date fair value. If the instrument contains a redemption feature that permits the holder to put the instrument to the issuer at any time for cash of $950, the amount initially presented in temporary equity is $1,000 even though the redemption value is $950.

Exceptions to the requirement to measure a temporary-equity-classified instrument initially at fair value include the following:

- An equity host that remains after the bifurcation of an embedded derivative (see Section 9.5.6).
- Equity-classified components of convertible debt (see Section 9.5.7).
- Convertible preferred stock with a BCF (see Section 9.5.8).
- An equity instrument issued with another freestanding financial instrument (see Section 9.5.9).
- Noncontrolling interests (see Section 9.5.10).
• Equity securities held by employee stock ownership plans (see Section 9.5.11).
• Share-based payment arrangements (see Section 9.5.12).

Further, we believe that it would generally be appropriate for an entity to deduct, from the related proceeds, specific incremental costs that are directly attributable to the issuance of an instrument classified in temporary equity when the entity initially measures the instrument at fair value, because SAB Topic 5.A (reproduced in ASC 340-10-599-1) states, in part:

Specific incremental costs directly attributable to a proposed or actual offering of securities may properly be deferred and charged against the gross proceeds of the offering.

Further, AICPA Technical Q&As Section 4110.01 states, in part:

Direct costs of obtaining capital by issuing stock should be deducted from the related proceeds, and the net amount recorded as contributed stockholders’ equity. . . . Such costs should be limited to the direct cost of issuing the security. Thus, there should be no allocation of officers’ salaries, and care should be taken that legal and accounting fees do not include any fees that would have been incurred in the absence of such issuance.

See Section 3.3.4.4 for further discussion of what qualifies as an issuance cost.

9.5.2 Subsequent Measurement

9.5.2.1 Overview

ASC 480-10 — SEC Materials — SEC Staff Guidance

SEC Staff Announcement: Classification and Measurement of Redeemable Securities

S99-3A(13) Subsequent measurement. The SEC staff's views regarding the subsequent measurement of a redeemable equity instrument that is subject to ASR 268 are included in paragraphs 14–16. Paragraphs 14 and 15 discuss the general views regarding subsequent measurement. Paragraph 16 discusses the application of those general views in the context of certain types of redeemable equity instruments.

S99-3A(14) If an equity instrument subject to ASR 268 is currently redeemable (for example, at the option of the holder), it should be adjusted to its maximum redemption amount at the balance sheet date. . . .

S99-3A(15) If an equity instrument subject to ASR 268 is not currently redeemable (for example, a contingency has not been met), subsequent adjustment of the amount presented in temporary equity is unnecessary if it is not probable that the instrument will become redeemable. If it is probable that the equity instrument will become redeemable (for example, when the redemption depends solely on the passage of time), the SEC staff will not object to either of the following measurement methods provided the method is applied consistently:

a. Accrete changes in the redemption value over the period from the date of issuance (or from the date that it becomes probable that the instrument will become redeemable, if later) to the earliest redemption date of the instrument using an appropriate methodology, usually the interest method. Changes in the redemption value are considered to be changes in accounting estimates.

b. Recognize changes in the redemption value (for example, fair value) immediately as they occur and adjust the carrying amount of the instrument to equal the redemption value at the end of each reporting period. This method would view the end of the reporting period as if it were also the redemption date for the instrument.

S99-3A(17) Application of the fair value option. Measurement of a redeemable equity instrument (or host contract) subject to ASR 268 at fair value through earnings in lieu of the measurement guidance provided in paragraphs 14–16 is not appropriate.FN16

FN16 Paragraph 825-10-15-5(f) prohibits the election of the fair value option for financial instruments that are, in whole or in part, classified in stockholder’s equity (including temporary equity).
While the probability that an instrument will become redeemable does not affect its classification as temporary equity (see Section 9.4.1), such probability may affect the instrument’s subsequent measurement. Unless an exception applies, the measurement of a temporary-equity classified instrument after initial recognition differs depending on whether, as of the balance sheet date, (1) the instrument is currently redeemable or, if it is not currently redeemable, (2) it is probable that the instrument will become redeemable. The table below provides an overview of the subsequent measurement requirements that apply in each circumstance.

<table>
<thead>
<tr>
<th>Circumstance</th>
<th>Subsequent Measurement</th>
</tr>
</thead>
<tbody>
<tr>
<td>The instrument is currently redeemable.</td>
<td>Maximum redemption amount (i.e., the current redemption value) subject to a floor equal to the initial carrying amount.</td>
</tr>
<tr>
<td>The instrument is not currently redeemable, but it is probable that the instrument will become redeemable in the future (e.g., as a result of the passage of time).</td>
<td>Accounting policy choice between (1) accreted redemption value and (2) current redemption value. In both cases, the measurement is subject to a floor equal to the initial carrying amount.</td>
</tr>
<tr>
<td>The instrument is not currently redeemable, and it is not probable that the instrument will become redeemable in the future.</td>
<td>Not required to be remeasured.</td>
</tr>
</tbody>
</table>

As of each balance sheet date and on an ongoing basis, the issuer reassesses whether the instrument is currently redeemable or it is probable that it will become redeemable.

If the instrument is not currently redeemable, but it is probable that the instrument will become redeemable, the SEC staff expects consistent application of the accounting method selected (i.e., measurement either at the accreted redemption value or the current redemption value), along with appropriate disclosure of the selected policy in the footnotes to the financial statements. In addition, entities that elect to “accrete changes in the redemption amount” over the period from the date of issuance to the earliest redemption date must disclose the “redemption amount of the equity instrument as if it were currently redeemable” (see Section 9.8.2).

Adjustments to the carrying amount of temporary-equity classified instruments are recognized as a deemed dividend against retained earnings or, in the absence of retained earnings, paid-in capital (see Section 9.5.5). Special considerations apply to preferred stock with a stated dividend rate that increases over time (see Section 9.5.2.6).

Exceptions to the subsequent-measurement guidance apply to:

- Equity-classified components of convertible debt (see Section 9.5.7).
- Noncontrolling interests (see Section 9.5.10).
- Equity securities held by employee stock ownership plans (see Section 9.5.11).
- Share-based payment arrangements (see Section 9.5.12).

In accordance with ASC 480-10-S99-3A(17) and ASC 825-10-15-5(f), an issuer may not elect to measure an instrument presented in temporary equity at fair value with changes in fair value recognized in earnings.
9.5.2.2 **Current Redemption Value**

**SEC Staff Announcement: Classification and Measurement of Redeemable Securities**

**S99-3A(14)** If an equity instrument subject to ASR 268 is currently redeemable (for example, at the option of the holder), it should be adjusted to its maximum redemption amount at the balance sheet date. If the maximum redemption amount is contingent on an index or other similar variable (for example, the fair value of the equity instrument at the redemption date or a measure based on historical EBITDA), the amount presented in temporary equity should be calculated based on the conditions that exist as of the balance sheet date (for example, the current fair value of the equity instrument or the most recent EBITDA measure). The redemption amount at each balance sheet date should also include amounts representing dividends not currently declared or paid but which will be payable under the redemption features or for which ultimate payment is not solely within the control of the registrant (for example, dividends that will be payable out of future earnings).

FN13 See also Section 260-10-45.

**S99-3A(15)** If it is probable that the equity instrument will become redeemable (for example, when the redemption depends solely on the passage of time), the SEC staff will not object to the following measurement method provided the method is applied consistently: . . .

b. Recognize changes in the redemption value (for example, fair value) immediately as they occur and adjust the carrying amount of the instrument to equal the redemption value at the end of each reporting period. This method would view the end of the reporting period as if it were also the redemption date for the instrument.

Subsequent measurement at the current redemption value (subject to a floor equal to the initial carrying amount) is required if the instrument is currently redeemable. If it is probable that the instrument will become redeemable, however, such subsequent measurement is elective (as one of two permissible accounting policy options).

The current redemption value is the maximum amount payable if redemption were to occur as of the balance sheet date (see Section 9.5.6 for a discussion of how to adjust the measurement for any temporary-equity classified host contract with a bifurcated derivative). The current redemption value includes any currently accumulated, undeclared dividends that the issuer would be required to pay upon a redemption; however, it excludes discretionary, undeclared dividends irrespective of whether the issuer expects or intends to pay them.

If the instrument is not currently redeemable (e.g., because the redemption feature is contingent and, although the contingency has not been met, it is probable that it will be met in the future, or the instrument will become redeemable on a specified date in the future), the current redemption value is measured as if the instrument were redeemable at the end of the reporting period (i.e., the balance sheet date). That is, the end of the reporting period is viewed “as if it were also the redemption date for the instrument.”

If the redemption amount fluctuates on the basis of a market price or index (e.g., the current stock price or the most recent EBITDA), the current redemption value is determined on the basis of the current market price or index level as of the balance sheet date. This measurement applies even if the ability to redeem the instrument is contingent on the attainment of a specific market price or index level. If the index used for redemptions is updated periodically (e.g., October 31 of each year), the issuer should use the most recently calculated index amount for measurements as of the balance sheet date (e.g., it should use the October 31 index amount for the year ending on December 31). The issuer should not seek to project what the index level will be for future redemptions (e.g., based on a trailing or rolling metric).
If a conversion feature causes an instrument to be classified as temporary equity (e.g., the issuer could be forced to cash settle the feature pursuant to ASC 815-40-25; see Section 9.4.6), the current redemption value would reflect the current conversion value (i.e., the amount of cash the issuer would be assumed to have to deliver upon a conversion).

**Example 9-5**

Entity X issues a perpetual preferred stock instrument for $100 at the beginning of the reporting period, when the stock price was $100. The instrument is redeemable at an amount equal to the quoted market price of X’s common stock one year after the end of the reporting period. At the beginning of the reporting period, X elected to subsequently measure the instrument at its current redemption value. If the quoted market price of the common stock at the end of the reporting period is $150, the current redemption value is $150 even though (1) the instrument is not currently redeemable and (2) the expected future redemption amount (based on the future market price of the common stock) if the instrument is redeemed may be different from $150. Therefore, X would adjust the carrying amount of the instrument from $100 to $150.

### 9.5.2.3 Accreted Redemption Value

**SEC Staff Announcement: Classification and Measurement of Redeemable Securities**

S99-3A(15) If it is probable that the equity instrument will become redeemable (for example, when the redemption depends solely on the passage of time), the SEC staff will not object to . . . the following measurement [method] provided the method is applied consistently:

a. Accrete changes in the redemption value over the period from the date of issuance (or from the date that it becomes probable that the instrument will become redeemable, if later) to the earliest redemption date of the instrument using an appropriate methodology, usually the interest method. Changes in the redemption value are considered to be changes in accounting estimates. . . .

**SEC Staff Accounting Bulletins**

SAB Topic 3.C, Redeemable Preferred Stock [Reproduced in ASC 480-10-S99-2]  
**Facts:** Rule 5-02.27 of Regulation S-X states that redeemable preferred stocks are not to be included in amounts reported as stockholders’ equity, and that their redemption amounts are to be shown on the face of the balance sheet. However, the Commission's rules and regulations do not address the carrying amount at which redeemable preferred stock should be reported, or how changes in its carrying amount should be treated in calculations of earnings per share and the ratio of earnings to combined fixed charges and preferred stock dividends.

**Question 1:** How should the carrying amount of redeemable preferred stock be determined?

**Interpretive Response:** The initial carrying amount of redeemable preferred stock should be its fair value at date of issue. Where fair value at date of issue is less than the mandatory redemption amount, the carrying amount shall be increased by periodic accretions, using the interest method, so that the carrying amount will equal the mandatory redemption amount at the mandatory redemption date. The carrying amount shall be further periodically increased by amounts representing dividends not currently declared or paid, but which will be payable under the mandatory redemption features, or for which ultimate payment is not solely within the control of the registrant (e.g., dividends that will be payable out of future earnings). Each type of increase in carrying amount shall be effected by charges against retained earnings or, in the absence of retained earnings, by charges against paid-in capital.

The accounting described in the preceding paragraph would apply irrespective of whether the redeemable preferred stock may be voluntarily redeemed by the issuer prior to the mandatory redemption date, or whether it may be converted into another class of securities by the holder. Companies also should consider the guidance in FASB ASC paragraph 480-10-S99-3A (Distinguishing Liabilities from Equity Topic).
Subsequent measurement at the accreted redemption value (subject to a floor equal to the initial carrying amount) is one of two permitted accounting policy options if the instrument is not currently redeemable but it is probable that it will become redeemable. The issuer determines the accreted redemption value on the basis of periodic accretions of any difference between the initial carrying amount and the future redemption amount (including dividends not currently declared or paid, but payable upon redemption) over the period from the date of issuance (or the date on which it becomes probable that the instrument is redeemable, if later) to the earliest redemption date. If the redemption amount fluctuates on the basis of a market price or index (e.g., the current stock price or the most recent EBITDA), the future redemption amount is determined on the basis of the current market price or index level as of the balance sheet date. Projections of future changes (e.g., in fair value for an instrument redeemable at fair value) are not permitted.

The issuer uses an appropriate method (usually the effective interest method) to calculate the periodic accretion under which the accreted redemption value equals the redemption amount on the earliest redemption date. As stated in ASC 835-30-35-2, under the effective interest method, the issuer amortizes the difference between the present value and the redemption value to the earliest redemption date “in such a way as to result in a constant rate of interest when applied to the amount outstanding at the beginning of any given period.” The accretion calculation under the interest method should include all dividends that will be payable on the redemption date. Special considerations apply to preferred stock with an increasing dividend rate (see Section 9.5.2.6).

Calculating the accreted redemption value by using the interest method tends to be straightforward when the timing and amount of the future cash flows (including the redemption amount) are fixed. If the timing or amount of the future cash flows varies, determining the accreted redemption value and the associated accretion pattern is more complex. If the redemption value varies on the basis of an index or other similar variable (e.g., fair value), the amortization schedule of periodic accretions needs to be updated regularly to reflect periodic changes in the redemption value. Similarly, the accretion pattern needs to be adjusted if the earliest redemption date changes (e.g., on the basis of estimates of when it is probable that an exercise contingency will be met). As the redemption value changes over time, the issuer adjusts the accretion pattern by using an appropriate method (e.g., a retrospective or prospective interest method). We believe that an entity should select one method as its accounting policy and apply it consistently to similar instruments. If an entity applies a retrospective interest method (similar to that under ASC 310-20-35-26 or ASC 320-10-35-41), the impact of the recalculation of the effective interest on the carrying amount of the instrument is recognized in the current period; prior-period financial statements are not restated.

A policy of measuring an instrument for which the timing or amount of redemption varies at its accreted redemption value may mitigate some of the volatility in the carrying amount associated with measuring the instrument at its current redemption value, since changes in the redemption value are amortized over the period until the earliest redemption date under the accreted redemption value method but recognized immediately under the current redemption value method. To avoid some of the complexity associated with measuring such instruments at their accreted redemption value, however, the issuer may instead elect an accounting policy under which the instruments are measured at their current redemption value.

If an instrument is not currently redeemable, nor is it probable that the instrument will become redeemable, the issuer is not required to accrete a difference between the current carrying amount and the redemption amount even if the redemption amount exceeds the current carrying amount.
Example 9-6

Entity Y issues a perpetual preferred stock instrument at the beginning of the annual reporting period for $100.00, when the stock price was $133.10. The instrument is redeemable at an amount equal to the quoted market price of the issuer’s common stock two years after the end of the annual reporting period. The stock price remained constant at $133.10 during the year until the end of the annual reporting period, when it increased to $177.80. At the beginning of the annual reporting period, Y elected to subsequently measure the instrument at its accreted redemption value and to use a prospective interest method to reflect subsequent changes in the timing and amount of future cash flows. To amortize the difference between $100.00 and $133.10 over three years, Y prepared an amortization schedule that uses an effective interest rate of 10 percent. After one year, therefore, the accreted redemption value before adjustment for the changes in the redemption value is $110.00 ($100 + 10% × $100). Because the stock price increased to $177.80 at the end of the reporting period, however, Y would update its accretion pattern for the remaining two years. Under the prospective interest method and in accordance with the revised amortization schedule prepared at the end of the reporting period, the difference between the current carrying amount of $110.00 and the current redemption value of $177.80 would be amortized over the remaining two years (i.e., the new effective interest rate is 25 percent).

9.5.2.4 Multiple Redemption Features

The measurement of the redemption value (whether the instrument is measured at its current redemption value or its accreted redemption value) reflects the amount that would be payable under redemption features that both (1) cause the instrument to be classified in temporary equity (e.g., holder redemption options or redemption features outside the control of the issuer) and (2) require it to be remeasured (i.e., features that cause the instrument to be considered currently redeemable or will probably cause it to become redeemable).

Redemption features that do not cause the instrument to be classified as temporary equity (e.g., redemption features solely within the control of the issuer or upon ordinary liquidation events) are not reflected in the measurement of the redemption value.

Example 9-7

An equity instrument includes a holder put option exercisable at $90 and an issuer call option exercisable at $110. The redemption value is $90 (provided that the holder cannot direct the issuer to exercise the call option) even though the redemption amount would be higher should the issuer elect to exercise its call option. The call option does not affect the measurement of the redemption value because it does not result in a requirement to classify the equity instrument in temporary equity (only the put option does).

Similarly, redemption features that do not require the instrument to be remeasured (i.e., features that do not cause the instrument to be considered currently redeemable or do not cause its redeemability to become probable) do not affect the measurement of the redemption value.

Example 9-8

Entity Z issues an instrument that includes the following two redemption features: (1) upon a change of control (which is not probable), the instrument will be mandatorily redeemed for $120 and (2) the holder has a noncontingent put option with an exercise price of $100 that will become exercisable on a specified date in the future. In measuring the redemption value, Z takes into account the put option, but not the contingent redemption feature, because it is not probable that the instrument will become redeemable under the contingent redemption feature.
If an instrument contains more than one redemption feature that (1) causes the instrument to be classified as temporary equity and (2) is currently exercisable or will probably become exercisable, the redemption value reflects the maximum amount that the issuer might have to pay under those features.

**Example 9-9**

An equity-classified instrument includes a contingent put option with an exercise price of $100 and another contingent put option with an exercise price of $110. If it is probable that each feature will become exercisable, the redemption value is the higher of $100 and $110 (i.e., $110).

**9.5.2.5 Limit on Reductions to the Carrying Amount**

In accordance with ASC 480-10-S99-3A(16), an issuer is not permitted to reduce the carrying amount of a temporary-equity classified instrument below its initial carrying amount except for share-based payment arrangements, employee stock ownership plans, and convertible debt instruments with a separated equity component (for which special measurement guidance applies). For example, if the current redemption value of a currently redeemable instrument is $100 (e.g., the instrument can be put by the investor to the issuer for $100) and the initial fair value of the instrument was $105, the issuer is not permitted to reduce the amount presented for the instrument in temporary equity below $105 even though the carrying amount exceeds the redemption value.

**9.5.2.6 Increasing Rate Preferred Stock**

In accordance with SAB Topic 5.Q, the SEC staff believes that an entity must use the interest method to recognize dividends on increasing-rate preferred stock. Although SAB Topic 5.Q specifically discusses preferred stock issued at a discount to its liquidation preference, with stated dividends that increase over time, the guidance also applies to preferred stock issued at its liquidation preference that contains a stated dividend rate that increases over time.

Although ASC 480-10-S99-3A(15) gives an entity the option of recognizing redemption-amount measurement adjustments related to redeemable preferred stock by using one of two methods when preferred stock is not redeemable on the balance sheet date but it is probable that it will become redeemable (see Section 9.5.2.1), the entity must apply the effective yield method when SAB Topic 5.Q applies. Under SAB Topic 5.Q, it is not appropriate to immediately recognize the entire discount between the issuance price and the liquidation preference related to increasing-rate preferred stock.
For further discussion of the scope and application of SAB Topic 5.Q, see Section 3.2.2.3 of Deloitte’s *A Roadmap to the Presentation and Disclosure of Earnings per Share*.

### 9.5.3 Assessment of Whether an Instrument Is Currently Redeemable

If a holder of a temporary-equity classified instrument currently has the right to exercise a redemption feature (e.g., a put right) and no conditions need to be met (or those conditions are currently met) to effect a redemption, the instrument is considered currently redeemable. An instrument would not be considered currently redeemable if the redemption feature cannot be exercised by the holder on the balance sheet date (e.g., if it can only be exercised on a specified future date or (dates) or if a redemption would require the satisfaction of conditions outside the holder’s control that are not met as of the balance sheet date).

We believe that if a condition needs to be met for the holder to exercise a redemption feature, and the holder controls whether the condition is met as of the balance sheet date, the instrument should be considered currently redeemable even if the condition was not met as of the balance sheet date (i.e., the condition is not substantive in the analysis). For example, an equity instrument may be redeemable at the option of the holder upon the holder’s voluntary decision to terminate employment with the issuer. In such a case, the instrument may be considered currently redeemable as of the balance sheet date even if the holder has made no decision to terminate employment, because the holder controls whether the condition is satisfied as of the balance sheet date. Similarly, if an instrument is redeemable upon a vote by a majority of the holders of the outstanding instrument, the instrument would be considered currently redeemable, because the holder (as a class) controls whether the condition is met as of the balance sheet date (i.e., the shareholder vote is not a substantive contingency, but an exercise of a current redemption right).

The issuer’s option to redeem the instrument as of the balance sheet date does not affect the assessment of whether the instrument is currently redeemable unless the holder has the power to control the issuer’s decision to exercise the redemption feature (see Section 9.4.4). If the holder has the power to direct the issuer to exercise the call option as of the balance sheet date, however, the instrument would be considered currently redeemable, because the option is not contingent.

We believe that when an instrument is redeemable upon a change of control, merger, consolidation, sale of substantially all assets, or other similar deemed liquidation event, and the holder controls the issuer’s board of directors, it is acceptable, but not required, to view the instrument as currently redeemable. Some view the deemed liquidation condition as nonsubstantive (i.e., the instrument should be viewed as currently redeemable) because the holder has the power to direct the issuer’s actions through its control of the issuer’s board of directors. Others view the same condition as substantive (i.e., the instrument should be viewed as not currently redeemable) because redemption is contingent on the identification of a market participant willing to purchase the assets for consideration in an amount sufficient to distribute the redemption amount to the holders of the redeemable equity instruments (see Section 9.5.4.5).

### 9.5.4 Assessing Whether It Is Probable That an Instrument Will Become Redeemable

#### 9.5.4.1 Overview

The measurement of a redeemable equity instrument that is not currently redeemable depends on whether it is probable that the instrument will become redeemable. The ASC master glossary defines “probable” as the “future event or events are likely to occur” (i.e., probable is a higher threshold than “reasonably possible” or “more likely than not,” but near certainty is not required).
In evaluating whether it is probable that an instrument will become redeemable, an entity does not assess the likelihood that the instrument will be redeemed. Even if an instrument’s redemption is not probable, the instrument’s becoming redeemable may be probable. For example, an equity share may contain (1) a noncontingent redemption feature that permits the holder to put the instrument to the issuer for cash two years from the reporting date and (2) no other feature relevant to the analysis. On the basis of its contractual terms, the instrument is certain to become redeemable with the passage of time irrespective of whether it is probable that the holder will exercise its put option. Similarly, it is probable that an equity share that contains a put feature that will become exercisable upon the occurrence of an uncertain future event (e.g., a project milestone) will become redeemable if it is probable that the event will occur even if the put option is not expected to be exercised if or when it becomes exercisable. Further, it is probable that an equity share that will, on the basis of the passage of time, become redeemable by the holder unless an uncertain future event occurs will become redeemable unless there is a more than remote chance that the event will occur (irrespective of the likelihood of the holder’s exercise of the contingent redemption right).

The table below provides an overview of the evaluation of whether it is probable that various features will become redeemable.

<table>
<thead>
<tr>
<th>Probable That Feature Will Become Redeemable</th>
<th>Not Probable That Feature Will Become Redeemable</th>
</tr>
</thead>
<tbody>
<tr>
<td>Redeemable at the option of the holder on a specified date in the future</td>
<td>Redeemable at the option of the holder upon the occurrence of an event whose occurrence is not probable (e.g., an event that is reasonably possible)</td>
</tr>
<tr>
<td>Redeemable at the option of the holder upon the occurrence of an event that is probable of occurring</td>
<td>Automatically redeemed upon the occurrence of an event whose occurrence is not probable</td>
</tr>
<tr>
<td>Automatically redeemed upon the occurrence of an event whose occurrence is probable</td>
<td>Redeemable at the option of the holder on a specified date in the future unless an event that has a more than remote chance of occurring before that date happens</td>
</tr>
<tr>
<td>Redeemable at the option of the holder on a specified date in the future unless an event that has a remote chance of occurring before that date happens</td>
<td>Automatically redeemed on a specified date in the future unless an event that has a more than remote chance of occurring before that date happens</td>
</tr>
<tr>
<td>Automatically redeemed on a specified date in the future unless an event that has a remote chance of occurring before that date happens</td>
<td></td>
</tr>
</tbody>
</table>

We generally believe that because of the uncertainties associated with a business combination (including, e.g., the completion of due diligence and the obtaining of any necessary shareholder or regulatory approval), the occurrence of a business combination would not be considered probable until it has been consummated. Similarly, the successful completion of an IPO or the completion of an IPO at a targeted stock price generally would not be considered probable until the IPO is effective and the stock target price is reached. Further, it is typically not probable that a change of control or sale of all or substantially all of an entity’s assets will occur until the transaction has been consummated, because such transactions require the agreement of a third party that is willing to acquire the entity or all or substantially all of its assets, and there are typically substantive contingencies associated with the transactions before their closing, as discussed above.

If an entity does not remeasure an instrument presented in temporary equity because it is not probable that it will become redeemable, the entity should disclose “the reasons why it is not probable that the instrument will become redeemable” (see Section 9.8.2).
**Example 9-10**

Company A, an SEC registrant, owns and operates supermarkets in Alaska. On January 1, 20X4, A issues 100,000 shares of redeemable convertible preferred stock for $1,000 per share, with the following terms:

- **Written put option** — The preferred shares are redeemable by the holder any time after five years from issuance (i.e., on or after January 1, 20X9) for $1,100 per share if A has not opened 10 new supermarkets by January 1, 20X9.

- **Conversion option** — The preferred shares are convertible by the holder, any time after issuance, into common shares of A at a conversion rate of 1:1.

Company A should assess whether it is probable that the preferred shares will become redeemable by considering whether it is probable that it will not open 10 new supermarkets by January 1, 20X9. (In its probability assessment, A would not take into account the fact that the holders of the preferred stock can exercise their option to convert the preferred shares into common shares at any time after issuance of the preferred shares.)

Company A might conclude that, at inception of the preferred stock, it is reasonably possible (but not probable) that it will not open 10 new supermarkets before January 1, 20X9, and that therefore it is not probable that the preferred shares will become redeemable. On the basis of that conclusion, A would initially record the preferred stock at fair value (i.e., $1,000) and would not need to adjust that amount subsequently until it determines that it is probable that 10 new supermarkets will not be opened by January 1, 20X9. Company A should disclose the reasons why it believes that it is not probable that the preferred stock will become redeemable.

If at some point A concludes that it is probable that it will not open 10 new supermarkets by January 1, 20X9, and thus that it is probable that the shares will become redeemable, A should either (1) use the interest method discussed in ASC 835-30 to accrete the carrying amount of the preferred stock to its redemption value over the remaining period (from the date on which A determines that it is probable that the shares will become redeemable to January 1, 20X9) or (2) immediately adjust the carrying amount of the preferred stock to its redemption value (i.e., $1,100). Company A should elect either method as its accounting policy and apply it consistently.

9.5.4.2 **Mutually Exclusive Holder Options**

If an instrument contains multiple mutually exclusive options (e.g., both conversion and redemption features) controlled by the holder, the probability assessment under ASC 480-10-599-3A does not reflect the likelihood that the holder may exercise an option other than the redemption feature (e.g., a conversion option) before the redemption feature becomes exercisable. Thus, the probability that the holder will exercise a conversion feature before the instrument becomes redeemable is not relevant to the assessment of whether it is probable that the instrument will become redeemable.

In prepared remarks at the 2005 AICPA Conference on Current SEC and PCAOB Developments, then SEC Professional Accounting Fellow Mark Northan stated the following:

The staff has become aware of questions in practice regarding the application of ASR 268 [footnote omitted] to equity securities with redemption features and other options. The question that I will address today concerns preferred securities that include multiple mutually exclusive options that are exercisable by the holder. In one example, the first option is a conversion option that is currently exercisable. This option gives the holder the right to convert the security into a fixed number of common shares. The second option, which is not currently exercisable, is a redemption option that gives the holder the right to redeem the shares for cash. The second option would become exercisable following the passage of a specified period of time.

Under the staff guidance in [ASC 480-10-599-3A], these instruments are required to be classified outside of permanent equity because of the existence of a redemption feature.

The inquiries received by the staff concern the subsequent measurement of these securities following initial measurement at fair value. (ASC 480-10-599-3A) has differing guidance on subsequent measurement for redeemable securities that depends upon whether the securities are currently redeemable, or whether it is probable or not that the security will become currently redeemable in the future.
When applying this guidance to a security with both a conversion option and a redemption option like the one described earlier, some have argued that it is not probable that the security will become currently redeemable because of the likelihood that the holder will exercise the conversion option first. We have objected to this view because the exercise of the conversion option was controlled entirely by the holder. Absent that action by the holder, the security will become redeemable following only the passage of time. The probability assessment that is required by [ASC 480-10-S99-3A] would not factor in the likelihood that other options held by the holder may or may not be exercised first. Thus, the instrument that I have described would be considered to be probable of becoming currently redeemable regardless of the likelihood of earlier conversion. As a result, the changes in the redemption values for this instrument would be recognized over the period from the date of issuance to the earliest possible redemption date using either of the two methods specified in [ASC 480-10-S99-3A].

9.5.4.3 Holder Option in Instrument With Mandatory Conversion Feature

Although the assessment of whether it is probable that an instrument will become redeemable does not take into account any holder option to convert an instrument before redemption (see Section 9.5.4.2), an entity would consider any feature that does not depend on the holder and could trigger conversion before the earliest redemption opportunity. It therefore would not necessarily be probable that an instrument that contains an option that permits the holder to redeem the instrument on a specified date (or dates) would become redeemable if it contains a mandatory conversion feature that requires the instrument to be converted into shares of common stock upon the occurrence of a specified event that is outside the holder’s control (such as a qualified IPO). In these circumstances, it would not be probable that the holder redemption option would become exercisable if it is more than remote that the specified event (such as the qualified IPO) will occur before the earliest redemption date. Accordingly, such an instrument would probably not become redeemable (and it would not be required to be remeasured under the temporary-equity guidance) provided that the issuer controls the ability to share settle upon conversion (see Section 9.4.6).

In performing this assessment, the entity must consider the likelihood that the specified event (such as a qualified IPO as defined in the relevant agreements) would occur before the earliest redemption date as well as evaluate whether the entity controls the ability to share settle the conversion on the basis of ASC 815-40. The likelihood of the specified event and the entity’s ability to share settle the conversion feature should be reassessed as of each reporting date on the basis of the facts and circumstances as of that date (see Section 9.7.4). If an instrument becomes mandatorily convertible upon a qualified IPO as defined by reference to a specified monetary amount, it may be appropriate to involve valuation specialists in the evaluation of whether it is more than remote that such an IPO will occur. For a company that is just starting up, the likelihood that a qualified IPO will occur would not be expected to be more than remote.

A redeemable equity instrument with a mandatory conversion feature will probably become redeemable if:

- It is remote that the specified event (such as the qualified IPO) that would result in mandatory conversion into shares of common stock would occur before the earliest redemption date.
- The issuer does not control the ability to share settle the mandatory conversion feature upon the specified event (so that the conversion feature would be analyzed for accounting purposes as a cash-settled redemption feature).
- The holder has the ability to prevent the specified event triggering a mandatory conversion from occurring. (For instance, if mandatory conversion is required upon a qualified IPO and the holders control the entity, the holders can prevent the entity from undertaking a qualified IPO that would result in a mandatory conversion of the instrument.)
- The holder has the choice to redeem the instrument or convert the instrument into shares of common stock upon the occurrence of the specified event.
In recent discussions with staff in the SEC's Division of Corporation Finance, we have been made aware that the staff believes that the assessment of whether the occurrence of a qualified IPO is more than remote must be supported by an appropriate evaluation of all the relevant facts and circumstances on which the assessment is based. That is, the entity must have sufficiently persuasive information to support its conclusion that the occurrence of a qualified IPO is more than remote before an instrument otherwise becomes redeemable. In evaluating such likelihood, an entity must consider the manner in which "qualified IPO" is defined in the relevant agreements for the redeemable equity securities. If a qualified IPO is defined by reference to a minimum amount of securities sold in a public offering or a minimum price per security sold, the entity must consider that definition in its analysis. Further, if the entity has preliminary indications of the total offering or offering price, for example, on the basis of discussions with investment bankers, those preliminary indications must also be included in its analysis. In many situations, the entity will need to consult with its advisers for assistance in making these determinations.

In addition, the SEC staff has expressed the view that the assessment of such likelihood must be performed as of each reporting date on the basis of the facts and circumstances existing as of that date. The incorporation of subsequent information that was not known or knowable as of the reporting date is inappropriate. For example, if an entity has issued financial statements that are included in a registration statement filed with the SEC for an IPO of common stock, the filing of the IPO is a factor supporting a conclusion that it is more than remote that a qualified IPO will occur before a redemption feature becomes exercisable. However, the SEC staff would not accept an evaluation as of the most recent balance sheet date in support of the entity's assessment for prior balance sheet dates. Rather, the entity would need to perform an evaluation as of the prior balance sheet dates solely on the basis of the information that was known or knowable on those dates (i.e., the entity could not use the subsequent filing of a registration statement as support for its assessments as of prior balance sheet dates).

Since an entity evaluates, as of each financial reporting period, whether it is more than remote that a qualified IPO will occur before an instrument otherwise becomes redeemable, it is possible that the entity would be required to remeasure a redeemable equity security during some financial reporting periods and not be required to remeasure the security during other financial reporting periods. If an entity has previously remeasured a redeemable equity security and no longer is required to remeasure such a security, the entity should not reverse the prior measurement adjustments.

In the determination of whether the holders of redeemable equity securities control the ability to prevent an entity from consummating a qualified IPO, the relevant governance structure of the entity and the terms of the instrument must be considered. A conclusion that the holders do not control the entity's board of directors or the voting of shareholders may not be sufficient. For example, if the holders have to consent to an IPO, they control the ability to prevent the entity from consummating a qualified IPO and therefore remeasurement of the redemption amount under ASC 480-10-S99-3A would be required. If the holders have provided any required consents, remeasurement would still be required if the holders are able to revoke such consents.

9.5.4.4 **Issuer's Redemption Option**

Unless the holder has the power to control the issuer's decision to exercise an option (see Section 9.4.4), the existence of an issuer option to redeem the instrument does not affect the assessment of whether it is probable that an instrument will become redeemable or the determination of the earliest redemption date in accordance with the temporary equity guidance. Thus, SAB Topic 3.C states that the accounting for redeemable preferred stock “would apply irrespective of whether the redeemable preferred stock may be voluntarily redeemed by the issuer prior to the mandatory redemption date."
9.5.4.5  **Deemed Liquidation Features**

The consummation of a change of control, merger, consolidation, sale of substantially all assets, or other similar deemed liquidation event typically is not probable. Because an issuer is not required to remeasure instruments when they are not currently redeemable or when it is not probable that they will become redeemable, the issuer is generally not required to remeasure an instrument that is redeemable only upon the consummation of a deemed liquidation event that requires the involvement or action of a third party. This conclusion is acceptable even if the holders of the instrument have control over the entity. Even with such control, the redemption event may be viewed as contingent since redemption would require the agreement of a third party that is willing to acquire the entity or all or substantially all of its assets. It is typically not probable that a change of control or sale of all or substantially all of an entity’s assets will occur until the consummation of such transaction. Alternatively, it would be acceptable for a reporting entity to choose, as an accounting policy, to remeasure redeemable convertible preferred stock to its redemption amount when the redemption will occur only upon the consummation of a deemed liquidation and the holders of the redeemable convertible preferred stock have control over the entity (see Section 9.5.3).

9.5.5  **Recognition of Measurement Changes and Dividends**

<table>
<thead>
<tr>
<th>ASC 480-10 — SEC Materials — SEC Staff Guidance</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>SEC Staff Announcement: Classification and Measurement of Redeemable Securities</strong></td>
</tr>
<tr>
<td><strong>S99-3A(20)</strong>  Preferred stock instruments issued by a parent (or single reporting entity). Regardless of the accounting method selected in paragraph 15 and the redemption terms (that is, fixed price or fair value), the resulting increases or decreases in the carrying amount of a redeemable instrument other than common stock should be treated in the same manner as dividends on nonredeemable stock and should be effected by charges against retained earnings or, in the absence of retained earnings, by charges against paid-in capital. . . .</td>
</tr>
<tr>
<td><strong>S99-3A(21)</strong>  Common stock instruments issued by a parent (or single reporting entity). Regardless of the accounting method selected in paragraph 15, the resulting increases or decreases in the carrying amount of redeemable common stock should be treated in the same manner as dividends on nonredeemable stock and should be effected by charges against retained earnings or, in the absence of retained earnings, by charges against paid-in capital. . . .</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>SEC Staff Accounting Bulletins</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>SAB Topic 3.C, Redeemable Preferred Stock [Reproduced in ASC 480-10-S99-2]</strong></td>
</tr>
<tr>
<td><strong>Facts:</strong> Rule 5-02.27 of Regulation S-X states that redeemable preferred stocks are not to be included in amounts reported as stockholders’ equity, and that their redemption amounts are to be shown on the face of the balance sheet. However, the Commission’s rules and regulations do not address the carrying amount at which redeemable preferred stock should be reported, or how changes in its carrying amount should be treated in calculations of earnings per share and the ratio of earnings to combined fixed charges and preferred stock dividends. . . .</td>
</tr>
<tr>
<td><strong>Question 2:</strong> How should periodic increases in the carrying amount of redeemable preferred stock be treated in calculations of earnings per share and ratios of earnings to combined fixed charges and preferred stock dividends?</td>
</tr>
<tr>
<td><strong>Interpretive Response:</strong> Each type of increase in carrying amount described in the Interpretive Response to Question 1 should be treated in the same manner as dividends on nonredeemable preferred stock.</td>
</tr>
</tbody>
</table>
Because temporary equity represents equity, an issuer recognizes dividends, and changes in the carrying amount of a redeemable instrument classified as temporary equity, as equity transactions in a manner similar to the way it recognizes a dividend to the holder of a nonredeemable instrument; that is, it does not report them in net income or comprehensive income in its financial statements (see Section 9.6 for a discussion of how such changes affect the calculation of earnings per share).

**Connecting the Dots**

The redemption amount of redeemable stock may vary (e.g., it may be the fair value of the stock or it may be based on an index). In these situations, ASC 480-10-S99-3A allows an entity to reverse prior increases in the carrying amount of the stock that resulted from the application of the subsequent-measurement guidance in ASC 480-10-S99-3A (see Section 9.5.2.1). These increases would reverse the “deemed dividends” recorded in prior periods and would be treated as a “deemed contribution” by the stockholder. However, on a cumulative basis, adjustments to remeasure redeemable preferred stock to its redemption amount may not be negative. That is, decreases to the carrying amount that result from the application of ASC 480-10-S99-3A may only be recognized to the extent that such decreases reflect recoveries of previously recognized increases to the carrying amount as a result of the application of ASC 480-10-S99-3A (see Section 9.5.2.5).

To the extent that there are retained earnings, an entity recognizes against retained earnings dividends and changes in the carrying amount of an instrument classified as temporary equity. Thus, if the carrying amount increases, the entity would record the following entry:

```
Equity — retained earnings
Temporary equity
```

If there are no retained earnings, an entity recognizes against APIC the dividends and changes in the carrying amount. Thus, the following entry might be appropriate upon an increase in the carrying amount:

```
Equity — APIC
Temporary equity
```

If APIC is reduced to zero, an entity recognizes as an increase to the accumulated deficit the dividends and changes in the carrying amount. It would not be appropriate to measure APIC at a negative amount. Accordingly, the following entry might be appropriate upon an increase in the carrying amount when the issuer has a deficit:

```
Accumulated deficit
Temporary equity
```

In determining the appropriate recognition of dividends within equity, an entity should consider the state law of the jurisdiction in which it is incorporated. State law may specifically address the equity account from which distributions to stockholders can be made (e.g., surplus, net profits for the fiscal year in which the dividend is paid or the preceding fiscal year, or capital surplus). The entity should also consider the terms of its bylaws, charter, or articles of incorporation for any potentially applicable requirements.
Example 9-11

Entity E has redeemable common stock outstanding with a carrying amount of $100 million, a retained earnings balance of $100 million, and an APIC balance of $50 million. The stock is redeemable at its fair value.

Assume that on 12/31/X1, E is required to record a redemption amount adjustment of $200 million for its redeemable common stock (which increases its carrying amount to $300 million). As a result, E would first record a charge against retained earnings of $100 million to reduce retained earnings to zero and then would record a charge of $50 million to reduce APIC to zero. Given that both retained earnings and APIC have been reduced to zero, E would finally record a $50 million charge to create an accumulated deficit of $50 million.

Assume that in the period ended 12/31/X2, the redemption value of the common stock increased to $400 million and that during such period, E incurred a net loss of $75 million and there was no other activity that affected its equity accounts. The additional $100 million adjustment for the redemption amount of the common stock would increase the accumulated deficit to $225 million.

9.5.5.1 Paid-in-Kind Dividends

The terms of some redeemable equity instruments include a mandatory paid-in-kind (PIK) dividend feature that requires or permits the issuer to satisfy any required dividend payments by issuing additional shares of the same redeemable equity instrument. The following are two types of such PIK dividend features:

- On each dividend payment date, the issuer satisfies the dividend payment obligation by issuing additional redeemable equity securities to the holder(s). That is, additional fungible securities are issued.
- On each dividend payment date, the issuer increases the liquidation preference of the original equity instrument to reflect the dividend accrued to the benefit of the holder. Economically, other than with respect to potential differences due to the compounding terms of the instrument, the PIK feature has the same effect as delivering additional instruments.

ASC 470-20 contains specific requirements for the issuer’s identification of the commitment date for a convertible instrument issued as a payment of dividends or interest under a PIK feature (see Section 7.3.3 of Deloitte’s A Roadmap to the Issuer’s Accounting for Convertible Debt). We believe that this guidance can also be applied by analogy to nonconvertible instruments. The guidance distinguishes between discretionary and nondiscretionary PIK features as follows:

<table>
<thead>
<tr>
<th>PIK Feature</th>
<th>Description</th>
<th>Commitment Date for PIK Dividends</th>
</tr>
</thead>
</table>
| Discretionary | A PIK feature is discretionary if either of the following conditions exist:  
- The issuer or the holder can elect a form of payment other than paid in kind (e.g., the issuer has the option to settle dividend payment obligations by either delivering cash or making a payment in kind).  
- In cases in which the convertible instrument or a portion thereof is converted before dividends are accrued, the holder will not always receive the number of equity shares upon conversion as if all dividends have been paid in kind. | The date that the dividends are accrued |
As described above and in ASC 470-20-30-17(b), the following is one of the conditions that must be satisfied for PIK dividend payments to be considered nondiscretionary: “[i]f the original instrument or a portion thereof is converted before accumulated dividends or interest are declared or accrued, the holder will always receive the number of shares upon conversion as if all accumulated dividends or interest have been paid in kind.” Given the ambiguity of this wording (see Section 7.3.3 of Deloitte’s A Roadmap to the Issuer’s Accounting for Convertible Debt), we believe that there are two acceptable interpretations of this condition and that entities should select one and apply it consistently as an accounting policy election:

- **View A** — Regardless of when during the security’s term the holder converts the instrument into equity shares, the holder must always receive upon conversion all of the dividends that would have accrued during the entire life of the security (i.e., to the contractual maturity date).

Under this view, the issuer must know at the inception of the original convertible instrument, regardless of the ultimate conversion date, the exact number of equity shares that will be issued to the holder upon full conversion (i.e., conversion of the original instrument adjusted for PIK dividends or, if PIK dividends are paid through the issuance of additional convertible instruments, conversion of both the original convertible instrument and any additional convertible instruments. Potential contingent adjustments to the conversion rate for other reasons do not necessarily need to be considered). If the issuer cannot determine the number of equity shares that will be issued or if the number of equity shares will differ depending on when the instrument is converted, the PIK feature is discretionary under this view. In most cases, PIK dividend payments would be discretionary under View A since entities typically do not issue convertible instruments that allow the holder to effectively earn future dividends that would not have accrued on an early conversion.

- **View B** — Regardless of when during the security’s term the holder converts the instrument into equity shares, the holder must always receive upon conversion all of the dividends that would have accrued during the entire period in which the security has been outstanding (i.e., to the conversion date).

Under this view, the holder always receives upon conversion the number of equity shares as if all dividends that have accrued (i.e., been earned to date) are paid in equity shares even if such dividends have not yet been contractually paid (i.e., if conversion occurs between contractual dividend payment dates). Thus, the frequency of contractual dividend payment dates has no impact on the number of equity shares that the holder will receive upon conversion because a holder that elects to convert the security in between contractual dividend payment dates will receive additional equity shares for the dividend that has accrued from the last contractual date.

We believe that in applying the above alternatives to a nonconvertible instrument, an entity should substitute the “redemption date” for the “conversion date.”
The view selected will not affect the conclusion that PIK dividends are discretionary in cases in which a convertible (or nonconvertible) equity instrument allows either the holder or issuer to choose to pay dividends in cash or in kind. In these circumstances, the PIK dividends would be considered discretionary regardless of whether the entity adopted View A or View B above.

ASC 470-20 does not specifically address how to determine the initial amount to recognize for PIK dividends. In Discussion Document 3 (March 8, 2001), the EITF Issue 00-27 Working Group stated, in part:

The FASB staff recommends that for purposes of recognizing a paid-in-kind dividend, the fair value of the paid-in-kind instrument should be determined on the commitment date . . . . As a result, the fair value (and deemed proceeds) from the issuance of the paid-in-kind instrument always will be determined on the same date as the fair value of the stock underlying the conversion option in the paid-in-kind instrument. If the issuer is committed to paying dividends in the form of paid-in-kind instruments, the commitment date will be the commitment date for the original instrument. The fair value of paid-in-kind instruments issued as dividends will equal the fair value of the original instruments evidenced in the transaction. If the issuer has discretion to pay the dividends in another form such as cash, the fair value of the paid-in-kind instrument issued as a dividend will be determined on the date the issuer commits to its issuance.

Although the approach recommended by the EITF Issue 00-27 Working Group was not codified, we believe that it is generally appropriate for the initial recognition of PIK dividend payments. That is, if the PIK feature is nondiscretionary, an entity initially measures the instrument issued as PIK dividends on the basis of the **fair value of the original instrument on its commitment date**. However, if the PIK feature is discretionary, an entity initially measures the instrument issued as PIK dividends on the basis of the **fair value of the PIK instrument on its commitment date**, which is generally the dividend payment date.

**Connecting the Dots**
For additional discussion related to the recognition and measurement of BCFs in PIK convertible instruments, see Section 7.3.3 of Deloitte’s *A Roadmap to the Issuer’s Accounting for Convertible Debt*.

### 9.5.6 Bifurcated Embedded Derivatives

<table>
<thead>
<tr>
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</tr>
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<td><strong>S99-3A(12) Initial measurement.</strong> The SEC staff believes the initial carrying amount of a redeemable equity instrument that is subject to ASR 268 should be its issuance date fair value, except as follows: . . .</td>
</tr>
<tr>
<td>e. For host equity contracts (see paragraph 3(b)), the initial amount presented in temporary equity should be the initial carrying amount of the host contract pursuant to Section 815-15-30. . . .</td>
</tr>
<tr>
<td><strong>S99-3A(16) Subsequent measurement.</strong> The following additional guidance is relevant to the application of the SEC staff’s views in paragraphs 14 and 15: . . .</td>
</tr>
<tr>
<td>e. For a redeemable equity instrument other than those discussed in (a), (b), and (d) of this paragraph, regardless of the accounting method applied in paragraphs 14 and 15, the amount presented in temporary equity should be no less than the initial amount reported in temporary equity for the instrument. That is, reductions in the carrying amount of a redeemable equity instrument from the application of paragraphs 14 and 16 are appropriate only to the extent that the registrant has previously recorded increases in the carrying amount of the redeemable equity instrument from the application of paragraphs 14 and 15.</td>
</tr>
</tbody>
</table>
Irrespective of whether an embedded feature is bifurcated as a derivative instrument under ASC 815-15 from an equity-classified host contract (e.g., preferred stock), the issuer should evaluate whether any of the temporary equity classification criteria are met for the hybrid contract in its entirety (inclusive of the embedded derivative). However, the initial amount presented in temporary equity is the amount attributable to the hybrid instrument that remains after separation of the embedded derivative in accordance with ASC 815-15-30-2.

Example 9-12

Issuer A issues preferred stock for net proceeds of $100. The stock is redeemable by the holder at any time for $98. Further, the stock contains a call option with an exercise price indexed to a foreign currency. Assume that A concludes that it should bifurcate the embedded call option. If the initial amount allocated to the embedded derivative is $5 (an asset), the initial carrying amount of the host contract after separation of the embedded derivative is $105. Therefore, the initial carrying amount presented in temporary equity is $105. Even though the redemption value is $98, A cannot reduce the amount of temporary equity to this amount because the SEC precludes reductions in the amount of temporary equity recorded for a redeemable equity instrument below the initial carrying amount unless an exception applies (see Section 9.5.2.5).

Example 9-13

Issuer B has issued preferred stock with the following terms and features:

- It is redeemable at the holder’s option or upon the occurrence of an event that is not solely within B’s control. Upon redemption, B would be obligated to pay the liquidation preference amount in cash.
- It is convertible into B’s common stock. Upon the stock’s conversion, the parties determine the number of common shares B is required to issue by dividing the liquidation preference amount of the preferred stock by a fixed price.
- It accrues dividends on the liquidation preference amount at a fixed dividend rate (8 percent quarterly).
- On each dividend payment date, B has a choice of either paying accrued dividends in cash or delivering additional preferred stock instruments (i.e., PIK dividends).

Issuer B classifies the preferred stock in temporary equity because of the redemption option. Assume that B concludes that the conversion option embedded in the preferred stock should be separately accounted for as an embedded derivative liability at fair value, with changes in fair value recognized in earnings.

If B elects to pay the dividend by issuing additional preferred stock instruments, it recognizes the PIK dividend in accordance with ASC 505-20-30-3 as a reduction (debit) to retained earnings in an amount equal to the fair value of the additional preferred stock issued. The embedded conversion option in the additional preferred stock issued is recognized as a liability at its fair value. Further, in accordance with ASC 815-15-30-2 and ASC 480-10-S99-3A(12)(e), temporary equity is increased in an amount equal to the fair value of the additional preferred stock issued less the initial fair value of the conversion option. If, however, B elects to pay the dividends in cash, the amount recognized as a reduction in retained earnings should be based on the amount of the cash payment.

ASC 480-10-S99-3A does not specifically address the subsequent measurement of a temporary-equity classified host contract that remains after separation of an embedded derivative.
Example 9-14

A convertible preferred stock instrument is redeemable in cash at the greater of (1) the conversion value and (2) the original issue price plus accrued cumulative unpaid dividends. The issuer has concluded that the conversion option must be bifurcated as a derivative under ASC 815-15 (including a portion of the cash-settled redemption feature equal to the difference between the conversion value and the original issue price plus accrued and cumulative unpaid dividends). Assume that (1) the instrument (a) is not currently redeemable and (b) will probably become redeemable and (2) the issuer has elected to measure the instrument at its accreted redemption value. In these circumstances, we believe that it is acceptable to accrete only the host contract to its redemption amount (i.e., original issue price plus accrued cumulative unpaid dividends). Under this approach, the remeasurement of the host contract does not reflect the possibility of a redemption that is based on the conversion value since the conversion spread is recognized separately as a derivative liability.

9.5.7 Convertible Debt With a Separated Equity Component

ASC 480-10 — SEC Materials — SEC Staff Guidance

SEC Staff Announcement: Classification and Measurement of Redeemable Securities

S99-3A(12) Initial measurement. The SEC staff believes the initial carrying amount of a redeemable equity instrument that is subject to ASR 268 should be its issuance date fair value, except as follows: . . .

d. For convertible debt instruments that contain a separately classified equity component, an amount should initially be presented in temporary equity only if the instrument is currently redeemable or convertible at the issuance date for cash or other assets (see paragraph 3(e)). The portion of the equity-classified component that is presented in temporary equity (if any) is measured as the excess of (1) the amount of cash or other assets that would be required to be paid to the holder upon a redemption or conversion at the issuance date over (2) the carrying amount of the liability-classified component of the convertible debt instrument at the issuance date. . . .

S99-3A(16) (Subsequent measurement.) The following additional guidance is relevant to the application of the SEC staff's views in paragraphs 14 and 15: . . .

d. For convertible debt instruments that contain a separately classified equity component, an amount should be presented in temporary equity only if the instrument is currently redeemable or convertible at the balance sheet date for cash or other assets (see paragraph 3(e)). The portion of the equity-classified component that is presented in temporary equity (if any) is measured as the excess of (1) the amount of cash or other assets that would be required to be paid to the holder upon a redemption or conversion at the balance sheet date over (2) the carrying amount of the liability-classified component of the convertible debt instrument at the balance sheet date. FN15 . . .

FN15 ASR 268 does not impact the application of other applicable GAAP to the accounting for the liability component or the accounting upon derecognition of the liability and/or equity component.

The equity-classified component of convertible instruments separated into liability and equity components, such as certain convertible instruments that contain beneficial conversion or CCFs (see Section 9.3.5), should be evaluated under the temporary-equity guidance only if the instrument is currently redeemable or convertible as of the balance sheet date (see Sections 9.4.8 and 9.5.3). However, the issuer would not necessarily present the entire amount of the equity component as temporary equity. The amount of temporary equity is limited to the excess (if any) of “(1) the amount of cash or other assets that would be required to be paid to the holder upon a redemption or conversion . . . over (2) the carrying amount of the liability-classified component of the convertible debt instrument” as of both initial measurement and the subsequent balance sheet dates. (We believe that in measuring the liability-classified component, the issuer may appropriately include any bifurcated embedded derivative.)
Example 9-15

A convertible debt instrument that is subject to the cash conversion guidance in ASC 470-20 was issued for net proceeds equal to its principal amount of $100. The instrument includes a cash-settled put option that permits the investor to put the instrument back to the issuer at any time for $98. In addition, the instrument is not currently convertible, and the issuer has concluded that the put option is (1) not required to be bifurcated and accounted for as a derivative under ASC 815-15 and (2) considered nonsubstantive under ASC 470-20 (and therefore does not affect the amortization period for any recognized debt discount). In accordance with the cash conversion guidance in ASC 470-20, the issuer determines that the carrying amount of the liability component is $90 and the carrying amount of the equity component is $10. In these circumstances, a portion of the equity component is currently redeemable since the holder currently can put the convertible debt instrument to the issuer for $98, and the carrying amount of the liability component is only $90. The amount reported in temporary equity is the excess of the current redemption amount ($98) over the current carrying amount of the liability component ($90) of the convertible debt; that is, $8. If, in this example, the put option instead was exercisable only on a future date or contingent on an event, and the contingency is not met as of the reporting date, the instrument would be outside the scope of the temporary-equity guidance (irrespective of whether it is probable that the contingency will be met in the future). ASC 480-10-S99-3A only applies to convertible instruments with a separately classified equity component if the instrument is currently redeemable or convertible at the reporting date.

The SEC provides an exception to ASC 480-10-S99-3A(16)(e) (see Section 9.5.2.5) under which an entity is not precluded from reducing the amount of temporary equity below the initial amount reported for the equity component of a convertible debt instrument that is separated into liability and equity components. If the separation of an equity component results in the recognition of a debt discount that is amortized over the life of the debt instrument, for example, the periodic increase in the net carrying amount of the liability component would cause a corresponding reduction in the amount presented in temporary equity for an instrument for which the current redemption amount remains constant (e.g., a convertible debt instrument with a separated BCF that is puttable at par anytime).

Depending on the applicable taxation requirements, the separation of an equity component often causes the carrying amount of the liability component under GAAP (the book basis) to be different from the tax basis of the debt that is determined in accordance with ASC 740-10. In practice, such basis differences will usually result in the recognition of a deferred tax liability under ASC 740-10 provided that the tax basis exceeds the book basis after the separation of an equity component. Because the separation of the equity component from the debt creates the basis difference in the debt, the establishment of a deferred tax liability for the basis difference results in a charge to the related component of equity (see ASC 740-20-45-11(c) and ASC 470-20-25-27). We therefore believe that the temporary-equity guidance should be applied to the amount of the equity-classified component before any adjustment for the related tax effects, because the issuer's deferred tax liability does not affect the amount payable by the issuer to the investor upon any redemption.

Example 9-16

A convertible debt instrument within the scope of the cash conversion guidance in ASC 470-20 was issued for proceeds of $100. The tax basis in the debt under the applicable taxation requirements is the original issue price adjusted for any original issue discount or premium before separation of any equity component for accounting purposes (i.e., the tax basis is $100). Because of the application of the cash conversion guidance in ASC 470-20, however, the book basis in the debt (i.e., the carrying amount of the liability component) is $90 after separation of an equity component. If the issuer's tax rate is 35 percent, the issuer will recognize a deferred tax liability of $3.50 (= [$100 – $90] × 35%) with an offsetting adjustment to equity (APIC). Accordingly, the net amount credited to equity is $6.50. We believe that if the instrument is currently redeemable for $98, the amount of temporary equity is $8 rather than $6.50 because the temporary equity guidance is applied to the carrying amount of the equity-classified component before any adjustment for the related tax effects.
Sometimes the amount of cash or other assets that the issuer would be required to pay to the holder upon a redemption or conversion on the balance sheet date exceeds the carrying amount of the liability component by an amount greater than the carrying amount of the equity component determined in accordance with GAAP (e.g., the carrying amount of the BCF or the equity component of a cash convertible determined in accordance with ASC 470-20). This scenario could occur, for example, if the fair value of any bifurcated derivative instrument that is attributed to the liability component declines or the initial amount of proceeds allocated to the convertible instrument as a whole is less than its principal amount (where the principal amount equals the redemption amount). ASC 480-10-S99-3A does not explicitly address whether “the portion of the equity-classified component that is presented in temporary equity” can exceed the amount allocated to the equity-classified component under GAAP. We believe that either of the following two approaches is acceptable provided that it is applied consistently:

- Limit the amount of temporary equity to the amount allocated to the equity-classified component in accordance with GAAP (e.g., ASC 470-20).
- Reclassify an amount from permanent equity (APIC) to temporary equity so that the total of the carrying amounts of the liability and equity components equals the amount of cash or other assets that the issuer would be required to pay to the holder upon a redemption or conversion on the balance sheet date.

In either case, an entity is well advised to provide transparent disclosure.

### 9.5.8 Convertible Preferred Stock With a Separated Equity Component

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<td><strong>S99-3A(12) Initial measurement.</strong> The SEC staff believes the initial carrying amount of a redeemable equity instrument that is subject to ASR 268 should be its issuance date fair value, except as follows: . . .</td>
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<td>e. . . . Similarly, the initial amount presented in temporary equity for a preferred stock instrument that contains a beneficial conversion feature . . . should be the amount allocated to the instrument in its entirety pursuant to Subtopic 470-20 less any beneficial conversion feature recorded at the issuance date.</td>
</tr>
<tr>
<td><strong>S99-3A(16) Subsequent measurement.</strong> The following additional guidance is relevant to the application of the SEC staff’s views in paragraphs 14 and 15: . . .</td>
</tr>
<tr>
<td>e. For a redeemable equity instrument other than those discussed in (a), (b), and (d) of this paragraph, regardless of the accounting method applied in paragraphs 14 and 15, the amount presented in temporary equity should be no less than the initial amount reported in temporary equity for the instrument. That is, reductions in the carrying amount of a redeemable equity instrument from the application of paragraphs 14 and 16 are appropriate only to the extent that the registrant has previously recorded increases in the carrying amount of the redeemable equity instrument from the application of paragraphs 14 and 15.</td>
</tr>
</tbody>
</table>
While ASC 480-10-S99-3A includes specific classification, measurement, and EPS guidance for convertible debt with a separated equity component (see Sections 9.4.8 and 9.5.7), that guidance does not directly apply to equity-classified convertible stock with a separated equity component (e.g., a BCF or an equity component that resulted from a modification or exchange that affected the conversion option or a reclassification of the embedded conversion option from a liability to equity). As discussed in more detail in Section 3.2.5.2.4 of Deloitte’s A Roadmap to the Presentation and Disclosure of Earnings per Share, an entity can elect one of two views as an accounting policy related to classifying a separately recognized equity component associated with such an equity instrument:

- **View A** — Classify the equity component in permanent equity.
- **View B** — Classify the equity component in temporary equity.

The classification view applied will affect the measurement and EPS accounting as follows when a convertible preferred stock instrument must be remeasured to its redemption amount under ASC 480-10-S99-3A:

- **View A** — An entity should remeasure the carrying amount of the convertible preferred stock to its current redemption amount (or in accordance with its policy elected under ASC 480-10-S99-3A(15) if the convertible preferred stock is not currently redeemable but it is probable that it will become redeemable) without regard to the amount recognized in permanent equity for the equity component.

- **View B** — An entity considers the aggregate of the carrying amounts of the convertible preferred stock and separately recognized equity component in determining the amount of any measurement adjustment required under ASC 480-10-S99-3A. While the amount reported in temporary equity for the separately recognized equity component is not subsequently adjusted, that amount will indirectly affect the amount of the ASC 480-10-S99-3A measurement adjustment that needs to be made to the carrying amount of the convertible preferred stock reported in temporary equity.

Under both views, an entity must consider ASC 470-20-35-7, which states, in part:

> All discounts retain their character such that a discount resulting from the accounting for a beneficial conversion option is amortized from the date of issuance to the earliest conversion date. For SEC registrants, other discounts on perpetual preferred stock that has no stated redemption date but that is required to be redeemed if a future event that is outside the control of the issuer occurs (such as a change in control) shall be accounted for in accordance with Section 480-10-S99.

Unless an exception applies (see Section 9.5.2), an issuer is not permitted to reduce the amount of temporary equity below the initially recorded amount even if that amount exceeds the redemption value.

If convertible stock with a CCF or BCF is classified as a liability under ASC 480-10 (see Chapters 4 and 6 and Section 9.3.5), the issuer should apply the measurement guidance for convertible debt with separated liability and equity components (see Section 9.5.7) instead of this guidance.
9.5.9 Redeemable Equity Instruments Issued With Other Instruments

**ASC 480-10 — SEC Materials — SEC Staff Guidance**

SEC Staff Announcement: Classification and Measurement of Redeemable Securities

*S99-3A(12) Initial measurement.* The SEC staff believes the initial carrying amount of a redeemable equity instrument that is subject to ASR 268 should be its issuance date fair value, except as follows: . . .

e. . . . Similarly, the initial amount presented in temporary equity for a preferred stock instrument that . . . is issued with other instruments should be the amount allocated to the instrument in its entirety pursuant to Subtopic 470-20 less any beneficial conversion feature recorded at the issuance date.

*S99-3A(16) (Subsequent measurement.*) The following additional guidance is relevant to the application of the SEC staff's views in paragraphs 14 and 15: . . .

e. For a redeemable equity instrument other than those discussed in (a), (b), and (d) of this paragraph, regardless of the accounting method applied in paragraphs 14 and 15, the amount presented in temporary equity should be no less than the initial amount reported in temporary equity for the instrument. That is, reductions in the carrying amount of a redeemable equity instrument from the application of paragraphs 14 and 16 are appropriate only to the extent that the registrant has previously recorded increases in the carrying amount of the redeemable equity instrument from the application of paragraphs 14 and 15.

When a redeemable equity instrument is issued with other freestanding financial instruments (e.g., a detachable warrant), the issuer allocates the proceeds received between the redeemable equity instrument and the other units of account before applying the temporary-equity guidance. In such circumstances, the initial measurement of the redeemable equity instrument is not its initial fair value but rather the amount allocated to the instrument less any BCF (see Section 9.5.7) or bifurcated derivative (see Section 9.5.6).

Depending on the characteristics of the other instruments and their subsequent measurement, different allocation methods apply. If one of the instruments will be subsequently measured at fair value and changes in fair value will be recognized in earnings (e.g., a freestanding derivative instrument within the scope of ASC 815), proceeds are typically allocated on the basis of the instrument's fair value, and the residual proceeds are allocated to the redeemable equity instrument and any other units of account that are not remeasured at fair value (see Section 3.3.4). If the other units of account are not subsequently measured at fair value, it may be appropriate to allocate proceeds on a relative-fair-value basis.

Unless an exception applies (see Section 9.5.2.5), an issuer is not permitted to reduce the amount of temporary equity below the initially recorded amount even if that amount exceeds the redemption value.

9.5.10 Noncontrolling Interests

**ASC 480-10 — SEC Materials — SEC Staff Guidance**

SEC Staff Announcement: Classification and Measurement of Redeemable Securities

*S99-3A(12) Initial measurement.* The SEC staff believes the initial carrying amount of a redeemable equity instrument that is subject to ASR 268 should be its issuance date fair value, except as follows: . . .

c. For noncontrolling interests, the initial amount presented in temporary equity should be the initial carrying amount of the noncontrolling interest pursuant to Section 805-20-30. . . .
The initial carrying amount that is recognized in temporary equity for noncontrolling interests is the initial carrying amount determined in accordance with the accounting requirements for noncontrolling interests (including those in ASC 805-10, ASC 805-20, and ASC 810-10).

After initial recognition, the issuer applies a two-step approach to measuring noncontrolling interests under the temporary-equity guidance on each balance sheet date. First, the entity applies the measurement guidance in ASC 810-10 by attributing a portion of the net income or loss of the subsidiary to the noncontrolling interest. Second, the entity applies the subsequent measurement guidance in ASC 480-10-S99-3A. The noncontrolling interest’s carrying amount is the higher of (1) the cumulative amount that would result from applying the measurement guidance in ASC 810-10 (i.e., the initial carrying amount, increased or decreased for the noncontrolling interest’s share of net income or loss — as well as its share of other comprehensive income or loss — and dividends) or (2) the redemption value.

Under ASC 480-10-S99-3A(16)(e), an issuer generally cannot reduce the amount of temporary equity reported for an instrument within the scope of the temporary-equity guidance below its initial carrying amount. However, this limitation does not apply to reductions in the carrying amount of a noncontrolling interest that result from the application of the noncontrolling interest guidance in ASC 810-10. It only applies to reductions in the carrying amount that result from the application of the temporary-equity guidance.

Because temporary equity represents equity, changes in the carrying amount of noncontrolling interests classified as temporary equity are accounted for as equity transactions and are not reported in net income or comprehensive income in the issuer’s financial statements (see Section 9.6.3 for a discussion of how such changes affect the calculation of earnings per share).
9.5.11 Equity Securities Held by Employee Stock Ownership Plans

ASC 480-10 — SEC Materials — SEC Staff Guidance

SEC Staff Announcement: Classification and Measurement of Redeemable Securities

S99-3A(12) initial measurement. The SEC staff believes the initial carrying amount of a redeemable equity instrument that is subject to ASR 268 should be its issuance date fair value, except as follows: . . .

b. For employee stock ownership plans where the cash redemption obligation relates only to a market value guarantee feature, the registrant may elect as an accounting policy to present in temporary equity either (i) the entire guaranteed market value amount of the equity securities or (ii) the maximum cash obligation based on the fair value of the underlying equity securities at the balance sheet date. . . .

S99-3A(16) [Subsequent measurement.] The following additional guidance is relevant to the application of the SEC staff's views in paragraphs 14 and 15: . . .

b. For employee stock ownership plans where the cash redemption obligation relates only to a market value guarantee feature, the registrant may elect as an accounting policy to present in temporary equity either (i) the entire guaranteed market value amount of the equity securities or (ii) the maximum cash obligation based on the fair value of the underlying equity securities at the balance sheet date.

SEC Observer Comment: Sponsor’s Balance Sheet Classification of Capital Stock With a Put Option Held by an Employee Stock Ownership Plan

S99-4 The following is the text of SEC Observer Comment: Sponsor’s Balance Sheet Classification of Capital Stock with a Put Option Held by an Employee Stock Ownership Plan.

ASR 268 (see also paragraph 480-10-S99-3A) requires that to the extent that there are conditions (regardless of their probability of occurrence) whereby holders of equity securities may demand cash in exchange for their securities, the sponsor must reflect the maximum possible cash obligation related to those securities outside of permanent equity. Thus, securities held by an ESOP (whether or not allocated) must be reported outside of permanent equity if by their terms they can be put to the sponsor for cash. With respect to ESOP securities where the cash obligation relates only to market value guarantee features, the SEC staff would not object to registrants only classifying outside of permanent equity an amount that represents the maximum cash obligation of the sponsor based on market prices of the underlying security as of the reporting date; accordingly, reclassifications of equity amounts would be required based on the market values of the underlying security. Alternatively, the SEC staff would not object to classifying the entire guaranteed value amount outside of permanent equity due to the uncertainty of the ultimate cash obligation because of a possible market value decline in the underlying security.

Provided that “the cash redemption obligation relates only to a market value guarantee feature,” the SEC permits an issuer to elect to measure redeemable equity instruments held by an ESOP at “either (i) the entire guaranteed market value amount of the equity securities or (ii) the maximum cash obligation [of the sponsor] based on the fair value of the underlying equity securities at the balance sheet date.”

This exception should not be applied by analogy. For example, it would not apply when an amount other than the market value guarantee may need to be redeemed by the sponsor for cash or other assets and such redemption could occur upon any event outside the sponsor’s control. If the exception does not apply, the entire carrying amount of the ESOP’s outstanding redeemable shares of stock must be classified in temporary equity.
9.5.12 Share-Based Payment Arrangements

**ASC 480-10 — SEC Materials — SEC Staff Guidance**

**SEC Staff Announcement: Classification and Measurement of Redeemable Securities**

**S99-3A(12) Initial measurement.** The SEC staff believes the initial carrying amount of a redeemable equity instrument that is subject to ASR 268 should be its issuance date fair value, except as follows: . . .

a. For share-based payment arrangements with employees, the initial amount presented in temporary equity should be based on the redemption provisions of the instrument and the proportion of consideration received in the form of employee services at initial recognition. For example, upon issuance of a fully vested option that allows the holder to put the option back to the issuer at its intrinsic value upon a change in control, an amount representing the intrinsic value of the option at the date of issuance should be presented in temporary equity.

**S99-3A(16) [Subsequent measurement.]** The following additional guidance is relevant to the application of the SEC staff's views in paragraphs 14 and 15:

a. For share-based payment arrangements with employees, the amount presented in temporary equity at each balance sheet date should be based on the redemption provisions of the instrument and should take into account the proportion of consideration received in the form of employee services (that is, the pattern of recognition of compensation cost pursuant to Topic 718). FN14 . . .

FN14 See also the Interpretative Response to Question 2 in Section E of Section 718-10-S99.

**SEC Staff Accounting Bulletins**


**Facts:** Under a share-based payment arrangement, Company F grants to an employee shares (or share options) that all vest at the end of four years (cliff vest). The shares (or shares underlying the share options) are redeemable for cash at fair value at the holder’s option, but only after six months from the date of share issuance (as defined in FASB ASC Topic 718). Company F has determined that the shares (or share options) would be classified as equity instruments under the guidance of FASB ASC Topic 718. However, under ASR 268 and related guidance, the instruments would be considered to be redeemable for cash or other assets upon the occurrence of events (e.g., redemption at the option of the holder) that are outside the control of the issuer. . . .

**Question 2:** How should Company F apply ASR 268 and related guidance to the shares (or share options) granted under the share-based payment arrangements with employees that may be unvested at the date of grant?
**Interpretive Response:** Under FASB ASC Topic 718, when compensation cost is recognized for instruments classified as equity instruments, additional paid-in-capital is increased. If the award is not fully vested at the grant date, compensation cost is recognized and additional paid-in-capital is increased over time as services are rendered over the requisite service period. A similar pattern of recognition should be used to reflect the amount presented as temporary equity for share-based payment awards that have redemption features that are outside the issuer’s control but are classified as equity instruments under FASB ASC Topic 718. The staff believes Company F should present as temporary equity at each balance sheet date an amount that is based on the redemption amount of the instrument, but takes into account the proportion of consideration received in the form of employee services. Thus, for example, if a nonvested share that qualifies for equity classification under FASB ASC Topic 718 is redeemable at fair value more than six months after vesting, and that nonvested share is 75% vested at the balance sheet date, an amount equal to 75% of the fair value of the share should be presented as temporary equity at that date. Similarly, if an option on a share of redeemable stock that qualifies for equity classification under FASB ASC Topic 718 is 75% vested at the balance sheet date, an amount equal to 75% of the intrinsic value of the option should be presented as temporary equity at that date.

**FN85** Depending on the fact pattern, this may be recorded as common stock and additional paid in capital.

**FN86** The potential redemption amount of the share option in this illustration is its intrinsic value because the holder would pay the exercise price upon exercise of the option and then, upon redemption of the underlying shares, the company would pay the holder the fair value of those shares. Thus, the net cash outflow from the arrangement would be equal to the intrinsic value of the share option. In situations where there would be no cash inflows from the share option holder, the cash required to be paid to redeem the underlying shares upon the exercise of the put option would be the redemption value.

**Question 3:** Would the methodology described for employee awards in the Interpretive Response to Question 2 above apply to nonemployee awards to be issued in exchange for goods or services with similar terms to those described above?

**Interpretive Response:** See Topic 14.A for a discussion of the application of the principles in FASB ASC Topic 718 to nonemployee awards. The staff believes it would generally be appropriate to apply the methodology described in the Interpretive Response to Question 2 above to nonemployee awards.

Special considerations apply in the measurement of share-based payment arrangements under the SEC’s temporary equity guidance. For such arrangements, the amount presented in temporary equity at initial recognition and each balance sheet date is “based on the redemption provisions of the instrument and the proportion of consideration received in the form of employee services” (i.e., the measurement of such arrangements consider not only the redemption value, but also the proportion attributed to the requisite employee services rendered to date). See Deloitte’s *A Roadmap to Accounting for Share-Based Payment Awards* for further discussion.
9.6 EPS Considerations

9.6.1 Preferred Stock

ASC 480-10 — SEC Materials — SEC Staff Guidance

SEC Staff Announcement: Classification and Measurement of Redeemable Securities

S99-3A(20) Preferred stock instruments issued by a parent (or single reporting entity). Regardless of the accounting method selected in paragraph 15 and the redemption terms (that is, fixed price or fair value), the resulting increases or decreases in the carrying amount of a redeemable instrument other than common stock should be treated in the same manner as dividends on nonredeemable stock and should be effected by charges against retained earnings or, in the absence of retained earnings, by charges against paid-in capital. Increases or decreases in the carrying amount should reduce or increase income available to common stockholders in the calculation of earnings per share and the ratio of earnings to combined fixed charges and preferred stock dividends. Additionally, Paragraph 260-10-S99-2, provides guidance on the accounting at the date of a redemption or induced conversion of a preferred stock instrument.

SEC Staff Accounting Bulletins

SAB Topic 3.C, Redeemable Preferred Stock [Reproduced in ASC 480-10-S99-2]

Facts: Rule 5-02.27 of Regulation S-X states that redeemable preferred stocks are not to be included in amounts reported as stockholders’ equity, and that their redemption amounts are to be shown on the face of the balance sheet. However, the Commission’s rules and regulations do not address the carrying amount at which redeemable preferred stock should be reported, or how changes in its carrying amount should be treated in calculations of earnings per share and the ratio of earnings to combined fixed charges and preferred stock dividends. . . .

Question 2: How should periodic increases in the carrying amount of redeemable preferred stock be treated in calculations of earnings per share and ratios of earnings to combined fixed charges and preferred stock dividends?

Interpretive Response: Each type of increase in carrying amount described in the Interpretive Response to Question 1 should be treated in the same manner as dividends on nonredeemable preferred stock.

In the EPS calculation, changes in the carrying amount of preferred stock classified as temporary equity are treated as an adjustment to income available to common stockholders. Thus, an increase in the carrying amount decreases income available to common stockholders, and a decrease in the carrying amount increases it. However, the carrying amount generally cannot be reduced to an amount below the initial carrying amount (see Section 9.5.2).

For additional discussion of the EPS treatment of redeemable preferred stock, see Sections 3.2.2.4 and 4.8.4.3 of Deloitte’s A Roadmap to the Presentation and Disclosure of Earnings per Share.

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4 SEC Final Rule Release No. 33-10532, which became effective on November 5, 2018, deletes the requirement in Regulation S-K to disclose the ratio of earnings to combined fixed charges and preference dividends.

5 See footnote 4.
9.6.2 Common Stock

ASC 480-10 — SEC Materials — SEC Staff Guidance

SEC Staff Announcement: Classification and Measurement of Redeemable Securities

S99-3A(21) Common stock instruments issued by a parent (or single reporting entity). Regardless of the accounting method selected in paragraph 15, the resulting increases or decreases in the carrying amount of redeemable common stock should be treated in the same manner as dividends on nonredeemable stock and should be effected by charges against retained earnings or, in the absence of retained earnings, by charges against paid-in capital. However, increases or decreases in the carrying amount of a redeemable common stock should not affect income available to common stockholders. Rather, the SEC staff believes that to the extent that a common shareholder has a contractual right to receive at share redemption (in other than a liquidation event that meets the exception in paragraph 3(f)) an amount that is other than the fair value of the issuer’s common shares, then that common shareholder has, in substance, received a distribution different from other common shareholders. Under Paragraph 260-10-45-59A, entities with capital structures that include a class of common stock with different dividend rates from those of another class of common stock but without prior or senior rights, should apply the two-class method of calculating earnings per share. Therefore, when a class of common stock is redeemable at other than fair value, increases or decreases in the carrying amount of the redeemable instrument should be reflected in earnings per share using the two-class method. For common stock redeemable at fair value, the SEC staff would not expect the use of the two-class method, as a redemption at fair value does not amount to a distribution different from other common shareholders. The two-class method of computing earnings per share is addressed in Section 260-10-45. The SEC staff believes that there are two acceptable approaches for allocating earnings under the two-class method when a common stock instrument is redeemable at other than fair value. The registrant may elect to: (a) treat the entire periodic adjustment to the instrument’s carrying amount (from the application of paragraphs 14–16) as being akin to a dividend or (b) treat only the portion of the periodic adjustment to the instrument’s carrying amount (from the application of paragraphs 14–16) that reflects a redemption in excess of fair value as being akin to a dividend. Under either approach, decreases in the instrument’s carrying amount should be reflected in the application of the two-class method only to the extent they represent recoveries of amounts previously reflected in the application of the two-class method.

Changes in the carrying amount of common stock classified as temporary equity (other than a noncontrolling interest) do not affect income available to common stockholders in the calculation of EPS. Instead, an entity uses the two-class method under ASC 260-10-45 to reflect such changes unless the redemption right is for an amount equal to the fair value of the common shares. Accordingly, the two-class method:

- Applies if the redemption right is for an amount other than fair value (e.g., a fixed price or a price determined on the basis of a non-fair-value formula), because such a right effectively represents a holder right to a distribution (upon redemption) that is different from the distributions to holders of nonredeemable common stock.

- Does not apply if the redemption right is at an amount equal to the fair value of the common stock, because the issuer’s purchase of common stock at fair value conceptually does not represent an economically preferential distribution. While a redemption right at fair value provides the holder with an ability to exit its investment at its current fair value (i.e., liquidity), a redemption would not transfer any value to or from the holder of the redeemable instrument. Accordingly, if the redemption right is at fair value, adjustments to the carrying amount do not affect the calculation of EPS.
If the common stock is redeemable at a fixed amount, it would not be considered redeemable at fair value, because there is no assurance the fair value on the redemption date will equal the fixed amount. If the common stock is redeemable at an amount determined on the basis of a formula, it would not be considered redeemable at fair value unless “the formula is designed to equal or reasonably approximate fair value.” The SEC does not consider formulas based solely on a fixed multiple of the issuer’s earnings (e.g., 10 times the issuer’s most recent EBITDA or an average EBITDA) as designed to equal or reasonably approximate fair value because the appropriate multiple may change over time as a result of changes in market conditions and entity-specific factors. A formula that is based on the average trading price of the common stock price for a short period before redemption potentially could be viewed as one that was designed to reasonably approximate fair value. For a common equity instrument issued by an investment fund (e.g., noncontrolling interests in consolidated investment funds), the net asset value (NAV) per share calculated in a manner consistent with the measurement principles of ASC 946 as of the reporting entity’s measurement date may be a reasonable approximation of fair value (see ASC 820-10-35-59) depending on whether there are restrictions on redemptions and whether the NAV would have qualified as a fair value measurement under the practical expedient in ASC 820-15-35-59.

The SEC staff permits an entity that applies the two-class method to common stock redeemable at an amount other than fair value to choose between the following two approaches of allocating earnings to the redeemable common stock:

- Treat the entire change in the carrying amount of the redeemable common stock as a dividend to the holders of such stock.
- Treat only the portion of the change in the carrying amount of the redeemable common stock that reflects a redemption in excess of its fair value as a dividend to holders of such stock (e.g., if the redemption value exceeded fair value by $7 at the beginning of the period and $12 at the end of the period, the entity would analyze the increase in the excess of $5 during the period as a distribution to the holders of the redeemable common stock during that period).

Note that the carrying amount generally cannot be reduced to an amount below the initial carrying amount (see Section 9.5.2).

For additional discussion of the EPS treatment of redeemable common stock, see Sections 3.2.4.2, 3.3.2.1, 4.8.4.3, 5.4.2, and 5.5.3.1 of Deloitte’s A Roadmap to the Presentation and Disclosure of Earnings per Share.

9.6.3 Noncontrolling Interests

9.6.3.1 Noncontrolling Interests in the Form of Preferred Stock

ASC 480-10 — SEC Materials — SEC Staff Guidance

SEC Staff Announcement: Classification and Measurement of Redeemable Securities

S99-3A(22) . . . The SEC staff believes the guidance in paragraphs 20 and 21 should be applied to noncontrolling interests as follows:

a. Noncontrolling interest in the form of preferred stock instrument. The impact on income available to common stockholders of the parent arising from adjustments to the carrying amount of a redeemable noncontrolling interest other than common stock depends upon whether the redemption feature in the equity instrument was issued, or is guaranteed, by the parent. If the redemption feature was issued, or is guaranteed, by the parent, the entire adjustment under paragraph 20 reduces or increases income available to common stockholders of the parent. Otherwise, the adjustment is attributed to the parent and the noncontrolling interest in accordance with Paragraphs 260-10-55-64 through 55-67. . . .
When a noncontrolling interest in the form of preferred stock is presented in temporary equity, the calculation of EPS depends on whether the redemption feature that triggers temporary equity classification has been issued or guaranteed by the parent entity:

- If the redemption feature has been issued or guaranteed by the parent entity, the EPS treatment is similar to that of a redeemable preferred share issued directly by the parent (see Section 9.6.1), and changes in the carrying amount of the redeemable noncontrolling interest are treated as an adjustment to income available to common stockholders. Thus, an increase in the carrying amount decreases income available to common stockholders, and a decrease in the carrying amount increases income available to common stockholders.

- If the redemption feature has not been issued or guaranteed by the parent entity (i.e., the redemption feature was issued by the subsidiary and has not been guaranteed by the parent), changes in the carrying amount of the redeemable noncontrolling interest are allocated between the parent and the noncontrolling interest.

Redemption features that may be considered issued or guaranteed by the parent include, but are not limited to, (1) put options issued by a parent to the holder of preferred shares issued by the parent's subsidiary if the put options are considered embedded in the noncontrolling interest at the consolidated level (see Section 3.3) and (2) put features that are embedded in preferred shares issued by a subsidiary if they are subject to a guarantee by its parent.

For additional discussion of the EPS treatment of noncontrolling interest in the form of redeemable preferred stock, see Sections 3.2.3.3.1 and 8.8.4 of Deloitte's *A Roadmap to the Presentation and Disclosure of Earnings per Share*.

9.6.3.2 Noncontrolling Interests in the Form of Common Stock

Adjustments to the carrying amount of a noncontrolling interest issued in the form of a common stock instrument to reflect a fair value redemption feature do not impact earnings per share. Adjustments to the carrying amount of a noncontrolling interest issued in the form of a common stock instrument to reflect a non-fair value redemption feature do impact earnings per share; however, the manner in which those adjustments reduce or increase income available to common stockholders of the parent may differ. If the terms of the redemption feature are fully considered in the attribution of net income under Paragraph 810-10-45-21, application of the two-class method is unnecessary. If the terms of the redemption feature are not fully considered in the attribution of net income under Paragraph 810-10-45-20, application of the two-class method at the subsidiary level is necessary in order to determine net income available to common stockholders of the parent.

Subtopic 810-10 does not provide detailed guidance on the attribution of net income to the parent and the noncontrolling interest. The SEC staff understands that when a noncontrolling interest is redeemable at other than fair value some registrants consider the terms of the redemption feature in the calculation of net income attributable to the parent (as reported on the face of the income statement), while others only consider the impact of the redemption feature in the calculation of income available to common stockholders of the parent (which is the control number for earnings per share purposes).
An entity uses the two-class method under ASC 260-10-45 to reflect measurement adjustments made under ASC 480-10-S99-3A related to a noncontrolling interest in the form of redeemable common shares unless either (1) the redemption right is for an amount equal to the fair value of the common shares or (2) the entity fully considers the terms of the redemption feature in the attribution of net income under ASC 810-10-45.

The SEC staff permits an entity that applies the two-class method to common stock redeemable at an amount other than fair value to choose between the following two approaches of allocating earnings to the stock:

- Treat the entire measurement adjustment under ASC 480-10-S99-3A as a dividend to the holders of such stock.
- Treat only the portion of the measurement adjustment under ASC 480-10-S99-3A that reflects a redemption in excess of its fair value as a dividend to holders of such stock.

For additional discussion of the EPS treatment of noncontrolling interest in the form of redeemable common stock, see Sections 3.2.3.3.2 and 8.8.4 of Deloitte’s *A Roadmap to the Presentation and Disclosure of Earnings per Share*.

### 9.6.4 Convertible Debt With Separated Equity Component

<table>
<thead>
<tr>
<th>ASC 480-10 — SEC Materials — SEC Staff Guidance</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>SEC Staff Announcement: Classification and Measurement of Redeemable Securities</strong></td>
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<tr>
<td><strong>S99-3A(23)</strong> Convertible debt instruments that contain a separately classified equity component. For convertible debt instruments subject to ASR 268 (see paragraph 3(e)), there should be no incremental earnings per share accounting from the application of this SEC staff announcement. Subtopic 260-10 addresses the earnings per share accounting.</td>
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</tbody>
</table>

There is no incremental EPS impact associated with the classification of all or part of an equity component in convertible debt (e.g., a BCF or the equity component of a cash convertible under ASC 470-20) as temporary equity.
9.7 Derecognition

9.7.1 Extinguishments

ASC 260-10 — SEC Materials — SEC Staff Guidance

SEC Staff Announcement: The Effect on Calculation of Earnings per Share for a Period That Includes the Redemption or Induced Conversion of Preferred Stock

S99-2 . . .

Scope

This SEC staff announcement applies to redemptions and induced conversions of equity-classified preferred stock instruments. For purposes of this announcement:

1. Modifications and exchanges of preferred stock instruments that are accounted for as extinguishments, resulting in a new basis of accounting for the modified or exchanged preferred stock instrument, are considered redemptions.
2. A preferred stock instrument classified within temporary equity pursuant to the guidance in ASR 268 and paragraph 480-10-S99-3A is considered equity-classified, and redemptions and induced conversions of such securities would be subject to this guidance.
3. If an equity-classified security is subsequently required to be reclassified as a liability based on the provisions of other GAAP (for example, because a preferred share becomes mandatorily redeemable pursuant to Subtopic 480-10), the reclassification is considered a redemption of equity by issuance of a debt instrument.

The accounting for conversions of preferred stock instruments into other equity-classified securities pursuant to conversion privileges provided in the terms of the instruments at issuance is not affected by this announcement.

The Effect on Income Available to Common Stockholders of a Redemption or Induced Conversion of Preferred Stock

If a registrant redeems its preferred stock, the SEC staff believes that the difference between (1) the fair value of the consideration transferred to the holders of the preferred stock and (2) the carrying amount of the preferred stock in the registrant's balance sheet (net of issuance costs) should be subtracted from (or added to) net income to arrive at income available to common stockholders in the calculation of earnings per share. The SEC staff believes that the difference between the fair value of the consideration transferred to the holders of the preferred stock and the carrying amount of the preferred stock in the registrant's balance sheet represents a return to (from) the preferred stockholder that should be treated in a manner similar to the treatment of dividends paid on preferred stock. This calculation guidance applies to redemptions of convertible preferred stock regardless of whether the embedded conversion feature is “in-the-money” or “out-of-the-money” at the time of redemption. The fair value of the consideration transferred is reduced by the commitment date intrinsic value of the conversion option if the redemption includes the reacquisition of a previously recognized beneficial conversion feature in a convertible preferred stock instrument. . . .

ASC 260-10-S99-2 provides guidance on the accounting for extinguishments (redemptions) of equity-classified preferred stock (whether presented in temporary equity or permanent equity). Under that guidance, an SEC registrant compares (1) the fair value of the consideration transferred to the holders of the preferred stock and (2) the carrying amount of the preferred stock immediately before the modification or exchange (net of issuance costs). The difference is treated as a return to (or from) the holder of the preferred stock in a manner similar to dividends paid on preferred stock. For instance, any excess of fair value of the consideration transferred to the holders of the preferred stock over the carrying amount of the preferred stock in the issuer's balance sheet is treated as a dividend to those holders and charged against retained earnings or, in the absence of retained earnings, charged against paid-in-capital (see Section 9.5.5).
Note that the carrying amount that should be used in the calculation is not necessarily the carrying amount as of the most recent balance sheet date. The issuer should make one last measurement adjustment immediately before the modification or exchange if the measurement of the instrument under the temporary-equity guidance has changed since the most recent balance sheet date (e.g., because of accretion or changes in the redemption value; see Section 9.5.2).

Depending on the circumstances, therefore, the entity would make the following accounting entry if an instrument classified in its entirety in temporary equity is extinguished at an amount that is less than its net carrying amount:

- Temporary equity (at its net carrying amount)
- Cash (or other consideration transferred; e.g., debt or equity securities, at fair value)
- Equity — retained earnings (for the amount of the difference)

In calculating EPS, the entity would deduct the difference from (or add it to) net earnings to determine the net earnings available to common shareholders under ASC 260-10-45-11.

**ASC 260-10 — SEC Materials — SEC Staff Guidance**

SEC Staff Announcement: The Effect on Calculation of Earnings per Share for a Period That Includes the Redemption or Induced Conversion of Preferred Stock

S99-2 . . .

When a registrant effects a redemption or induced conversion of only a portion of the outstanding securities of a class of preferred stock, the SEC staff believes that, for the purpose of determining whether the “if-converted” method is dilutive for the period, the shares redeemed or converted should be considered separately from the other shares of the same class that are not redeemed or converted. The SEC staff does not believe that it is appropriate to aggregate securities with different effective dividend yields when determining whether the “if-converted” method is dilutive, which would be the result if a single, aggregate computation was made for the entire series of preferred stock.

For example, assume a registrant has 100 shares of convertible preferred stock outstanding at the beginning of the period. The convertible preferred stock was issued at fair value, which was equal to its par value of $10 per share, and has a stated dividend of 5 percent, and each share of preferred stock is convertible into 1 share of common stock. During the period, 20 preferred shares were redeemed by the registrant for $12 per share.

In this example, the SEC staff believes that the registrant should determine whether conversion is dilutive (1) for 80 of the preferred shares by applying the “if-converted” method from the beginning of the period to the end of the period using the stated dividend of 5 percent and (2) for 20 of the preferred shares by applying the “if-converted” method from the beginning of the period to the date of redemption using both the stated dividend of 5 percent and the $2 per share redemption premium.

Accordingly, assuming that the dividend for the period for the preferred stock was $0.125 per share, a determination of whether the 20 redeemed shares are dilutive should be made by comparing the $2.125 per-share effect of assuming those shares are not converted to the effect of assuming those 20 shares were converted into 20 shares of common stock, weighted for the period for which they were outstanding. The determination of the “if-converted” effect of the 80 shares not redeemed should be made separately, by comparing the EPS effect of the $0.125 per-share dividend to the effect of assuming conversion into 80 shares of common stock.

ASC 260-10-S99-2 contains special guidance on the calculation of diluted EPS that applies when a portion of an outstanding class of preferred stock is redeemed or subject to an induced conversion.

For additional discussion of the EPS treatment of redemptions of preferred stock, see Section 3.2.2.6.2.2 of Deloitte’s *A Roadmap to the Presentation and Disclosure of Earnings per Share.*
9.7.2 Conversions

9.7.2.1 Conversions Pursuant to the Original Terms

If a temporary-equity-classified instrument (e.g., convertible preferred stock) that does not contain any BCF is converted into a permanent-equity classified instrument (e.g., common stock or a different class of preferred stock), the old instrument is derecognized, and the new instrument is recognized typically at the current carrying amount of the old instrument on the date of conversion. Previous adjustments to the carrying amount of the old instrument under the temporary-equity guidance are not reversed (see also Section 9.7.4). If the old instrument contained a BCF, the same accounting applies except that under ASC 470-20-40-1, any remaining unamortized discount associated with the BCF on the date of conversion is recognized as a deemed dividend.

9.7.2.2 Induced Conversions

ASC 260-10 — SEC Materials — SEC Staff Guidance

<table>
<thead>
<tr>
<th>SEC Staff Announcement: The Effect on Calculation of Earnings per Share for a Period That Includes the Redemption or Induced Conversion of Preferred Stock</th>
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</thead>
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<tr>
<td>S99-2</td>
</tr>
</tbody>
</table>

If convertible preferred stock is converted into other securities issued by the registrant pursuant to an inducement offer, the SEC staff believes that the excess of (1) the fair value of all securities and other consideration transferred in the transaction by the registrant to the holders of the convertible preferred stock over (2) the fair value of securities issuable pursuant to the original conversion terms should be subtracted from net income to arrive at income available to common stockholders in the calculation of earnings per share. Registrants should consider the guidance provided in Subtopic 470-20 to determine whether the conversion of preferred stock is pursuant to an inducement offer.

ASC 470-20 contains guidance on the accounting for induced conversions of convertible debt. ASC 470-20-40-13 states that “conversions of convertible debt to equity securities pursuant to terms that reflect changes made by the debtor to the conversion privileges provided in the terms of the debt at issuance (including changes that involve the payment of consideration) for the purpose of inducing conversion.” In addition, ASC 470-20-40-16 indicates that if the conversion is an “induced conversion” as described in ASC 470-20-40-13 through 40-15, the “debtor shall recognize an expense equal to the fair value of all securities and other consideration transferred in the transaction in excess of the fair value of securities issuable pursuant to the original conversion terms.” Under ASC 470-20-40-13, “[t]hat guidance applies only to conversions that both:

a. Occur pursuant to changed conversion privileges that are exercisable only for a limited period of time . . .

b. Include the issuance of all of the equity securities issuable pursuant to conversion privileges included in the terms of the debt at issuance for each debt instrument that is converted . . .”

ASC 470-20 does not address the accounting for induced conversions of equity-classified preferred stock. If an inducement offer related to convertible preferred stock would have met the characteristics of an inducement offer in ASC 470-20, however, the SEC staff requires issuers to deduct, in their EPS calculation, “the excess of (1) the fair value of all securities and other consideration transferred in the transaction by the registrant to the holders of the convertible preferred stock over (2) the fair value of securities issuable pursuant to the original conversion terms” in determining income available to common stockholders (see ASC 260-10-S99-2).
Depending on the circumstances, therefore, the issuer would record the following accounting entry if a preferred share classified in temporary equity is converted into common stock pursuant to an induced conversion offer:

Temporary equity (net carrying amount)
Retained earnings (inducement amount)
Equity — common stock

For additional discussion of the EPS treatment of induced conversions of preferred stock, see Section 3.2.2.6.3 of Deloitte’s A Roadmap to the Presentation and Disclosure of Earnings per Share.

9.7.3 Modifications and Exchanges

ASC 470-50 provides guidance on determining whether a modification or exchange of debt instruments should be accounted for as a modification or as an extinguishment; however, there is no specific guidance under GAAP on whether an amendment to, or exchange of, an equity-classified preferred stock instrument (whether presented in temporary or permanent equity) that is not within the scope of ASC 718 should be accounted for as an extinguishment or a modification.

If the preferred stock is required to be reclassified as a liability, the reclassification is considered an extinguishment under ASC 260-10-S99-2 (and the fair value of the preferred stock immediately after the modification or exchange, along with any other consideration, is treated as the fair value of the consideration transferred; see Section 9.7.1).

In prepared remarks at the 2014 AICPA Conference on Current SEC and PCAOB Developments, Kirk Crews, then professional accounting fellow in the SEC’s Office of the Chief Accountant, noted that registrants may use one of the following approaches in determining whether an amendment to, or exchange of, an equity-classified preferred stock constitutes a modification or extinguishment when the preferred stock is not reclassified as a liability:

- **Qualitative approach** — An entity would consider the significance of additions, removals, and changes to existing contractual terms. In addition, the entity would “evaluate the business purpose for the changes and how the changes may influence the economic decisions of the investor.” If the entity determined that the changes were significant, it would treat the amendments or exchange as an extinguishment; otherwise, it would treat the changes as a modification to the preferred stock. (Mr. Crews suggested that the qualitative approach is the “most common approach” observed by the SEC staff.)

- **Fair value approach** — An entity would compare the fair value of the preferred stock after the amendment or exchange to the fair value of the preferred stock immediately before the amendment or exchange to determine whether the preferred stock is substantially different. If there is a 10 percent or greater change in the fair value of the preferred stock, the entity would consider the preferred stock to be substantially different and account for the amendment or exchange as an extinguishment. If, however, the change is less than 10 percent, a preferred stock modification has occurred.

- **Cash flow approach** — An entity would compare the contractual cash flows of the preferred stock after the amendment or exchange with the contractual cash flows of the preferred stock immediately before the amendment or exchange to determine whether the preferred stock is substantially different. As it would under the fair value approach, the entity would consider a change of 10 percent or greater to be substantially different and would account for the
amendment or exchange as an extinguishment. A change of less than 10 percent would be considered a modification.

In addition, Mr. Crews noted that some registrants may be using the legal form approach to determine whether an amendment to, or exchange of, an equity-classified preferred stock constitutes a modification or an extinguishment. Under the legal form approach, an exchange that results in the issuance of new preferred stock would be accounted for as an extinguishment of the exchanged preferred stock. Mr. Crews cautioned registrants that the legal form is merely one factor in the evaluation of whether an amendment or exchange should be accounted for as a modification or an extinguishment and emphasized that the form of the change in and of itself should not be determinative of the accounting outcome.

If a modification or exchange represents an extinguishment for accounting purposes, it is accounted for as a redemption of the existing equity instrument and the issuance of a new instrument (see Section 9.7.1).

At the 2014 AICPA Conference on Current SEC and PCAOB Developments, Mr. Crews suggested that if a registrant determines that an amendment to, or exchange of, equity-classified preferred stock is a modification, it would be appropriate for the entity to analogize to the guidance in ASC 718-20-35-3 on modifications to equity-classified share-based payment awards. If the fair value of the instrument after the modification exceeds its fair value before the modification, the entity should recognize the incremental fair value to reflect the modification. Mr. Crews indicated that the staff would not object to an entity's recognition of the additional fair value in retained earnings as a deemed dividend from the entity to the preferred stockholders. (This implies that in computing EPS, entities would deduct the incremental fair value from net earnings in determining net earnings available to common shareholders under ASC 260-10-45-11.) Mr. Crews suggested that in certain unique circumstances, it may be appropriate to recognize the additional fair value as an expense (e.g., if facts and circumstances indicate that it is reflective of compensation for agreeing to restructure the preferred stock). He noted that while the SEC staff has accepted both methods, the appropriate method for recognizing the additional fair value would depend on “the underlying purpose for and circumstances surrounding the modification.”

For additional discussion of the evaluation of modification and exchanges of preferred or common stock and the related EPS impact, see Section 3.2.6 of Deloitte's A Roadmap to the Presentation and Disclosure of Earnings per Share.

### 9.7.4 Reclassifications

After an equity instrument’s issuance, it may begin or cease to meet the criteria for temporary-equity classification. Its classification should therefore be reassessed under the guidance on temporary-equity classification whenever circumstances change. Examples of events or changes in circumstances that could trigger reclassification include:

- The expiration of redemption features that triggered temporary-equity classification (e.g., an investor put option or contingent redemption feature embedded in a preferred stock instrument).
- The modification of terms of the equity instrument to remove all redemption features (see also Section 9.7.3).
- A change in the holder’s ability to control whether the issuer will trigger or exercise a redemption feature or permit a holder redemption option to become exercisable (e.g., because the holder gains or loses control over the board; see Section 9.4.4). For instance, a call option embedded in an equity instrument would be assessed differently depending on whether the holder can direct the entity to exercise the call option through board representation or voting rights.
• A change in the issuer’s ability to settle a share-settled redemption feature in its equity shares in accordance with the equity classification conditions in ASC 815-40-25 (e.g., a change in the number of authorized, but unissued shares available to settle the instrument; see Section 9.4.6).

• It becomes certain that an outstanding share with redemption provisions will be redeemed and subject to the liability classification guidance in ASC 480-10 (see Section 4.4). For example, redemption might become certain if a substantive equity conversion option embedded in a mandatorily redeemable preferred share expires or a contingency that triggers the automatic redemption of a share is met.

• An instrument ceases to be subject to ASC 718 (see Section 9.3.9).

9.7.4.1 Reclassifications From Temporary Equity Into Permanent Equity

<table>
<thead>
<tr>
<th>ASC 480-10 — SEC Materials — SEC Staff Guidance</th>
</tr>
</thead>
</table>

SEC Staff Announcement: Classification and Measurement of Redeemable Securities

S99-3A(18) If classification of an equity instrument as temporary equity is no longer required (if, for example, a redemption feature lapses, or there is a modification of the terms of the instrument), the existing carrying amount of the equity instrument should be reclassified to permanent equity at the date of the event that caused the reclassification. Prior financial statements are not adjusted. Additionally, the SEC staff believes that it would be inappropriate to reverse any adjustments previously recorded to the carrying amount of the equity instrument (pursuant to paragraphs 14–16) in conjunction with such reclassifications.

If an equity instrument no longer meets any of the criteria for temporary-equity classification (and is not a liability under ASC 480-10), the instrument is remeasured up to the date of the reclassification (with a corresponding impact on EPS) and reclassified from temporary equity to permanent equity at its current carrying amount as of the date of the event that caused the reclassification. An issuer is precluded from retrospectively adjusting its balance sheet as if the temporary-equity guidance had never applied (i.e., as if the securities were not redeemable in prior financial reporting periods). In recording the reclassification to permanent equity, an entity cannot reverse prior redemption-amount adjustments that affected the EPS calculation. For example, in the period of reclassification, there should not be an EPS benefit equal to any cumulative charges to retained earnings that reduced EPS in prior periods. An EPS adjustment might be required, however, for a modification of terms (see Section 9.7.3).

The SEC’s guidance does not address which specific permanent equity accounts (e.g., retained earnings and APIC) should be affected by the reclassification. We believe that if previous measurement adjustments were reflected in the calculation of EPS, it would not be appropriate to adjust retained earnings (or accumulated deficit) to remove the effect of those adjustments (since a reclassification should not affect EPS). Further, if the holder agrees to forfeit its right to previously accrued and undeclared dividends, the corresponding amount should be recorded against paid-in capital (rather than retained earnings) because such amount represents a capital contribution. If a common stock instrument was redeemable at its fair value and had no EPS impact in previous periods (see Section 9.6.2), we believe that it would be appropriate to adjust permanent equity accounts (e.g., retained earnings or APIC) by the same amounts as the redemption-amount adjustments that had previously been recorded to those respective accounts. The prior redemption-amount adjustments would have no effect on EPS in this scenario (i.e., a preferential distribution has not occurred), and a permanent reduction to retained earnings is therefore unnecessary.
Example 9-17

On 1/1/X1, Entity E, an SEC registrant, issues redeemable common stock for proceeds of $100 million, which equals the stock’s par amount and its fair value as of its issuance date. The terms of the stock specify that (1) the holder has a right to require E to redeem the stock at a price equal to the current fair value of the stock on the redemption date and (2) the holder’s redemption right is exercisable at any time and expires if E consummates an IPO. Because E could be forced to redeem the stock, it classifies the stock in temporary equity. Entity E makes the following entry (in millions):

<table>
<thead>
<tr>
<th>Cash</th>
<th>100</th>
</tr>
</thead>
<tbody>
<tr>
<td>Temporary equity — redeemable common stock</td>
<td>100</td>
</tr>
</tbody>
</table>

On December 31, 20X1, the fair value of the stock has increased to $300 million. Thus, E is required to record a redemption-amount adjustment of $200 million to increase the carrying amount of the redeemable stock to $300 million. Assume that E has a retained earnings balance of $100 million and an APIC balance of $50 million (related to a previous issuance of nonredeemable common shares). Entity E first records a charge against retained earnings of $100 million to reduce retained earnings to zero. Then it records a charge of $50 million to reduce APIC to zero. Given that both retained earnings and APIC have been reduced to zero, E finally records a $50 million charge to create an accumulated deficit of $50 million. Hence, E makes the following entry to recognize the change in the redemption value during 20X1 (in millions):

<table>
<thead>
<tr>
<th>Equity — retained earnings</th>
<th>100</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity — APIC</td>
<td>50</td>
</tr>
<tr>
<td>Accumulated deficit</td>
<td>50</td>
</tr>
<tr>
<td>Temporary equity — redeemable common stock</td>
<td>200</td>
</tr>
</tbody>
</table>

On December 31, 20X2, the redemption value of the common stock has increased to $400 million. During 20X2, E incurred a net loss of $75 million, and there was no other activity that affected its equity accounts. The additional $100 million adjustment for the redemption amount of the common stock increases the accumulated deficit to $225 million (= $50 million + $75 million + $100 million). Entity E makes the following entry to reflect the change in the redemption value during 20X2 (in millions):

<table>
<thead>
<tr>
<th>Accumulated deficit</th>
<th>100</th>
</tr>
</thead>
<tbody>
<tr>
<td>Temporary equity — redeemable common stock</td>
<td>100</td>
</tr>
</tbody>
</table>

In the next period ended December 31, 20X3, E had no net earnings or net losses and, as a result of consummating an IPO, its common stock was no longer redeemable. On the date immediately before the IPO, the stock was redeemable for $400 million. Because the common stock was redeemable at its fair value and there was no EPS impact in previous periods, E adjusted its permanent equity accounts to remove the effect of the application of the temporary-equity guidance to the common stock. Accordingly, E recorded the reclassification of the common stock from temporary equity to permanent equity by recognizing a $100 million credit to paid-in capital for common stock, a $225 million credit to accumulated deficit, a $25 credit to retained earnings, and a $50 million credit to APIC (in millions):

<table>
<thead>
<tr>
<th>Temporary equity — redeemable common stock</th>
<th>400</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity — common stock</td>
<td>100</td>
</tr>
<tr>
<td>Accumulated deficit</td>
<td>225</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>25</td>
</tr>
<tr>
<td>Equity — APIC</td>
<td>50</td>
</tr>
</tbody>
</table>

The adjusted retained earnings balance equals $25 million, which reflects the initial retained earnings balance of $100 million less the cumulative net loss of $75 million. The adjusted APIC balance equals $50 million. These balances are the same as those that would have been reported had the temporary-equity guidance never been applied.
Reclassifications From Permanent Equity to Temporary Equity

The SEC’s temporary-equity guidance does not address reclassifications from permanent equity to temporary equity. Because that guidance requires an entity to initially measure an instrument classified as temporary equity at fair value (unless an exception applies), we believe that by analogy to the reclassification guidance in ASC 815-40, it would be appropriate (unless an exception applies) for an entity to reclassify the instrument out of permanent equity at its current fair value as of the date of the event that caused the reclassification. The entity would account for any adjustment to the carrying amount as an adjustment to equity (APIC).

Reclassifications Out of Equity and Into a Liability

If an instrument is reclassified from temporary equity to a liability, the reclassification is treated as an extinguishment of the original instrument (see Section 9.7.1). The difference between the carrying amount and the fair value of the instrument is recorded against equity.

Deconsolidation of a Subsidiary

When a subsidiary with a redeemable noncontrolling interest is deconsolidated, the issuer reverses any previous adjustments to the carrying amount of the noncontrolling interest that it has made in accordance with the temporary-equity guidance. Any gain or loss on deconsolidation under ASC 810 is calculated on the basis of the carrying amount of the noncontrolling interest after previous temporary-equity adjustments have been eliminated against equity. An entity is required to disclose the amount credited to equity of the parent upon the deconsolidation of the subsidiary (see Section 9.8.2).
9.8 Presentation and Disclosure

9.8.1 Presentation

9.8.1.1 Separate Presentation of Temporary Equity

<table>
<thead>
<tr>
<th>SEC Rules, Regulations, and Interpretations</th>
</tr>
</thead>
<tbody>
<tr>
<td>Regulation S-X Rule 5-02, Balance Sheets [Reproduced in ASC 210-10-599-1]</td>
</tr>
<tr>
<td>The purpose of this rule is to indicate the various line items and certain additional disclosures which, if applicable, and except as otherwise permitted by the Commission, should appear on the face of the balance sheets or related notes filed for the persons to whom this article pertains (see § 210.4–01(a)). . . .</td>
</tr>
<tr>
<td>Redeemable Preferred Stocks</td>
</tr>
<tr>
<td>27. Preferred stocks subject to mandatory redemption requirements or whose redemption is outside the control of the issuer.</td>
</tr>
<tr>
<td>(a) Include under this caption amounts applicable to any class of stock which has any of the following characteristics: (1) it is redeemable at a fixed or determinable price on a fixed or determinable date or dates, whether by operation of a sinking fund or otherwise; (2) it is redeemable at the option of the holder; or (3) it has conditions for redemption which are not solely within the control of the issuer, such as stocks which must be redeemed out of future earnings. Amounts attributable to preferred stock which is not redeemable or is redeemable solely at the option of the issuer shall be included under § 210.5–02.28 unless it meets one or more of the above criteria. . . .</td>
</tr>
<tr>
<td>(d) Securities reported under this caption are not to be included under a general heading “stockholders’ equity” or combined in a total with items described in captions 29, 30 or 31 which follow.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>SEC Rules, Regulations, and Interpretations</th>
</tr>
</thead>
<tbody>
<tr>
<td>CFRP 211, Redeemable Preferred Stocks [Reproduced in ASC 480-10-599-1]</td>
</tr>
<tr>
<td>.01 General: ASR 268:</td>
</tr>
<tr>
<td>On July 27, 1979, the Commission amended Regulation S-X to modify the financial statement presentation of preferred stocks subject to mandatory redemption requirements or whose redemption is outside the control of the issuer. The rules adopted do not impact reporting practices of registrants not having such securities outstanding. Registrants having such securities outstanding are required to present separately, in balance sheets, amounts applicable to the following three general classes of securities: (i) preferred stocks subject to mandatory redemption requirements or whose redemption is outside the control of the issuer; (ii) preferred stocks which are not redeemable or are redeemable solely at the option of the issuer; and (iii) common stocks. A general heading, “Stockholders’ Equity,” is not to be used and presentation of a combined total for equity securities, inclusive of redeemable preferred stocks, is prohibited. In addition, the rules require disclosure of redemption terms, five-year maturity data, and changes in redeemable preferred stocks in a separate note to the financial statements captioned “Redeemable Preferred Stocks.”</td>
</tr>
<tr>
<td>There is a significant difference between a security with mandatory redemption requirements or whose redemption is outside the control of the issuer and conventional equity capital. The Commission believes that it is necessary to highlight the future cash obligations attached to this type of security so as to distinguish it from permanent capital. It is expected that the rules will provide more meaningful presentation of the financial obligations of those companies which finance operations through the use of such securities.</td>
</tr>
<tr>
<td>The Commission noted an increase in the issuance, by registrants, of preferred stocks to finance operations, consummate mergers and acquisitions, or to restructure existing debt arrangements. Many of the preferred stock issues included terms which required the issuer to redeem the stock at a fixed or determinable price on a fixed or determinable date. Other issues required the issuer to redeem the stock at the option of the holder at the time certain prescribed conditions are met which are not necessarily within the control of the issuer, such as attainment of a specified level of earnings.</td>
</tr>
</tbody>
</table>
The Commission believes that redeemable preferred stocks are significantly different from conventional equity capital. Such securities have characteristics similar to debt and should, in the opinion of the Commission, be distinguished from permanent capital. The Commission believes that traditional financial reporting practices do not provide the most meaningful presentation of the financial obligations attached to these types of securities and that improvement in the financial statement presentation of redeemable preferred stocks is necessary.

The rules are intended to highlight the future cash obligations attached to redeemable preferred stock through appropriate balance sheet presentation and footnote disclosure. They do not attempt to deal with the conceptual question of whether such a security is a liability. Further, the rules do not attempt to deal with the income statement treatment of payments to holders of such a security or with any related income statement matters, including accounting for its extinguishment. The Commission is cognizant of these conceptual problems in determining the appropriate accounting for and reporting of redeemable preferred stock and believes that these matters can best be addressed by the FASB. As an interim measure, the rules require that the amounts applicable to redeemable preferred stock be presented in financial statements as a separate item — and not combined with equity investments not having similar redemption requirements. The Commission believes the presentation required by the rules will highlight the redemption obligation and the fact that amounts attributable to these securities are not part of permanent capital.

.02 Definitions

ASR 268:

The following definitions apply to the terms listed below as they are used in this section:

Preferred Stock Subject to Mandatory Redemption Requirements or Whose Redemption is Outside the Control of the Issuer (“Redeemable Preferred Stock”). The term means any stock which (i) the issuer undertakes to redeem at a fixed or determinable price on the fixed or determinable date or dates, whether by operation of a sinking fund or otherwise; (ii) is redeemable at the option of the holders, or (iii) has conditions for redemption which are not solely within the control of the issuer, such as stocks which must be redeemed out of future earnings.FN*

FN* Under this definition, preferred stock which meet one or more of the above criteria would be classified as redeemable preferred stock regardless of their other attributes such as voting rights, dividend rights or conversion features.

Preferred Stocks Which Are Not Redeemable or Are Redeemable Solely at the Option of the Issuer (“Non-Redeemable Preferred Stock”). The term means any preferred stock which does not meet the criteria for classification as a “redeemable preferred stock.”

.03 Exemption

ASR 268:

The Commission has concluded that the necessary refinements concerning the presentation in financial statements of amounts applicable to redeemable preferred stocks should not impact the present reporting practices of registrants who do not use such securities to finance their operations. Therefore, registrants not having such securities may continue to use the general heading “Stockholders’ Equity” and show a combined total. Where redeemable preferred stocks are outstanding, the Commission will not prohibit the combining of non-redeemable preferred stocks, common stocks and other equity accounts under an appropriate designated caption (e.g., “Non-Redeemable Preferred Stocks, Common Stocks, and Other Stockholders’ Equity”) provided that any combinations be exclusive of redeemable preferred stocks. . . .

Regulation S-X, Rule 5-02.27 (reproduced in ASC 210-10-599-1), contains the basic balance sheet presentation and footnote disclosure requirements for redeemable preferred stocks classified as temporary equity. It requires an entity to present in a separate caption on the face of the balance sheet the amount of such redeemable equity instruments.

Although temporary equity represents equity under GAAP (e.g., in connection with disclosing information about equity instruments under ASC 505-10-50 or evaluating whether a contract qualifies for the scope
exception to derivative accounting for contracts on own equity under ASC 815-10-15-74(a); see ASC 815-10-15-76), the SEC's rules preclude an entity from (1) combining the balance sheet line item for redeemable equity with line items for components of permanent equity (including those preferred stocks, common stocks, other stockholders' equity, and noncontrolling interests that qualify as permanent equity) and (2) including redeemable equity under a general heading for stockholders' equity (see also CFRP 211.03).

Accordingly, the SEC staff would object to an entity's inclusion of redeemable equity in any total or subtotal titled “stockholders’ equity” or “total equity” in the entity's financial statements, including the reconciliation of total equity under Regulation S-X, Rule 3-04 (reproduced in ASC 505-10-S99-1). As noted in the highlights of the June 23, 2009, joint meeting of the SEC Regulations Committee and the SEC staff, the staff believes that “the renaming of the caption in the statement of changes in shareholders' equity “total equity” to “total” does not make the inclusion of redeemable equity acceptable.”

### 9.8.1.2 Liability Classification Prohibited

**ASC 480-10 — SEC Materials — SEC Staff Guidance**

<table>
<thead>
<tr>
<th>SEC Staff Announcement: Classification and Measurement of Redeemable Securities</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>S99-3A(4)</strong> . . . The SEC staff does not believe it is appropriate to classify a financial instrument (or host contract) that meets the conditions for temporary equity classification under ASR 268 as a liability.(^{\text{FN10}})</td>
</tr>
</tbody>
</table>

\(^{\text{FN10}}\) At the June 14, 2007 EITF meeting, the SEC Observer stated that a financial instrument (or host contract) that otherwise meets the conditions for temporary equity classification may continue to be classified as a liability provided the financial instrument (or host contract) was classified and accounted for as a liability in fiscal quarters beginning before September 15, 2007 and has not subsequently been modified or subject to a remeasurement (new basis) event.

**SEC Rules, Regulations, and Interpretations**

<table>
<thead>
<tr>
<th>CFRP 211, Redeemable Preferred Stocks [Reproduced in ASC 480-10-S99-1]</th>
</tr>
</thead>
<tbody>
<tr>
<td>.05 Existing Agreements</td>
</tr>
<tr>
<td><strong>ASR 268:</strong></td>
</tr>
</tbody>
</table>

It is not the Commission's present intention to establish whether redeemable preferred stocks are liabilities or components of equity. Therefore, the rules should not require any change in the calculations of debt-equity ratios under existing loan agreements. Further, the Commission believes that creditors already consider the distinctive characteristics of the types of securities which comprise a company's capital structure when evaluating a potential loan.

In the past, the SEC staff did not object to liability classification for certain instruments that meet the conditions for temporary-equity classification. However, at the EITF's June 14, 2007, meeting, the SEC observer announced that the SEC staff would “no longer accept liability classification for financial instruments (or host contracts) that meet the conditions for temporary equity classification.” While CFRP 211.01 and CFRP 211.05 suggest that it was not the SEC's intention to establish whether redeemable preferred stocks are liabilities or components of equity, it would be inappropriate for an entity to classify as a liability an instrument that qualifies as temporary equity (see Section 9.3.2). When the SEC announced that it would object to liability classification for instruments that meet the criteria for temporary-equity classification, it grandfathered instruments that had previously been classified as liabilities. Accordingly, an entity may still have redeemable equity instruments outstanding that it has classified as liabilities, even though they do not meet the criteria for liability classification under ASC.
480-10. However, such classification is not permitted for financial instruments (or host contracts) “that [were] entered into, modified, or otherwise subject to a remeasurement (new basis) event in [fiscal quarters] beginning after September 15, 2007.” Further, a grandfathered instrument that continues to be classified on the balance sheet as a liability “would not be eligible for initial application of the fair value option under [ASC 825-10] or initial adoption of hedge accounting in fiscal quarters beginning after September 15, 2007.” (ASC 825-10-15-5(f) precludes application of the fair value option in ASC 825-10 for instruments that are classified in whole or in part in equity (including temporary equity).)

9.8.1.3 Presentation of Shareholder Loans

<table>
<thead>
<tr>
<th>SEC Staff Accounting Bulletins</th>
</tr>
</thead>
<tbody>
<tr>
<td>SAB Topic 4.E, Receivables From Sale of Stock [Reproduced in ASC 310-10-599-2]</td>
</tr>
<tr>
<td><strong>Facts:</strong> Capital stock is sometimes issued to officers or other employees before the cash payment is received.</td>
</tr>
<tr>
<td><strong>Question 2:</strong> How should the receivables from the officers or other employees be presented in the balance sheet.</td>
</tr>
<tr>
<td><strong>Interpretive Response:</strong> The amount recorded as a receivable should be presented in the balance sheet as a deduction from stockholders’ equity. This is generally consistent with Rule 5-02.[29] of Regulation S-X which states that accounts or notes receivable arising from transactions involving the registrant’s capital stock should be presented as deductions from stockholders’ equity and not as assets.</td>
</tr>
<tr>
<td>It should be noted generally that all amounts receivable from officers and directors resulting from sales of stock or from other transactions (other than expense advances or sales on normal trade terms) should be separately stated in the balance sheet irrespective of whether such amounts may be shown as assets or are required to be reported as deductions from stockholders’ equity.</td>
</tr>
<tr>
<td>The staff will not suggest that a receivable from an officer or director be deducted from stockholders’ equity if the receivable was paid in cash prior to the publication of the financial statements and the payment date is stated in a note to the financial statements. However, the staff would consider the subsequent return of such cash payment to the officer or director to be part of a scheme or plan to evade the registration or reporting requirements of the securities laws.</td>
</tr>
</tbody>
</table>

If the issuer of a redeemable equity instrument classified as temporary equity receives notes issued by the holders of the redeemable shares instead of cash in exchange for the instrument, Regulation S-X, Rule 5-02(27)(b), requires the issuer to present the shareholder loan as a reduction of temporary equity. The issuer should not present the shareholder loan as an asset or as a reduction of permanent equity.

This is consistent with the consensus in EITF Issue 89-11, in which the Task Force noted, in part:

> [W]hen ASR 268 . . . requires some or all of the value of the securities to be classified outside of permanent equity, a proportional amount of the debit in the equity section . . . if any, should be similarly classified.

9.8.2 Disclosure

<table>
<thead>
<tr>
<th>ASC 505-10</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Redeemable Securities</strong></td>
</tr>
<tr>
<td><strong>50-11</strong> An entity that issues redeemable stock shall disclose the amount of redemption requirements, separately by issue or combined, for all issues of capital stock that are redeemable at fixed or determinable prices on fixed or determinable dates in each of the five years following the date of the latest statement of financial position presented.</td>
</tr>
</tbody>
</table>
Chapter 9 — The SEC’s Guidance on Temporary Equity

SEC Rules, Regulations, and Interpretations

Regulation S-X, Rule 5-02, Balance Sheets [Reproduced in ASC 210-10-S99-1]

Redeemable Preferred Stocks

27. Preferred stocks subject to mandatory redemption requirements or whose redemption is outside the control of the issuer. . . .

(b) State on the face of the balance sheet the title of each issue, the carrying amount, and redemption amount. (If there is more than one issue, these amounts may be aggregated on the face of the balance sheet and details concerning each issue may be presented in the note required by paragraph (c) below.) Show also the dollar amount of any shares subscribed but unissued, and show the deduction of subscriptions receivable therefrom.

If the carrying value is different from the redemption amount, describe the accounting treatment for such difference in the note required by paragraph (c) below.

Also state in this note or on the face of the balance sheet, for each issue, the number of shares authorized and the number of shares issued or outstanding, as appropriate (See § 210.4–07).

(c) State in a separate note captioned “Redeemable Preferred Stocks” (1) a general description of each issue, including its redemption features (e.g. sinking fund, at option of holders, out of future earnings) and the rights, if any, of holders in the event of default, including the effect, if any, on junior securities in the event a required dividend, sinking fund, or other redemption payment(s) is not made; (2) the combined aggregate amount of redemption requirements for all issues each year for the five years following the date of the latest balance sheet; and (3) the changes in each issue for each period for which an income statement is required to be filed. (See also § 210.4–08(d).) . . .

CFRR 211: Redeemable Preferred Stocks [Reproduced in ASC 480-10-S99-1]

.04 Footnote Disclosure of Future Cash Obligations

ASR 268:

In the interest of clear and prominent disclosure of the future cash obligations attendant with these types of securities, the rules require disclosure of the term of redemption, five-year maturity data, and changes in these securities in a separate note to the financial statements captioned “Redeemable Preferred Stocks.” It should be noted that although in the past a registrant may have disclosed changes in redeemable preferred stocks in a statement of stockholders’ equity, such changes are now required to be disclosed in a separate note as described above. . . .

.06 Ratios and Materiality Tests

ASR 268: (7/27/79).

Where certain ratios or other data involving amounts attributable to stockholder’s equity are presented as required or are optionally presented in filings with the Commission, such ratios or other data should be accompanied by an explanation as to their basis of calculation. If material amounts of redeemable preferred stock are combined with amounts applicable to non-redeemable preferred and common stocks for purposes of computing a ratio, there should also be represented a similar ratio which excludes amounts applicable to redeemable preferred stock from equity and includes such amounts as debt. This would also apply to any financial information such as tables, charts, graphic illustrations and ratios presented in annual reports to shareholders if such reports are to meet the requirements to Rule 14a-3 of the General Rules and Regulations under the Exchange Act.

In addition, the Commission did not amend its rules, regulations and releases to the extent that they provide for various materiality tests for disclosure purposes using a percentage of total stockholders’ equity. In making these tests, registrants may use amounts applicable to all classes of capital stock.
SEC Staff Announcement: Classification and Measurement of Redeemable Securities

S99-3A(24) ASR 268 and SEC Regulation S-X require certain disclosures about redeemable equity instruments. In addition, the SEC staff expects the following disclosures to be provided in the notes to the financial statements:

a. A description of the accounting method used to adjust the redemption amount of a redeemable equity instrument (as discussed in paragraphs 14–16).

b. When a registrant elects to accrete changes in the redemption amount of a redeemable equity instrument in accordance with paragraph 15(a), the redemption amount of the equity instrument as if it were currently redeemable.

c. For a redeemable equity instrument that is not adjusted to its redemption amount, the reasons why it is not probable that the instrument will become redeemable.

d. When charges or credits discussed in paragraphs 20 and 22(a) are material, a reconciliation between net income and income available to common stockholders.

e. The amount credited to equity of the parent upon the deconsolidation of a subsidiary (as discussed in paragraph 19).

SEC Staff Accounting Bulletins


Facts: A registrant has various classes of preferred stock. Dividends on those preferred stocks and accretions of their carrying amounts cause income applicable to common stock to be less than reported net income.

Question 2: In ASR 280, the Commission stated that although it had determined not to mandate presentation of income or loss applicable to common stock in all cases, it believes that disclosure of that amount is of value in certain situations. In what situations should the amount be reported, where should it be reported, and how should it be computed?

Interpretive Response: Income or loss applicable to common stock should be reported on the face of the income statement\(^\text{FN1}\) when it is materially different in quantitative terms from reported net income or loss\(^\text{FN2}\) or when it is indicative of significant trends or other qualitative considerations. The amount to be reported should be computed for each period as net income or loss less: (a) dividends on preferred stock, including undeclared or unpaid dividends if cumulative; and (b) periodic increases in the carrying amounts of instruments reported as redeemable preferred stock (as discussed in Topic 3.C) or increasing rate preferred stock (as discussed in Topic 5.Q).

\(^\text{FN1}\) When a registrant reports net income and total comprehensive income in one continuous financial statement, the registrant must continue to follow the guidance set forth in the SAB Topic. One approach may be to provide a separate reconciliation of net income to income available to common stock below comprehensive income reported on a statement of income and comprehensive income.

\(^\text{FN2}\) The assessment of materiality is the responsibility of each registrant. However, absent concerns about trends or other qualitative considerations, the staff generally will not insist on the reporting of income or loss applicable to common stock if the amount differs from net income or loss by less than ten percent.

Regulation S-X, Rule 5-02.27(b), requires an issuer to provide the following information related to instruments classified as temporary equity on the face of the balance sheet:

- The title of the issue.
- The carrying amount.
- The redemption amount.
If there is more than one issuance, the entity must present the above information for each issuance either on the face of the balance sheet or in the related notes and must provide aggregate amounts on the face of the balance sheet. The issuer should also provide:

- The dollar amount of any shares subscribed but unissued.
- The deduction of subscriptions receivable therefrom.

Rule 5-02.27(c) and ASC 480-10-S99-3A(24) require an issuer to provide the following information about instruments classified as temporary equity in a separate note:

- A “general description of each issue, including its redemption features (e.g. sinking fund, at option of holders, out of future earnings) and the rights, if any, of holders in the event of default, including the effect, if any, on junior securities in the event a required dividend, sinking fund, or other redemption payment(s) is not made.”
- Five-year maturity data; that is, “the combined aggregate amount of redemption requirements for all issues each year for the five years following the date of the latest balance sheet.” The purpose of this guidance is to require “clear and prominent disclosure of the future cash obligations attendant with these types of securities” (CFRP 211.04). (Similar five-year data must be disclosed under ASC 505-10-50-11 by both SEC registrants and nonregistrants for redeemable stock that is redeemable at fixed or determinable prices on fixed or determinable dates.)
- The “changes in each issue for each period for which an income statement is required to be filed.”
- “A description of the accounting method used to adjust the redemption amount”, i.e., the subsequent measurement method (see Section 9.5.2). (Similarly, Rule 5-02.27(b) requires disclosure of the accounting treatment for any difference between the carrying value and the redemption amount.)
- “When a registrant elects to accrete changes in the redemption amount of a redeemable equity instrument [that is not currently redeemable; see Sections 9.5.2 and 9.5.3], the redemption amount of the equity instrument as if it were currently redeemable” (i.e., the current redemption value).
- “For a redeemable equity instrument that is not adjusted to its redemption amount [because it is not probable that it will become redeemable; see Sections 9.5.2 and 9.5.4], the reasons why it is not probable that the instrument will become redeemable.”
- When charges or credits related to preferred stock instruments (including noncontrolling interests in the form of preferred stock) are material, “a reconciliation between net income and income available to common stockholders.”
- “The amount credited to equity of the parent upon the deconsolidation of a subsidiary” (see Section 9.7.5).

When changes in the carrying amount of instruments presented as temporary equity cause income or loss applicable to common stock to be materially different from reported net income or loss, SAB Topic 6.B requires separate disclosure of income or loss applicable to common stock on the face of the income statement.

An issuer (including a nonpublic entity that is not required to apply the SEC’s temporary-equity guidance) should also consider the general disclosure requirements related to stockholders’ equity and specific outstanding securities issued by an entity under ASC 505-10-50. For instance, ASC 505-10-50-11 requires disclosure of “the amount of redemption requirements, separately by issue or combined, for
all issues of capital stock that are redeemable at fixed or determinable prices on fixed or determinable dates in each of the five years following the date of the latest statement of financial position presented."

An entity is not required to provide fair value measurement disclosures under ASC 825-10 for items classified in temporary equity, because instruments classified in temporary equity qualify under the scope exception in ASC 825-10-50-8(i) for items classified in stockholders’ equity. (ASC 815-10-15-76 notes that “[t]emporary equity is considered stockholders’ equity . . . even if it is required to be displayed outside of the permanent equity section.”)

If an issuer is required or elects to present financial information (such as ratios, tables, charts, and graphic illustrations) that includes amounts of stockholders’ equity, it should “explain the basis of calculation” (CFRP 211.06). “If material amounts of [temporary-equity classified] redeemable preferred stock are combined with amounts applicable to non-redeemable preferred and common stocks,” similar information should be provided that “excludes amounts applicable to redeemable preferred stock from equity.”
Chapter 10 — Comparison to IFRS Standards

10.1 Background

10.1.1 Circumstances in Which an Understanding of IFRS Standards May Be Relevant

An understanding of the differences between U.S. GAAP and IFRS Standards in the accounting for outstanding shares and other financial instruments within the scope of ASC 480-10 may be relevant for:

- U.S. entities that consolidate subsidiaries or other foreign operations that report under IFRS Standards.
- U.S. entities that provide financial statement information to a parent entity that reports under IFRS Standards.
- U.S. entities that negotiate transaction terms with entities that report under IFRS Standards (and vice versa).
- Entities that seek to compare their financial statements with those of international competitors.
- Foreign entities that report under IFRS Standards and consolidate subsidiaries or other operations that report under U.S. GAAP.
- Foreign entities that report under IFRS Standards and provide financial statement information to a parent entity that reports under U.S. GAAP.
- Investors and other users of financial statements that seek to compare financial statements prepared under U.S. GAAP and IFRS Standards.
- Standard setters and others that consider opportunities to converge accounting requirements.
- Parties that participate in discussions on or seek to influence the development of new accounting requirements under U.S. GAAP or IFRS Standards.

10.1.2 IFRS Guidance

Under IFRS Standards, an issuer applies IAS 32 to determine whether outstanding shares and other financial instruments should be classified as liabilities (or, in some circumstances, assets) or equity or be separated into liability and equity components. IAS 32 has a broader scope than does ASC 480-10. For example, IAS 32 addresses the accounting for convertible debt instruments, contracts on the entity’s own equity that do not embody obligations of the issuer (e.g., purchased put or call options on the entity’s own equity), and contracts that embody obligations to transfer a fixed number of the issuer’s equity shares but do not require the issuer to transfer assets or a variable number of equity shares (e.g., written call options, warrants, and forward sale contracts on the entity’s own equity). The discussion of key differences below applies only to contracts within the scope of ASC 480-10.
See Chapter 8 of Deloitte’s *A Roadmap to Accounting for Contracts on an Entity’s Own Equity* for a discussion of key differences between U.S. GAAP and IFRS Standards related to contracts on an entity’s own equity that are within the scope of ASC 815-40.

### 10.1.3 Key Differences

The table below summarizes key differences between U.S. GAAP and IFRS Standards in the accounting for outstanding equity shares and other financial instruments that are within the scope of ASC 480-10 (including the SEC’s temporary-equity guidance in ASC 480-10-3A). The table is followed by a detailed explanation of each difference.

<table>
<thead>
<tr>
<th></th>
<th><strong>U.S. GAAP</strong></th>
<th><strong>IFRS Standards</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Redeemable equity securities</strong></td>
<td>Financial instruments in the form of shares that embody an obligation to transfer assets are classified as liabilities only if the obligation is unconditional and the transfer of assets is therefore certain to occur. SEC registrants present equity-classified instruments that embody a conditional obligation to transfer assets as temporary equity.</td>
<td>Financial instruments in the form of shares that embody an obligation to transfer assets are classified as liabilities irrespective of whether the obligation is unconditional or conditional, with certain exceptions.</td>
</tr>
<tr>
<td><strong>Obligations to repurchase shares</strong></td>
<td>Physically settled forward-purchase contracts that embody an obligation to repurchase the issuer’s equity shares for cash are accounted for at either the present value of the redemption amount or the settlement value. Other physically settled contracts that embody an obligation to repurchase the issuer’s equity shares by transferring assets (e.g., a physically settled written put option or a forward purchase contract that provides the counterparty with a right to require either physical or net settlement) are accounted for at fair value.</td>
<td>Contracts that embody an obligation to repurchase the issuer’s equity shares by transferring assets are accounted for at the present value of the redemption amount if the issuer could be required to physically settle the contract by transferring assets in exchange for shares (e.g., a forward purchase or written put option contract that gives the counterparty the right to require either physical or net settlement).</td>
</tr>
<tr>
<td><strong>Obligations to issue a variable number of equity shares</strong></td>
<td>A financial instrument that embodies an unconditional obligation, or a financial instrument other than an outstanding share that embodies a conditional obligation, that the issuer must or may settle by delivering a variable number of equity shares is classified as an asset or a liability if, at inception, the obligation’s monetary value is based either solely or predominantly on a fixed monetary amount, variations in something other than the fair value of the issuer’s equity shares, or variations inversely related to changes in the fair value of the issuer’s equity shares.</td>
<td>Contracts that will be settled in a variable number of shares are accounted for as assets or liabilities.</td>
</tr>
</tbody>
</table>
10.2 Redeemable Equity Securities

Both U.S. GAAP and IFRS Standards require financial instruments issued in the legal form of shares that embody an unconditional obligation that requires the issuer to redeem the instrument by transferring its assets at a specified or determinable date (or dates) or upon an event that is certain to occur to be accounted for as liabilities (see Section 4.1 and paragraph 16 of IAS 32).

Under U.S. GAAP, financial instruments issued in the form of shares that embody a conditional obligation that could require the issuer to redeem the instrument generally are classified as equity because they are outside the scope of the liability classification guidance in ASC 480-10. The definition of mandatorily redeemable financial instruments (which must be classified as financial liabilities) in ASC 480-10-20 is limited to unconditional obligations. Therefore, outstanding shares that could be redeemed at the option of the holder, or upon some contingent event that is outside the control of the issuer and the holder, generally are not classified as financial liabilities under ASC 480-10. Under U.S. GAAP, mandatorily redeemable equity securities that are not certain to be redeemed (e.g., those containing an equity conversion option that permits the securities to be converted into nonredeemable equity securities before the mandatory redemption date) are also classified as equity. If redemption becomes certain to occur, the securities would be reclassified, and accounted for, as a liability. ASC 480-10-S99-3A indicates that when an equity instrument has a redemption feature that is not solely within the control of the issuer and the holder, an SEC registrant is required to present the instrument on the balance sheet between permanent equity and liabilities in a section labeled “temporary equity” or “mezzanine equity” (see Chapter 9).

Under IFRS Standards, an instrument should be accounted for as a liability if it gives the holder the right to put the instrument back to the issuer for cash or another financial asset (e.g., redeemable preferred shares) or is automatically put back to the issuer upon the occurrence of an uncertain future event (e.g., contingently mandatorily redeemable shares). Accordingly, there is no concept of “temporary equity” under IFRS Standards. Paragraph 18(b) of IAS 32 notes that the conditional redemption obligation creates a contractual obligation for the issuer to deliver cash or another financial asset. Paragraph 19(b) of IAS 32 states that the fact that a contractual obligation is conditional upon the holder’s exercising its right to require redemption does not negate the existence of a financial liability since the issuer “does not have the unconditional right to avoid delivering cash or another financial asset.”

Paragraph B79 of the Background Information and Basis for Conclusions of FASB Statement 150 notes:

IAS 32 requires the same accounting for conditionally redeemable instruments as for mandatorily redeemable instruments. [ASC 480-10] does not go that far. The Board acknowledges that the conditional obligation embedded in such shares may, if accounted for separately, meet the definition of a liability; however, the accounting for such compound instruments is beyond the scope of [ASC 480-10].

Under IAS 32, the issuer is exempt, in limited circumstances, from the liability classification requirement for puttable financial instruments. Specifically, IAS 32 requires that puttable instruments be presented as equity if the following four criteria are met:

1. The holder is entitled “to a pro rata share of the entity’s net assets [at] liquidation.”
2. “The instrument is in the class of instruments that is [the most] subordinate” and all instruments in that class are identical.
3. The instrument has no other characteristics that would meet the definition of a financial liability.
4. “The total expected cash flows attributable to the instrument over the life of the instrument are based substantially on the profit or loss, the change in the recognised net assets or the change in the fair value of the recognised and unrecognised net assets of the entity.”
Under IFRS Standards, instruments, or components of instruments, that obligate the entity to deliver a pro rata share of the net assets of the entity only on liquidation should be presented as equity if they meet criteria (1) and (2) above. See paragraphs 16A through 16D of IAS 32 for additional information.

### 10.3 Obligations to Repurchase Shares

#### 10.3.1 Forward Purchase Contracts on an Entity’s Own Equity

Under U.S. GAAP, a forward purchase contract on an entity’s own shares that is within the scope of ASC 480-10 is classified as a liability. If the forward contract requires physical settlement by repurchase of a fixed number of shares for cash, the contract is measured at the present value of the amount to be paid at settlement or settlement value (see Section 5.3.1). If the forward contract will be net share settled or net cash settled (or either party has the ability to elect net-cash or net-share settlement), however, the contract is accounted for at fair value, with changes in fair value recognized in earnings (see Sections 5.3.2 and 6.3).

Under IFRS Standards, paragraph 23 of IAS 32 requires a physically settled forward-purchase contract on an entity’s own shares to be accounted for as a liability at the present value of the redemption amount. This treatment applies if the issuer could be required to settle the contract by a gross exchange of cash for shares even if the holder has the right to elect net-cash or net-share settlement (i.e., it applies when the holder has the choice of settling the contract gross by the exchange of either cash or another financial asset for shares). This guidance differs from that in ASC 480-10, under which fair value accounting is required when an ASC 480-10 liability may be net share settled or net cash settled.

Paragraph B80 of the Background Information and Basis for Conclusions of FASB Statement 150 states, in part:

> The difference between IAS 32 . . . and this Statement is that IAS 32 would define the class of instruments to be measured at the present value of the redemption amount more broadly. The Board views physically settled forward purchase contracts of an entity’s own shares in exchange for cash as being similar to financing a stock purchase or a treasury stock transaction and, therefore, would require the recognition of a liability for the future sacrifice of assets, but that view holds only if the obligation to purchase is unconditional and requires physical settlement in exchange for cash.

#### 10.3.2 Written Put Options on an Entity’s Own Equity

Under U.S. GAAP, a written put option on an entity’s own shares is accounted for as a liability at fair value, with changes in fair value recognized in earnings (see Sections 5.3.1 and 6.3).

Under IFRS Standards, paragraph 23 of IAS 32 requires a physically settled written put option on an entity’s own shares to be accounted for in a manner similar to a physically settled forward-purchase contract on the entity’s own equity (see Section 10.3.1); that is, as a liability at the present value of the redemption amount. This treatment applies if the issuer could be required to settle the contract by a gross exchange of cash for shares even if the holder has the right to elect net-cash or net-share settlement (i.e., it applies when the holder has the choice of settling the contract gross by the exchange of either cash or another financial asset for shares).

Paragraph B80 of the Background Information and Basis for Conclusions of FASB Statement 150 states, in part:

> The difference between IAS 32 . . . and this Statement is that IAS 32 would define the class of instruments to be measured at the present value of the redemption amount more broadly.
10.4 Obligations to Issue a Variable Number of Equity Shares

Under U.S. GAAP, a financial instrument that embodies an unconditional obligation, or a financial instrument other than an outstanding share that embodies a conditional obligation, that the issuer must or may settle by delivering a variable number of equity shares is classified as an asset or a liability if, at inception, the obligation’s monetary value is based either solely or predominantly on a fixed monetary amount, variations in something other than the fair value of the issuer’s equity shares, or variations inversely related to changes in the fair value of the issuer’s equity shares (see Section 6.1). Obligations to issue a variable number of shares that do not meet the above conditions are typically accounted for as equity under U.S. GAAP.

Under IFRS Standards, paragraphs 21 and AG27(d) of IAS 32 require contracts that will be settled in a variable number of shares to be accounted for as assets or liabilities.

Paragraph B81 of the Background Information and Basis for Conclusions of FASB Statement 150 states, in part:

IAS 32 would require a liability to be recognized if an entity has a fixed monetary obligation or one that fluctuates in part or in full in response to changes in a variable other than the issuer's own shares that can be settled with a number of shares that equals that obligation. [That guidance is] consistent with this [ASC 480-10] except for instruments with monetary values that fluctuate in part based on something other than changes in the fair value of the issuer's shares and that are settled with a variable number of the issuer's equity shares. [ASC 480-10] excludes from its scope share-settled “dual-indexed” financial instruments that are indexed (or have fair values that fluctuate) in part based on changes in the fair value of the issuer's shares and in part based on one or more additional underlyings. . . . The Board notes that the accounting required for dual-indexed financial instruments that are within the scope of [ASC 815] is consistent with the accounting under . . . IAS 32.
Appendix A — Overview of Classification Requirements in ASC 480-10

A.1 Outstanding Shares

ASC 480-10 requires liability classification for outstanding shares that fall into one of the following two categories of instruments:

- Mandatorily redeemable financial instruments; that is, “shares that embody an unconditional obligation requiring the issuer to redeem the instrument by transferring its assets at a specified or determinable date (or dates) or upon an event that is certain to occur” (ASC 480-10-25-4 through 25-7; see Chapter 4).

- Shares that embody an unconditional obligation that the issuer must or may settle in a variable number of equity shares if at inception the monetary value is solely or predominantly (1) a fixed monetary amount, (2) based on variations in something other than the fair value of the issuer’s equity shares, or (3) based on variations inversely related to changes in the fair value of the issuer’s equity shares (ASC 480-10-25-14; see Chapter 6).

A.2 Financial Instruments Other Than Outstanding Shares

ASC 480-10 requires asset or liability classification for financial instruments other than outstanding shares if they fall into one of the following two categories of instruments:

- Instruments that both (1) embody an obligation to repurchase the issuer’s equity shares or are indexed to such an obligation and (2) require or may require the issuer to settle the obligation by transferring assets (ASC 480-10-25-8 through 25-13; see Chapter 5).

- Instruments that embody an unconditional or conditional obligation that the issuer must or may settle in a variable number of equity shares if at inception the monetary value is solely or predominantly (1) a fixed monetary amount, (2) based on variations in something other than the fair value of the issuer’s equity shares, or (3) based on variations inversely related to changes in the fair value of the issuer’s equity shares (ASC 480-10-25-14; see Chapter 6).
### Appendix B — Legacy FASB Guidance Codified in ASC 480-10

<table>
<thead>
<tr>
<th>Legacy Guidance</th>
<th>Title</th>
<th>Roadmap Discussion</th>
</tr>
</thead>
<tbody>
<tr>
<td>FASB Statement 150</td>
<td>Accounting for Certain Financial Instruments With Characteristics of Both Liabilities and Equity</td>
<td>All</td>
</tr>
<tr>
<td>FASB Staff Position FAS 150-1</td>
<td>Issuer's Accounting for Freestanding Financial Instruments Composed of More Than One Option or Forward Contract Embodying Obligations Under FASB Statement No. 150</td>
<td>Sections 5.2.1.2, 5.2.4, 6.2.4, and 6.2.5.2</td>
</tr>
<tr>
<td>FASB Staff Position FAS 150-2</td>
<td>Accounting for Mandatorily Redeemable Shares Requiring Redemption by Payment of an Amount That Differs From the Book Value of Those Shares Under FASB Statement No. 150</td>
<td>Sections 4.3.2 and 8.3.2</td>
</tr>
<tr>
<td>FASB Staff Position FAS 150-3</td>
<td>Effective Date, Disclosures, and Transition for Mandatorily Redeemable Financial Instruments of Certain Nonpublic Entities and Certain Mandatorily Redeemable Noncontrolling Interests Under FASB Statement No. 150</td>
<td>Sections 4.1.5.3 and 4.1.5.4</td>
</tr>
<tr>
<td>FASB Staff Position FAS 150-4</td>
<td>Issuers' Accounting for Employee Stock Ownership Plans Under FASB Statement No. 150</td>
<td>Section 2.4</td>
</tr>
<tr>
<td>FASB Staff Position FAS 150-5</td>
<td>Issuer's Accounting Under FASB Statement No. 150 for Freestanding Warrants and Other Similar Instruments on Shares That Are Redeemable</td>
<td>Section 5.1.1 and 5.2.1</td>
</tr>
<tr>
<td>EITF Issue 00-4</td>
<td>Majority Owner’s Accounting for a Transaction in the Shares of a Consolidated Subsidiary and a Derivative Indexed to the Noncontrolling Interest in that Subsidiary</td>
<td>Section 7.1</td>
</tr>
</tbody>
</table>
Appendix C — Sources of SEC Guidance on Temporary Equity

The table below lists the main sources of the SEC’s temporary-equity guidance, most of which is reproduced in the SEC sections of the FASB Codification. See Appendix E for a list of the titles of other standards and literature referred to in this Roadmap.

<table>
<thead>
<tr>
<th>Title</th>
<th>SEC Reference or Type of Literature</th>
<th>FASB ASC Reference</th>
<th>Notes</th>
</tr>
</thead>
<tbody>
<tr>
<td>Commercial and Industrial Companies, Balance Sheets, Preferred Stocks Subject to Mandatory Redemption Requirements or Whose Redemption is Outside the Control of the Issuer</td>
<td>Rule 5-02.27 (also 17 CFR § 210.5-02.27)</td>
<td>ASC 210-10-S99-1(27)</td>
<td></td>
</tr>
<tr>
<td>Bank Holding Companies, Balance Sheets, Preferred Stocks Subject to Mandatory Redemption Requirements or Whose Redemption is Outside the Control of the Issuer</td>
<td>Rule 9-03.18 (also 17 CFR § 210.9-03.18)</td>
<td>ASC 942-210-S99-1(18)</td>
<td>Refers to 17 CFR § 210.5-02.27 for guidance</td>
</tr>
<tr>
<td>Insurance Companies, Balance Sheets, Preferred Stocks Subject to Mandatory Redemption Requirements or Whose Redemption is Outside the Control of the Issuer</td>
<td>Rule 7-03.20 (also 17 CFR § 210.7-03.20)</td>
<td>ASC 944-210-S99-1(20)</td>
<td>States that 17 CFR § 210.5-02.27 must be followed</td>
</tr>
<tr>
<td>Presentation in Financial Statements of &quot;Redeemable Preferred Stocks&quot;</td>
<td>ASR 268</td>
<td></td>
<td>Most of ASR 268 has been incorporated into CFRP 211</td>
</tr>
<tr>
<td>Redeemable Preferred Stocks</td>
<td>CFRP 211 (also CFRR 211 or FRR 211)</td>
<td>ASC 480-10-S99-1</td>
<td></td>
</tr>
<tr>
<td>Redeemable Preferred Stock</td>
<td>SAB Topic 3.C</td>
<td>ASC 480-10-S99-2</td>
<td></td>
</tr>
<tr>
<td>Title</td>
<td>SEC Reference or Type of Literature</td>
<td>FASB ASC Reference</td>
<td>Notes</td>
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<tr>
<td>---------------------------------------------------------------------</td>
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<td>------------------------------</td>
</tr>
<tr>
<td>Classification and Measurement of Redeemable Securities</td>
<td>SEC Staff Announcement</td>
<td>ASC 480-10-S99-3A</td>
<td>Previously EITF Topic D-98</td>
</tr>
<tr>
<td>Sponsor’s Balance Sheet Classification of Capital Stock With a Put Option Held by an Employee Stock Ownership Plan</td>
<td>SEC Observer Comment</td>
<td>ASC 480-10-S99-4</td>
<td>Previously EITF Issue 89-11</td>
</tr>
</tbody>
</table>
Appendix D — Glossary of Selected Terms

Selected glossary terms in ASC 480-10-20 and the ASC master glossary are reproduced below.

### ASC 480-10 and ASC Master Glossary

<table>
<thead>
<tr>
<th><strong>Employee Stock Ownership Plan</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>An employee stock ownership plan is an employee benefit plan that is described by the Employee Retirement Income Security Act of 1974 and the Internal Revenue Code of 1986 as a stock bonus plan, or combination stock bonus and money purchase pension plan, designed to invest primarily in employer stock. Also called an employee share ownership plan.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th><strong>Equity Shares</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity shares refers only to shares that are accounted for as equity.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th><strong>Fair Value</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th><strong>Financial Instrument</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash, evidence of an ownership interest in an entity, or a contract that both:</td>
</tr>
<tr>
<td>a. Imposes on one entity a contractual obligation either:</td>
</tr>
<tr>
<td>1. To deliver cash or another financial instrument to a second entity</td>
</tr>
<tr>
<td>2. To exchange other financial instruments on potentially unfavorable terms with the second entity.</td>
</tr>
<tr>
<td>b. Conveys to that second entity a contractual right either:</td>
</tr>
<tr>
<td>1. To receive cash or another financial instrument from the first entity</td>
</tr>
<tr>
<td>2. To exchange other financial instruments on potentially favorable terms with the first entity.</td>
</tr>
<tr>
<td>The use of the term financial instrument in this definition is recursive (because the term financial instrument is included in it), though it is not circular. The definition requires a chain of contractual obligations that ends with the delivery of cash or an ownership interest in an entity. Any number of obligations to deliver financial instruments can be links in a chain that qualifies a particular contract as a financial instrument.</td>
</tr>
<tr>
<td>Contractual rights and contractual obligations encompass both those that are conditioned on the occurrence of a specified event and those that are not. All contractual rights (contractual obligations) that are financial instruments meet the definition of asset (liability) set forth in FASB Concepts Statement No. 6, Elements of Financial Statements, although some may not be recognized as assets (liabilities) in financial statements — that is, they may be off-balance-sheet — because they fail to meet some other criterion for recognition.</td>
</tr>
<tr>
<td>For some financial instruments, the right is held by or the obligation is due from (or the obligation is owed to or by) a group of entities rather than a single entity.</td>
</tr>
</tbody>
</table>
Freestanding Financial Instrument
A financial instrument that meets either of the following conditions:

a. It is entered into separately and apart from any of the entity's other financial instruments or equity transactions.

b. It is entered into in conjunction with some other transaction and is legally detachable and separately exercisable.

Issuer
The entity that issued a financial instrument or may be required under the terms of a financial instrument to issue its equity shares.

Issuer's Equity Shares
The equity shares of any entity whose financial statements are included in the consolidated financial statements.

Mandatorily Redeemable Financial Instrument
Any of various financial instruments issued in the form of shares that embody an unconditional obligation requiring the issuer to redeem the instrument by transferring its assets at a specified or determinable date (or dates) or upon an event that is certain to occur.

Market Participants
Buyers and sellers in the principal (or most advantageous) market for the asset or liability that have all of the following characteristics:

a. They are independent of each other, that is, they are not related parties, although the price in a related-party transaction may be used as an input to a fair value measurement if the reporting entity has evidence that the transaction was entered into at market terms.

b. They are knowledgeable, having a reasonable understanding about the asset or liability and the transaction using all available information, including information that might be obtained through due diligence efforts that are usual and customary.

c. They are able to enter into a transaction for the asset or liability.

d. They are willing to enter into a transaction for the asset or liability, that is, they are motivated but not forced or otherwise compelled to do so.

Monetary Value
What the fair value of the cash, shares, or other instruments that a financial instrument obligates the issuer to convey to the holder would be at the settlement date under specified market conditions.

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

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

Noncontrolling Interest
The portion of equity (net assets) in a subsidiary not attributable, directly or indirectly, to a parent. A noncontrolling interest is sometimes called a minority interest.

Obligation
A conditional or unconditional duty or responsibility to transfer assets or to issue equity shares. Because Topic 480 relates only to financial instruments and not to contracts to provide services and other types of contracts, but includes duties or responsibilities to issue equity shares, this definition of obligation differs from the definition found in FASB Concepts Statement No. 6, Elements of Financial Statements, and is applicable only for items in the scope of that Topic.
ASC 480-10 and ASC Master Glossary (continued)

**Orderly Transaction**
A transaction that assumes exposure to the market for a period before the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets or liabilities; it is not a forced transaction (for example, a forced liquidation or distress sale).

**Parent**
An entity that has a controlling financial interest in one or more subsidiaries. (Also, an entity that is the primary beneficiary of a variable interest entity.)

**Physical Settlement [Definition 2]**
A form of settling a financial instrument under which both of the following conditions are met:

- a. The party designated in the contract as the buyer delivers the full stated amount of cash or other financial instruments to the seller.
- b. The seller delivers the full stated number of shares of stock or other financial instruments or nonfinancial instruments to the buyer.

**Registration Payment Arrangement**
An arrangement with both of the following characteristics:

- a. It specifies that the issuer will endeavor to do either of the following:
  
  1. File a registration statement for the resale of specified financial instruments and/or for the resale of equity shares that are issuable upon exercise or conversion of specified financial instruments and for that registration statement to be declared effective by the U.S. Securities and Exchange Commission (SEC) (or other applicable securities regulator if the registration statement will be filed in a foreign jurisdiction) within a specified grace period
  
  2. Maintain the effectiveness of the registration statement for a specified period of time (or in perpetuity).

- b. It requires the issuer to transfer consideration to the counterparty if the registration statement for the resale of the financial instrument or instruments subject to the arrangement is not declared effective or if effectiveness of the registration statement is not maintained. That consideration may be payable in a lump sum or it may be payable periodically, and the form of the consideration may vary. For example, the consideration may be in the form of cash, equity instruments, or adjustments to the terms of the financial instrument or instruments that are subject to the registration payment arrangement (such as an increased interest rate on a debt instrument).

**Related Parties**
Related parties include:

- a. Affiliates of the entity
- b. Entities for which investments in their equity securities would be required, absent the election of the fair value option under the Fair Value Option Subsection of Section 825-10-15, to be accounted for by the equity method by the investing entity
- c. Trusts for the benefit of employees, such as pension and profit-sharing trusts that are managed by or under the trusteeship of management
- d. Principal owners of the entity and members of their immediate families
- e. Management of the entity and members of their immediate families
- f. Other parties with which the entity may deal if one party controls or can significantly influence the management or operating policies of the other to an extent that one of the transacting parties might be prevented from fully pursuing its own separate interests
- g. Other parties that can significantly influence the management or operating policies of the transacting parties or that have an ownership interest in one of the transacting parties and can significantly influence the other to an extent that one or more of the transacting parties might be prevented from fully pursuing its own separate interests.
Appendix D — Glossary of Selected Terms

ASC 480-10 and ASC Master Glossary (continued)

**Securities and Exchange Commission Registrant**
An entity (or an entity that is controlled by an entity) that meets any of the following criteria:

- a. It has issued or will issue debt or equity securities that are traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local or regional markets).
- b. It is required to file financial statements with the Securities and Exchange Commission (SEC).
- c. It provides financial statements for the purpose of issuing any class of securities in a public market.

**Share-Based Payment Arrangements**
An arrangement under which either of the following conditions is met:

- a. One or more suppliers of goods or services (including employees) receive awards of equity shares, equity share options, or other equity instruments.
- b. The entity incurs liabilities to suppliers that meet either of the following conditions:
  1. The amounts are based, at least in part, on the price of the entity's shares or other equity instruments. (The phrase at least in part is used because an award may be indexed to both the price of the entity's shares and something other than either the price of the entity's shares or a market, performance, or service condition.)
  2. The awards require or may require settlement by issuance of the entity's shares.

The term shares includes various forms of ownership interest that may not take the legal form of securities (for example, partnership interests), as well as other interests, including those that are liabilities in substance but not in form. Equity shares refers only to shares that are accounted for as equity.

Also called share-based compensation arrangements.

**Shares**
Shares includes various forms of ownership that may not take the legal form of securities (for example, partnership interests), as well as other interests, including those that are liabilities in substance but not in form. (Business entities have interest holders that are commonly known by specialized names, such as stockholders, partners, and proprietors, and by more general names, such as investors, but all are encompassed by the descriptive term owners. Equity of business entities is, thus, commonly known by several names, such as owners’ equity, stockholders’ equity, ownership, equity capital, partners’ capital, and proprietorship. Some entities [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.)

**Subsidiary**
An entity, including an unincorporated entity such as a partnership or trust, in which another entity, known as its parent, holds a controlling financial interest. (Also, a variable interest entity that is consolidated by a primary beneficiary.)

**Transfer**
The term transfer is used in a broad sense consistent with its use in FASB Concepts Statement No. 6, Elements of Financial Statements (such as in paragraph 137), rather than in the narrow sense in which it is used in Subtopic 860-10.

**Variable-Rate Forward Contracts**
Variable-rate forward contracts are commonly used to effect equity forward transactions. The contract price on those forward contracts is not fixed at inception but varies based on changes in a specified index (for example, three-month U.S. London Interbank Offered Rate [LIBOR]) during the life of the contract.
Appendix E — Titles of Standards and Other Literature

The following are the titles of standards and other literature mentioned in this publication other than the SEC’s principal guidance on the presentation of temporary equity, which is listed in Appendix C:

**AICPA Literature**

**Audit and Accounting Guide**
*Depository and Lending Institutions: Banks and Savings Institutions, Credit Unions, Finance Companies, and Mortgage Companies*

**Technical Questions and Answers**
Section 4110, “Issuance of Capital Stock”

**FASB Literature**

**ASC Topics**
*ASC 105, Generally Accepted Accounting Principles*
*ASC 205, Presentation of Financial Statements*
*ASC 210, Balance Sheet*
*ASC 225, Income Statement*
*ASC 250, Accounting Changes and Error Corrections*
*ASC 260, Earnings per Share*
*ASC 310, Receivables*
*ASC 320, Investments — Debt and Equity Securities*
*ASC 321, Investments — Equity Securities*
*ASC 323, Investments — Equity Method and Joint Ventures*
*ASC 325, Investment — Other*
*ASC 340, Other Assets and Deferred Costs*
*ASC 450, Contingencies*
*ASC 460, Guarantees*
*ASC 470, Debt*
ASC 480, Distinguishing Liabilities From Equity
ASC 505, Equity
ASC 606, Revenue From Contracts With Customers
ASC 718, Compensation — Stock Compensation
ASC 740, Income Taxes
ASC 805, Business Combinations
ASC 810, Consolidation
ASC 815, Derivatives and Hedging
ASC 820, Fair Value Measurement
ASC 825, Financial Instruments
ASC 830, Foreign Currency Matters
ASC 835, Interest
ASC 855, Subsequent Events
ASC 860, Transfers and Servicing
ASC 942, Financial Services — Depository and Lending
ASC 944, Financial Services — Insurance
ASC 946, Financial Services — Investment Companies

**ASUs**

ASU 2009-04, Accounting for Redeemable Equity Instruments — Amendment to Section 480-10-599

ASU 2015-03, Interest — Imputation of Interest (Subtopic 835-30): Simplifying the Presentation of Debt Issuance Costs

ASU 2016-19, Technical Corrections and Improvements

ASU 2017-11, Earnings per Share (Topic 260); Distinguishing Liabilities From Equity (Topic 480); Derivatives and Hedging (Topic 815): Accounting for Certain Financial Instruments With Down Round Features; Replacement of the Indefinite Deferral for Mandatorily Redeemable Financial Instruments of Certain Nonpublic Entities and Certain Mandatorily Redeemable Noncontrolling Interests With a Scope Exception

ASU 2018-07, Compensation — Stock Compensation (Topic 718): Improvements to Nonemployee Share-Based Payment Accounting

ASU 2018-09, Codification Improvements

**Concepts Statement**

No. 6, Elements of Financial Statements

**International Standard**

IAS 32, Financial Instruments: Presentation
**SEC Literature**

**ASRs**
No. 268 (FRR Section 211), *Redeemable Preferred Stocks*
No. 280 (FRR Section 44), *General Revision of Regulation S-X*

**Exchange Act of 1934 Rule**
Rule 14a-3, “Information to Be Furnished to Security Holders”

**Final Rule**
No. 33-10532, *Disclosure Update and Simplification*

**Other Literature**
*The Division of Corporation Finance: Frequently Requested Accounting and Financial Reporting Interpretations and Guidance*

**Regulation S-X**
Rule 3-04, “Changes in Stockholders’ Equity and Noncontrolling Interests”
Rule 3-10, “Financial Statements of Guarantors and Issuers of Guaranteed Securities Registered or Being Registered”
Rule 5-02, “Balance Sheets”
(See Appendix C for additional references.)

**SAB Topics**
Topic 3.C, “Redeemable Preferred Stock”
Topic 4.E, “Receivables From Sale of Stock”
Topic 5.Q, “Increasing Rate Preferred Stock”
Superseded Literature

Derivatives Implementation Group Issue
No. F6, “Fair Value Hedges: Concurrent Offsetting Matching Swaps and Use of One as Hedging Instrument”

EITF Abstract
Topic D-98, “Classification and Measurement of Redeemable Securities”

EITF Issues
No. 89-11, “Sponsor’s Balance Sheet Classification of Capital Stock With a Put Option Held by an Employee Stock Ownership Plan”
No. 90-19, “Convertible Bonds With Issuer Option to Settle for Cash Upon Conversion”
No. 00-27, “Application of Issue No. 98-5 to Certain Convertible Instruments”
No. 02-2, “When Certain Contracts That Meet the Definition of Financial Instruments Should Be Combined for Accounting Purposes”
(See Appendix B for additional references.)

FASB Staff Positions
(See Appendix B.)

FASB Statements
(See Appendix B for additional references.)
## Appendix F — Abbreviations

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>AICPA</td>
<td>American Institute of Certified Public Accountants</td>
</tr>
<tr>
<td>APIC</td>
<td>additional paid-in capital</td>
</tr>
<tr>
<td>ASC</td>
<td>FASB Accounting Standards Codification</td>
</tr>
<tr>
<td>ASR</td>
<td>Accounting Series Release</td>
</tr>
<tr>
<td>ASU</td>
<td>FASB Accounting Standards Update</td>
</tr>
<tr>
<td>BCF</td>
<td>beneficial conversion feature</td>
</tr>
<tr>
<td>CAQ</td>
<td>Center for Audit Quality</td>
</tr>
<tr>
<td>CEO</td>
<td>chief executive officer</td>
</tr>
<tr>
<td>CFR</td>
<td>Code of Federal Regulations</td>
</tr>
<tr>
<td>CFRP</td>
<td>Codification of Financial Reporting Policies</td>
</tr>
<tr>
<td>CFRR</td>
<td>see CFRP</td>
</tr>
<tr>
<td>DECS</td>
<td>debt exchangeable for common stock</td>
</tr>
<tr>
<td>EBIT</td>
<td>earnings before interest and taxes</td>
</tr>
<tr>
<td>EBITDA</td>
<td>earnings before interest, taxes, depreciation, and amortization</td>
</tr>
<tr>
<td>EITF</td>
<td>Emerging Issues Task Force</td>
</tr>
<tr>
<td>EPS</td>
<td>earnings per share</td>
</tr>
<tr>
<td>ESOP</td>
<td>employee stock ownership plan</td>
</tr>
<tr>
<td>FASB</td>
<td>Financial Accounting Standards Board</td>
</tr>
<tr>
<td>FDA</td>
<td>Food and Drug Administration</td>
</tr>
<tr>
<td>FELINE</td>
<td>flexible equity-linked exchangeable</td>
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</table>

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>FRR</td>
<td>Financial Reporting Release</td>
</tr>
<tr>
<td>GAAP</td>
<td>generally accepted accounting principles</td>
</tr>
<tr>
<td>IAS</td>
<td>International Accounting Standard</td>
</tr>
<tr>
<td>IFRS</td>
<td>International Financial Reporting Standard</td>
</tr>
<tr>
<td>IPO</td>
<td>initial public offering</td>
</tr>
<tr>
<td>LIBOR</td>
<td>London Interbank Offered Rate</td>
</tr>
<tr>
<td>NAV</td>
<td>net asset value</td>
</tr>
<tr>
<td>PCAOB</td>
<td>Public Company Accounting Oversight Board</td>
</tr>
<tr>
<td>PEPS</td>
<td>premium exchangeable participating securities</td>
</tr>
<tr>
<td>PIK</td>
<td>paid in kind</td>
</tr>
<tr>
<td>PRIDES</td>
<td>preferred redeemable increased dividend equity securities</td>
</tr>
<tr>
<td>SAB</td>
<td>SEC Staff Accounting Bulletin</td>
</tr>
<tr>
<td>SBIC</td>
<td>small business investment company</td>
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<tr>
<td>SEC</td>
<td>Securities and Exchange Commission</td>
</tr>
<tr>
<td>S&amp;P 500</td>
<td>Standard &amp; Poor's 500 stock market index</td>
</tr>
<tr>
<td>VSF</td>
<td>variable-share forward</td>
</tr>
<tr>
<td>VWAP</td>
<td>volume-weighted average daily market price</td>
</tr>
<tr>
<td>ZCall</td>
<td>zero-strike call option</td>
</tr>
</tbody>
</table>
Appendix G — Changes Made in the 2019 Edition of This Publication

The tables below summarize the substantive changes made since the 2018 edition of this Roadmap as a result of FASB standard-setting activities, discussions regarding implementation matters with the FASB and SEC staffs, and other practice developments.

New Content
The following table describes the content that was added to the Roadmap:

<table>
<thead>
<tr>
<th>Sections (or Other Content) Added</th>
<th>Topic</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>3.3.3.5</td>
<td>Tranche preferred stock agreement</td>
<td>Illustrates the identification of units of account in a tranche preferred stock agreement</td>
</tr>
<tr>
<td>4.2.4</td>
<td>Preferred stock with CCF</td>
<td>Discusses the classification of convertible preferred stock with a CCF under ASC 480</td>
</tr>
<tr>
<td>5.2.5</td>
<td>Put warrants</td>
<td>Discusses the application of ASC 480 to put warrants</td>
</tr>
<tr>
<td>8.4.1</td>
<td>EPS for mandatorily redeemable financial instruments and physically settled forward contracts to repurchase common stock</td>
<td>Discusses the computation of EPS for mandatorily redeemable financial instruments and physically settled forward contracts to repurchase common stock</td>
</tr>
<tr>
<td>8.4.2</td>
<td>EPS for other forward purchase contracts and written put options on common stock</td>
<td>Discusses the computation of EPS for certain forward purchase contracts and written put options on common stock</td>
</tr>
<tr>
<td>8.4.3</td>
<td>EPS for certain variable-share obligations</td>
<td>Discusses the computation of EPS for certain variable-share obligations</td>
</tr>
<tr>
<td>9.5.2.6</td>
<td>Increasing-rate preferred stock</td>
<td>Discusses the accounting for increasing-rate redeemable preferred stock</td>
</tr>
<tr>
<td>9.5.5.1</td>
<td>PIK dividends</td>
<td>Discusses the accounting for redeemable stock that pays PIK dividends</td>
</tr>
<tr>
<td>Appendix B</td>
<td>Legacy FASB guidance codified in ASC 480-10</td>
<td>Identifies FASB legacy literature that was incorporated into ASC 480-10</td>
</tr>
</tbody>
</table>
## Amended Content

The following table describes the content that was amended in the Roadmap:

<table>
<thead>
<tr>
<th>Sections Amended</th>
<th>Topic</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>1, 2.2.4, 6.3</td>
<td>Share-settled debt</td>
<td>Updated to clarify that “share-settled debt” refers to share-settled obligations that are not in the legal form of debt but have the same economic payoff profile as debt</td>
</tr>
<tr>
<td>2.2.2</td>
<td>Financial instruments</td>
<td>Clarified that a hybrid financial instrument may contain an embedded nonfinancial feature</td>
</tr>
<tr>
<td>2.5</td>
<td>Preferred stock with CCF</td>
<td>Expanded discussion of the applicability of ASC 480-10 to preferred stock with CCFs</td>
</tr>
<tr>
<td>3.3.1</td>
<td>Concept of a “freestanding financial instrument”</td>
<td>Amended discussion related to whether items are considered “legally detachable”</td>
</tr>
<tr>
<td>3.3.2</td>
<td>Combination guidance</td>
<td>Expanded discussion of whether items should be combined</td>
</tr>
<tr>
<td>3.3.4</td>
<td>Allocation of proceeds and issuance costs</td>
<td>Expanded discussion of how an entity should allocate transaction proceeds and issuance costs among freestanding financial instruments</td>
</tr>
<tr>
<td>4.1.2</td>
<td>Legal form of a share</td>
<td>Expanded discussion of the definition of a share</td>
</tr>
<tr>
<td>4.1.5.3</td>
<td>Noncontrolling interest exception</td>
<td>Added discussion of subsidiaries that are not substantive entities, and removed discussion of trust-preferred securities</td>
</tr>
<tr>
<td>4.1.5.4</td>
<td>Exception for certain instruments of certain nonpublic entities</td>
<td>Added table to illustrate the application of ASC 480 to a mandatorily redeemable financial instrument issued by a nonpublic entity</td>
</tr>
<tr>
<td>4.2.3</td>
<td>Redemption requirement that is contingent on the issuer’s liquidity</td>
<td>Expanded discussion of the evaluation of redemption requirements that are contingent on available liquidity</td>
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<tr>
<td>4.3.1.4</td>
<td>Preferred stock with CCF</td>
<td>Expanded discussion of the accounting for convertible preferred stock with CCF</td>
</tr>
<tr>
<td>4.3.2, 8.3.2</td>
<td>FASB Maintenance Update 2018-12</td>
<td>Incorporated amendments to the Codification text made by FASB Maintenance Update 2018-12</td>
</tr>
<tr>
<td>4.4.2</td>
<td>Accounting for reclassifications</td>
<td>Made editorial clarifications and added example of the reclassification of preferred stock from equity to a liability</td>
</tr>
<tr>
<td>4.5</td>
<td>Equity-for-debt exchange</td>
<td>Amended guidance and example to exempt troubled-debt restructurings from scope</td>
</tr>
<tr>
<td>Sections Amended</td>
<td>Topic</td>
<td>Description</td>
</tr>
<tr>
<td>------------------</td>
<td>----------------------------------------------------------------------</td>
<td>-------------------------------------------------------------------------------------------------</td>
</tr>
<tr>
<td>5.1.3</td>
<td>An obligation to repurchase the issuer’s equity shares or one that is indexed to such an obligation</td>
<td>Expanded discussion of the application of ASC 480-10-25-8 to contracts on mandatorily redeemable financial instruments</td>
</tr>
<tr>
<td>5.2.1.1</td>
<td>Obligation to issue an instrument that embodies an obligation that requires or may require a transfer of assets: overview</td>
<td>Added commentary from FASB Staff Position FAS 150-5</td>
</tr>
<tr>
<td>6.2.5.1</td>
<td>Financial instruments with contingent obligation: outstanding shares</td>
<td>Expanded discussion of the application of ASC 480 to an outstanding share with multiple embedded obligations</td>
</tr>
<tr>
<td>9.3.4 and 9.5.6</td>
<td>Bifurcated embedded derivatives</td>
<td>Removed wording that implied that there is only one acceptable view for measurement</td>
</tr>
<tr>
<td>9.4.1</td>
<td>Characteristics that trigger temporary-equity classification</td>
<td>Noted that the SEC staff expects the temporary-equity criteria to be strictly and rigidly applied</td>
</tr>
<tr>
<td>9.4.2</td>
<td>Evaluation of whether an event is under the sole control of the issuer</td>
<td>Added examples of events that would or would not be considered within the issuer’s control</td>
</tr>
<tr>
<td>9.4.3</td>
<td>Redemption triggered by holder’s death or disability</td>
<td>Clarified that if an instrument becomes mandatorily redeemable upon the disability of the holder, it might need to be reclassified</td>
</tr>
<tr>
<td>9.4.4</td>
<td>Special considerations when the holder has the ability to control issuer decisions</td>
<td>Added discussion of how the existence of (1) fiduciary duties or (2) multiple classes of stock affect the assessment of whether a redeemable equity instrument should be classified as temporary equity</td>
</tr>
<tr>
<td>9.4.5.3</td>
<td>Deemed liquidation events</td>
<td>Expanded discussion of deemed liquidation provisions</td>
</tr>
<tr>
<td>9.4.6</td>
<td>Features that the issuer must or may settle in its equity shares</td>
<td>Added commentary from EITF 00-27</td>
</tr>
<tr>
<td>9.4.10</td>
<td>Classification of ESOP shares within temporary equity</td>
<td>Expanded discussion of the application of the temporary-equity guidance to ESOP shares</td>
</tr>
<tr>
<td>9.5.2.3</td>
<td>Accreted redemption value</td>
<td>Moved the discussion of increasing-rate preferred stock to Section 9.5.2.6</td>
</tr>
<tr>
<td>9.5.4.3</td>
<td>Holder option in instrument with mandatory conversion feature</td>
<td>Expanded text to reflect recent discussions with the SEC staff</td>
</tr>
<tr>
<td>9.5.5</td>
<td>Recognition of measurement changes and dividends</td>
<td>Added discussion of variable redemption terms</td>
</tr>
<tr>
<td>9.5.8</td>
<td>Convertible preferred stock with a separated equity component</td>
<td>Amended and expanded discussion of the application of the temporary-equity guidance to preferred stock with a separated equity component</td>
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</table>
(Table continued)

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<thead>
<tr>
<th>Sections Amended</th>
<th>Topic</th>
<th>Description</th>
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<tbody>
<tr>
<td>9.5.11</td>
<td>Equity securities held by employee stock</td>
<td>Clarified that the measurement exception for certain ESOP shares should not be applied by analogy</td>
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<tr>
<td></td>
<td>ownership plans</td>
<td></td>
</tr>
<tr>
<td>9.7.3</td>
<td>Modifications and exchanges</td>
<td>Removed commentary which suggested diversity exists related to recording anything for a modification that added value</td>
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