

## Summary and Background of Milestone Draft

This draft proposes classification requirements for entities that issue or hold single-component instruments, including instruments whose payoffs are related to an entity's own equity instruments. In addition, it addresses certain issues that were raised after the issuance of FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*, particularly in relation to instruments, such as mandatorily redeemable shares, that have ownership characteristics and also require the reporting entity to settle the instrument with cash or other assets.

Under the principles proposed in this draft, the following single-component instruments would be classified as equity:

1. Perpetual instruments
2. Direct ownership instruments
3. Indirect ownership instruments indexed to and settled or ultimately settled with the same direct ownership instruments on which their counterparty payoffs are based.

Other instruments in the scope of this draft would be classified as liabilities or assets.

This draft applies to single-component instruments (arrangements comprising one component). The Board plans to define characteristics of multiple-component instruments in deliberations of its next milestone. Examples of instruments that appear to be single-component instruments are provided in Appendix A of this draft. However, some of the instruments described may be determined to be multiple-component instruments based on the Board's decisions in the next phase of this project. Some possible examples of multiple-component instruments are puttable stock, put warrants, convertible debt, prepaid contracts, and variable share forward contracts.

The Board plans to address the following issues in the next milestone:

1. Measurement, display, and subsequent classification assessments for single-component instruments
2. Definition of multiple-component instruments
3. Substantive and non-substantive settlement requirements (including paragraphs 12–32 of EITF Issue No. 00-19, “Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company’s Own Stock”)
4. Separation and classification approaches for multiple-component instruments
5. Criteria for linking certain instruments
6. Earnings per share (EPS).

Below are some examples of authoritative literature that would be significantly affected by the Board’s tentative decisions in this milestone draft. The list is not meant to be comprehensive.

1. Statement 150 and related FASB Staff Positions
2. FASB Statement No. 123 (revised 2004), *Share-Based Payment*
3. Issue 00-19
4. ASR No. 268, *Presentation in Financial Statements of “Redeemable Preferred Stocks,”* and EITF Topic No. D-98, “Classification and Measurement of Redeemable Securities” (The SEC staff would determine if and how ASR 268 and Topic D-98 would be affected.)
5. AICPA Statement of Position 93-6, *Employers’ Accounting for Employee Stock Ownership Plans.*

## **BACKGROUND INFORMATION**

### **Introduction**

Some of the decisions in this draft reflect the reconsideration (and, in some cases, confirmation) of certain decisions that the Board reached in developing Statement 150. The Board undertook this project in response to concerns raised about classification in the statement of financial position of instruments that have characteristics of liabilities and equity. Prior to the issuance of Statement 150, instruments with those characteristics were presented in the statement of financial position as entirely equity, entirely liabilities, or between liabilities and equity.

Statement 150 (Phase 1 of the project) requires certain financial instruments that have characteristics of equity and liabilities to be classified entirely as liabilities. The Board was concerned about certain financial instruments that were classified as equity but that embody obligations to deliver assets—a characteristic of a liability under the current definition in FASB Concepts Statement No. 6, *Elements of Financial Statements*. Instruments with those characteristics include mandatorily redeemable shares and instruments, other than outstanding shares, that require, or that could require, an entity to repurchase its own shares. The Board also was concerned about other certain financial instruments that require, or that could require, the delivery of an entity's own shares but provide the counterparty a return unlike that of an equity holder. Statement 150 requires liability classification for those financial instruments.

The requirements of Statement 150 are based on both the current definition of a liability in Concepts Statement 6 and the Board's intention to expand that definition to include obligations to deliver shares that do not establish an ownership relationship. However, certain results of applying Statement 150 caused the Board to defer indefinitely some of its provisions until it could reconsider them. One of the provisions in question involves mandatorily redeemable common stock, which Statement 150 requires to be classified as a liability. This draft would require such instruments to be classified as equity if they meet certain conditions.

## **Project History**

In 1997, the Board resumed deliberations on issues raised in its 1990 Discussion Memorandum, *Distinguishing between Liability and Equity Instruments and Accounting for Instruments with Characteristics of Both*. One objective of the project was to determine whether an instrument that has characteristics of equity should be reported as an asset, a liability, or equity.

In October 2000, the Board issued two Exposure Drafts, *Accounting for Financial Instruments with Characteristics of Liabilities, Equity, or Both*, and *Proposed Amendment to FASB Concepts Statement No. 6 to Revise the Definition of Liabilities*. In December 2001, the Board began its redeliberations of the issues in the Exposure Drafts based on comments received.

In June 2002, the Board decided that a limited-scope Statement was needed to change the classification of certain instruments, even though issues affecting other instruments were not yet resolved.

The issuance of Statement 150 in May 2003 concluded Phase 1 of the Board's redeliberations of certain provisions of the October 2000 Exposure Drafts. Statement 150 requires certain financial instruments that had previously been classified as equity to be classified as liabilities (or assets in some circumstances). In November 2003, FASB Staff Position (FSP) FAS 150-3, "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, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*," was issued. That FSP deferred the effective dates for applying the provisions of Statement 150 to mandatorily redeemable shares of certain nonpublic entities and certain mandatorily redeemable noncontrolling interests.

The Board began Phase 2 of the liabilities and equity project in July 2003. The Board plans to amend or replace Statement 150 and all related FSPs.

## **The Reasons for the Classification Requirements of This Draft**

In this draft, the Board developed principles for classifying single-component instruments based on an Ownership-Settlement Approach as described in the standards section. That approach is based on the following reasoning:

1. To provide the most useful information to users of financial statements regarding liquidity and ownership, the Board decided that classifications should be based on both economic characteristics and ultimate settlement, instead of just one of those factors. Therefore, the Board concluded that two criteria should be considered in distinguishing liabilities and assets from equity: an ownership criterion and a settlement criterion.
2. Board members believe that one of the key objectives of this project is to develop criteria that result in consistent balance sheet classification for similar instruments, thereby reducing accounting arbitrage. The Board considered other approaches that are simpler and less subject to arbitrage; however, the Board concluded that those simpler approaches result in less relevant information. The Board believes that linkage criteria and the consideration of substantive versus nonsubstantive and remote features, which will be addressed later in the project, will limit accounting arbitrage. The Board believes that the Ownership-Settlement Approach for classification would result in more representationally faithful information than other approaches considered and can be used as a basis for accounting for multiple-component instruments.
3. In developing and applying the Ownership-Settlement Approach, the Board decided that perpetual instruments lack a settlement obligation and, therefore, meet a primary determining factor in equity classification decisions.
4. Additionally, the Board decided that a direct ownership instrument is the most basic form of equity because the holder bears the ultimate risks and rewards generated by the activities of the issuing entity, limited only by its share of the ownership and, for limited-liability entities, by the amount of the holder's investment. The Board has concluded that a direct ownership instrument provides a benchmark to which other financial instruments with settlement requirements can be compared to determine whether they are indirect ownership instruments based on their counterparty payoffs at settlement.
5. The Board decided that an instrument that is an indirect ownership instrument (for example, a physically settled written call option on the entity's equity shares) should be classified as equity because the holder has an interest similar to an owner and, upon settlement, ultimately becomes an owner. The Board also decided that such an instrument is equity only if the holder's interest and the ultimate settlement are with the same class of direct ownership shares. That is because the Board believes that an

indirect ownership instrument is a step on the path toward becoming a direct owner of the instrument on which its payoff is based.

6. The Board decided that other instruments embodying settlement requirements that are not direct or indirect ownership instruments should be classified as liabilities or assets because the counterparties are not owners nor do they have relationships that are similar to owners.
7. Consistent with decisions reached in its project on purchase method procedures and non-controlling interests, the Board also decided that a consolidated entity's equity instruments issued by members of a consolidated group would generally be considered equity of the consolidated entity, and, therefore, included those instruments in applying the Ownership-Settlement Approach for the reporting entity.

### **International Convergence Considerations**

Consistent with its broader convergence goals, the Board will use this project to further converge with accounting standards developed by the IASB. Presently, the FASB and the IASB plan to conduct this project under a "modified joint approach." Under that approach, the initial due process document issued by the FASB will be in the form of a Preliminary Views. That document will be concurrently published by the IASB for comment by its constituents. The Boards plan to use the input received on those initial due process documents as the basis for a joint project to develop a common standard of accounting and reporting. In that joint project, the Boards will deliberate and develop a common proposed Statement, to be followed by joint redeliberations and development of a common final Statement.

Currently, IAS 32, *Financial Instruments: Disclosure and Presentation*, is the international standard for the classification of financial instruments, including those within the scope of this draft. The following paragraphs summarize the current differences between the Board's proposed guidance and the IASB's standard.

This draft does not address multiple-component instruments, but IAS 32 provides guidance for certain multiple-component instruments. For example, paragraphs 18 and 19 of IAS 32 state that if an entity does not have an unconditional right to avoid delivering cash or another financial asset to settle a contractual obligation, the obligation meets the definition of a financial liability. Therefore, under IAS 32, puttable shares are

financial liabilities. In contrast, puttable shares are outside the scope of this draft because the Board has not determined whether such shares are single- or multiple-component instruments.

Also under paragraphs 18 and 19 of IAS 32, mandatorily redeemable shares are liabilities regardless of their ownership characteristics. In contrast, this draft would require shares that are mandatorily redeemable for their proportionate shares of the fair value of an entity to be classified as equity if they meet the two characteristics described in paragraph 20 of this draft.

The IASB is currently considering issuing an amendment to IAS 32 that would classify puttable shares and other similar financial instruments as equity if they satisfy certain criteria that are similar to the criteria in paragraph 20 of this draft.

Additionally, under IFRIC Interpretation 2, *Members' Shares in Co-operative Entities and Similar Instruments*, shares are classified as equity if the reporting entity has an unconditional right to refuse redemption or if redemption is unconditionally prohibited by local law, regulation, or the entity's governing charter. The FASB will address similar issues related to those instruments at future meetings. However, under the provisions of this draft, members' shares in cooperatives and similar instruments that meet the direct ownership characteristics in paragraph 20 would be classified as equity.

Under paragraphs 16(a) and 16(b) of IAS 32, an instrument is equity if (1) it does not include a contractual obligation to deliver cash or another financial asset (or to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavorable to the entity) and (2) it is a derivative that the issuer must settle by exchanging a fixed amount of cash or another financial asset for a fixed number of its own equity instruments. Therefore, a physically settled purchased option to repurchase a fixed number of an entity's shares for a fixed amount of cash would be classified as equity. Under the provisions of this draft, a purchased call option, regardless of how it would be settled, would be an asset because its value to the counterparty does not change in the same direction as the holder's equity.

Furthermore, under paragraph 16(b) of IAS 32, any instrument that includes a contractual obligation or right for the issuer to receive or deliver a variable number of its own equity instruments is classified as an asset or a liability. For example, a net-share settled written call option would be classified as a liability<sup>1</sup> under IAS 32. In contrast, this draft would require an instrument settled in shares (fixed or variable number) to be classified as equity if the instrument establishes an ownership interest—direct or indirect.

In summary, the principles of IAS 32 focus on whether there is an obligation to transfer assets or a variable number of shares. The principles in this draft are based on an Ownership-Settlement Approach that focuses on both that obligation and whether the counterparty is an owner or is in a position similar to that of an owner.

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<sup>1</sup>If the net-share settled written call option is issued to an employee as a form of compensation, the instrument is accounted for under IFRS 2, *Share-based Payment*, and is generally classified as equity.

# Milestone Draft—Proposed Classification for Single-Component Financial Instruments and Certain Other Instruments

July 2005

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## **Milestone Draft—Proposed Classification for Single-Component Financial Instruments and Certain Other Instruments**

**July 2005**

### **INTRODUCTION**

1. This draft describes the Board’s tentative decisions about classification of single-component financial instruments and certain other instruments through its meetings ending on April 6, 2005. The Board’s decisions represent only one part of its liabilities and equity project. The objective of the project is to establish principles for determining whether an instrument should be reported as an asset, a liability, or equity.

2. The Board’s deliberations in this project are divided into milestones. This draft describes tentative decisions reached in the first milestone and is in a format similar to that of an Exposure Draft.<sup>1</sup> However, this draft does not address all matters that are expected to be addressed in an Exposure Draft, including the definition and classification of multiple-component instruments, measurement, earnings per share, disclosure, transition, and effective date. Those matters will be considered by the Board in the next milestone.

3. In that next milestone, the Board also will address whether certain instruments in the scope of this draft should be separately displayed on the face of the balance sheet. For example, instruments classified as equity that have settlement requirements might be displayed within a separate section in equity. Additionally, the Board will consider whether the initial classification of instruments in the scope of this draft should be reassessed.

4. This draft describes decisions reached as one part of Phase 2 of the Board’s liabilities and equity project. The Board’s overall objective is to develop a comprehensive

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<sup>1</sup>Even though this draft is in a format similar to an Exposure Draft, the Board plans to issue a Preliminary Views for public comment before issuing an Exposure Draft. The Preliminary Views will not address disclosure, transition, or the effective date.

accounting standard that would address classification for all financial instruments and certain other instruments. Eventually, that Statement would replace FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*, and its related FASB staff positions. Statement 150 (Phase 1 of this project) requires certain instruments previously considered as equity to be classified as liabilities because the instruments either (a) embody obligations meeting the current definition of a liability in FASB Concepts Statement No. 6, *Elements of Financial Statements*, or (b) embody obligations settled with shares but do not establish ownership relationships. In Phase 2, the Board is reconsidering issues related to accounting for instruments that are in the scope of Statement 150 and also is considering the accounting for certain instruments that are not addressed in that Statement.

### **Concepts Statement 6**

5. Some of the classification requirements proposed in this draft are not consistent with the current definition of a liability in Concepts Statement 6. For example, certain obligations to deliver assets are classified as equity and certain obligations to issue the reporting entity's shares are classified as liabilities. At the completion of this project, the Board plans to address whether and, if so, how the definition of a liability and, perhaps, the definition of an asset in Concepts Statement 6 should be amended within its conceptual framework project. This draft does not describe how the definitions in Concepts Statement 6 might be changed.

### **Appendixes**

6. Appendix A provides implementation guidance and illustrates the classification of certain instruments that, based on the Board's tentative decisions made to date, are within the scope of this draft.

## **PROPOSED STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING**

### **Scope and Key Terms**

7. The classification requirements in this draft would apply to all single component instruments issued or held by business enterprises<sup>2</sup> that are either (a) financial instruments or (b) non-financial instruments that are settled with or that have payoffs based on financial instruments issued by the reporting entity or by an entity within a consolidated group.

8. The meanings of certain terms used in this draft are explained in the following paragraphs.

#### **Single-Component and Multiple-Component Instruments**

9. The final Statement that results from Phase 2 of the liabilities and equity project is expected to address both single-component and multiple-component instruments. This milestone draft addresses only instruments that consist of a single component. The Board has not yet discussed how to distinguish between single-component instruments and multiple-component instruments, and how to identify individual components within a multiple-component instrument. Some of the instruments that the Board considered in developing the classification requirements described in this draft are listed in Appendix A. In future deliberations, the Board may conclude that some of the instruments listed as single-component instruments in Appendix A have multiple components, and other instruments that are not listed in Appendix A may later be determined to consist of only a single component.

#### **Settlement, Settlement Requirement, and Ultimate Settlement**

10. Settlement of an instrument refers to the extinguishment of the reporting entity's obligation or right by delivery or receipt of consideration other than distributions of the entity's net assets in liquidation. Settlement does not refer to the expiration of an

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<sup>2</sup>*Business enterprises* include all entities except not-for-profit organizations.

unexercised option because, generally,<sup>3</sup> no consideration is delivered or received at expiration.<sup>4</sup> Consideration means any form of payment or performance. Delivery or receipt by an entity of its own shares or other instruments is considered settlement for purposes of identifying a settlement requirement.

11. A settlement requirement obligates or could obligate one party to make a settlement and gives the other party the right, including a conditional right, to receive a settlement. An instrument that entitles the holder to a share of the issuer's net assets only in liquidation does not have a settlement requirement.

12. Ultimate settlement refers to the last step in a series of settlements that is required or that could be required by the terms of an instrument. For example, an instrument that is settled with warrants to purchase perpetual common stock has an interim settlement (the warrants) and an ultimate settlement). The receipt of the perpetual common stock through exercise of the warrants is the ultimate settlement.

#### **Counterparty**

13. In this draft, classification of an instrument in the reporting entity's financial statements is determined by analyzing the counterparty's payoff at settlement. The counterparty, the party other than the reporting entity to an instrument in the scope of this draft, may be the holder or the issuer of the instrument. For equity instruments, the counterparty is generally the holder of the instrument, for example, the holder of common shares. However, for certain equity instruments, the counterparty is the issuer, for example, the writer of a put option on the reporting entity's shares is the counterparty if the put option is held by the reporting entity. That arrangement gives the reporting entity the right to require that the counterparty purchase the reporting entity's shares.

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<sup>3</sup>An option premium may be paid fully or partially upon expiration of an instrument. However, regardless of when it is paid, the initial net investment is ignored in analyzing the counterparty's payoff.

<sup>4</sup>The definition of settlement for purposes of this draft differs from the definition under FASB Statement No. 123 (revised 2004), *Share-Based Payment*, which includes expiration of an option and other events. The Statement 123(R) definition of settlement is used for different purposes, such as in recognizing compensation cost.

### **Counterparty's Payoff**

14. The counterparty's payoff is the fair value of that counterparty's position at the settlement ignoring any initial net investment.

15. For example, if an entity enters into an option or forward contract, the counterparty's payoff is equal to the difference between the strike or contract price and the fair value of the shares at settlement (intrinsic value). Similarly, if an entity issues a mandatorily redeemable share, the counterparty's payoff is equal to the redemption amount of those shares (the amount of cash or the fair value of other consideration at settlement). Counterparty payoffs for certain instruments that the Board considered in developing the principles in this draft are illustrated in Appendix A.

### **Classification**

16. The classification of an instrument in the scope of this draft is determined by whether that instrument (a) has a settlement requirement or (b) is an ownership instrument.

17. This draft identifies three types of instruments that have equity characteristics: perpetual instruments, direct ownership instruments, and indirect ownership instruments. Issuers of perpetual instruments and direct ownership instruments would classify those instruments as equity. Issuers or holders of indirect ownership instruments indexed to and settled or ultimately settled with the same direct ownership instruments that their counterparty payoffs are based on would classify those instruments as equity.

18. All other instruments within the scope of this draft would be classified as liabilities or assets.

### **Perpetual Instruments**

19. Perpetual instruments have no settlement requirement and entitle the holder to a portion of the issuer's net assets in liquidation. Some common stocks and preferred

stocks are perpetual instruments.<sup>5</sup> Perpetual instruments are equity even if those instruments are not direct ownership instruments.

#### **Direct Ownership Instruments**

20. Direct ownership instruments must have both of the following characteristics:

- a. The instruments represent proportional claims to shares<sup>6</sup> of the net assets of the entity that are neither limited nor guaranteed (that is, there is no ceiling or floor other than zero net assets) either before or at liquidation. An instrument that is redeemable at fair value meets this characteristic. An instrument that is redeemable at book value or a formula based on book value also meets this characteristic if (1) there is no active market for the instrument or (2) the instrument can be exchanged only with the reporting entity.
- b. The claims represented by the instruments have no priority over any other claims if the issuer were to liquidate on the date the classification decision is being made.

21. An instrument that is settled with another instrument meeting the characteristics of a direct ownership instrument in paragraph 20 would not satisfy those characteristics prior to settlement even if the settlement is triggered by liquidation. For example, a written call option or forward sale contract on the reporting entity's direct ownership shares that must be exercised upon liquidation would not meet the two necessary characteristics because the holder does not have a claim until the instrument is exercised into the direct ownership shares. However, those instruments are indirect ownership instruments that may be classified as equity if they meet the requirements in paragraph 24.

22. Direct ownership instruments may or may not be perpetual. Certain mandatorily redeemable common stocks are direct ownership instruments that are not perpetual.

#### **Indirect Ownership Instruments**

23. Indirect ownership instruments must have all three of the following characteristics:

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<sup>5</sup>The Board plans to address whether a requirement to pay dividends (or interest) on a perpetual instrument results in an instrument with multiple components.

<sup>6</sup>Proportional claims to shares of the net assets are based on the level of ownership in the entity and vary based on the magnitude of the net assets and the instrument's defined share of the net assets. That portion may be partly or wholly determined by capital contributions (in the form of cash, services, or any other consideration) or number of shares owned as well as other factors.

- a. The instruments are not perpetual.
- b. The instruments lack one or both of the characteristics of direct ownership instruments, but have counterparty payoffs at settlement that are based on and vary in the same direction as the fair value of direct ownership instruments (refer to paragraph 25).
- c. The instruments do not include contingent exercise provisions based on (1) an observable market other than the market for the reporting entity's direct ownership instruments or (2) an observable index other than an index calculated or measured solely by reference to the reporting entity's own operations (for example, revenue of the reporting entity<sup>7</sup>). An example of an instrument containing such a contingent exercise provision is an option to purchase the reporting entity's shares that can be exercised only if the S&P 500 reaches a certain specified level. Contingent exercise provisions do not include provisions that affect the counterparty's payoff at settlement (refer to paragraph A25).

24. Indirect ownership instruments issued or held by the reporting entity would be classified as equity if either settlement or ultimate settlement (refer to paragraph A21) requires one party to deliver the same direct ownership instruments<sup>8</sup> on which the payoffs of the indirect ownership instruments are based (examples are physically or net-share-settled written call options and purchased put options). Otherwise, those instruments would be classified as assets or liabilities (examples are net-cash-settled written call options [liabilities] and purchased put options [assets], and net-share-settled written call options based on one class of shares and settled with a different class of shares [liabilities]).

25. Options and similar instruments with time (or volatility) value and limits on losses or gains may be indirect ownership instruments depending on their characteristics. Time (or volatility) value of an option or similar instrument does not affect the fair value of the

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<sup>7</sup>An example is an instrument that can be exercised or settled only if the reporting entity's revenue reaches a specified level. This paragraph does not refer to an instrument in which the counterparty's payoff at settlement is based on the reporting entity's revenue. That instrument would not meet the characteristic in paragraph 23(b) to be an indirect ownership instrument.

<sup>8</sup>Settlement with a perpetual instrument classified as equity would not result in the indirect ownership instrument being classified as equity unless (a) the perpetual instrument is a direct ownership instrument and (b) the indirect ownership instrument's payoff is based on and varies in the same direction as the fair value of that perpetual instrument.

counterparty's position at settlement because the holder receives the intrinsic value of the instrument to be delivered or received (the optioned instrument).<sup>9</sup>

26. Mandatorily convertible instruments also may be indirect ownership instruments. One example is a mandatorily convertible instrument that converts into a fixed number of shares that are direct ownership instruments.

#### *Indirect Ownership Instruments with Settlement Alternatives*

27. An indirect ownership instrument that can be settled by either delivering or receiving<sup>10</sup> the reporting entity's direct ownership instruments or by delivering or receiving other consideration<sup>11</sup> would be classified as a liability or an asset, regardless of whether the settlement method is determined by one of the parties or by conditions outside the control of either party. An example is a written call option on the reporting entity's direct ownership instruments that may be net cash settled or net share settled at the issuer's discretion.

28. If uncertainties about settlement alternatives are resolved, so that there is only one settlement method for an indirect ownership instrument the entity would reconsider whether the instrument should be classified as equity.

#### **Other Instruments**

29. Instruments in the scope of this draft that are not direct or indirect ownership instruments but that have settlement requirements would be classified as liabilities or assets, regardless of how those instruments would be settled.

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<sup>9</sup>If an instrument is transferred to another counterparty, the exchange price would include time (or volatility) value; however, the counterparty's payoff is analyzed from the standpoint of the reporting entity. For the reporting entity, settlement does not include expiration of an option, nor does it include the sale of the instrument from one counterparty to another counterparty.

<sup>10</sup>In this context, settlement refers to the reporting entity receiving its own direct ownership instruments, for example, in a net-share-settled purchased put option.

<sup>11</sup>As part of its deliberations on multiple-component instruments, the Board will consider instruments with settlement alternatives.

30. Examples of those instruments are written put options (liabilities) and purchased call options (assets) on the reporting entity's direct ownership instruments. Those instruments are not indirect ownership instruments because the counterparty's payoff varies inversely to the fair value of the entity's direct ownership instruments. Instruments also are not indirect ownership instruments if their payoffs are based on amounts fixed at inception or something other than the entity's direct ownership instruments.

### **Instruments of a Consolidated Subsidiary**

31. Direct or indirect ownership instruments issued or held by a consolidated subsidiary retain the same characteristics for classification in the consolidated financial statements (unless the consolidating entity changes the features of those instruments as described in paragraphs 32 and 33). For example, instruments that are direct ownership instruments in a subsidiary's separate financial statements are direct ownership instruments in the consolidated financial statements and also for purposes of identifying indirect ownership instruments in the consolidated financial statements. Therefore, instruments issued by a consolidated entity are indirect ownership instruments if changes in the counterparties' payoffs are based on and vary in the same direction as a subsidiary's direct ownership instruments. Additionally, indirect ownership instruments of the consolidated entity that are based on and settled or ultimately settled with the same direct ownership instruments of the subsidiary are classified as equity.

32. Settlement requirements of instruments should be reevaluated at the consolidated entity level to determine the classification of those instruments at that level. For example, perpetual instruments of a consolidated subsidiary with a known liquidation date (that are not direct ownership instruments) would not be equity in the consolidated entity's financial statements unless that entity has the same liquidation date as the subsidiary. Those instruments would not be perpetual for the consolidated entity because that entity has a requirement to distribute net assets before its liquidation.

33. Additionally, if the consolidated entity changes the settlement features of a consolidated subsidiary's instruments, for example, such that the holders' returns would

be guaranteed by the consolidated entity, those instruments should be reevaluated for classification purposes.

34. Shares issued by a consolidated entity (or any other entity within a consolidated group) are not direct ownership instruments of its subsidiary (or other subsidiaries within that group). Similarly, an instrument of a subsidiary within a group with a payoff that is based on and varies in the same direction as the fair value of the consolidated entity's direct ownership instruments is not an indirect ownership instrument for purposes of the subsidiary's financial statements. That instrument would be an indirect ownership instrument for the consolidated entity in its financial statements but would be classified as equity only if it would be settled with the same instrument on which the indirect ownership instrument's payoff is based.

# Milestone Draft—Proposed Classification for Single-Component Financial Instruments and Certain Other Instruments

July 2005

## Appendix A

### IMPLEMENTATION GUIDANCE

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## **Appendix A**

### **IMPLEMENTATION GUIDANCE**

#### **Introduction**

A1. This appendix provides flowcharts, tables, and examples that illustrate the classification requirements of this draft for single-component instruments.

#### **Applying the Classification Requirements**

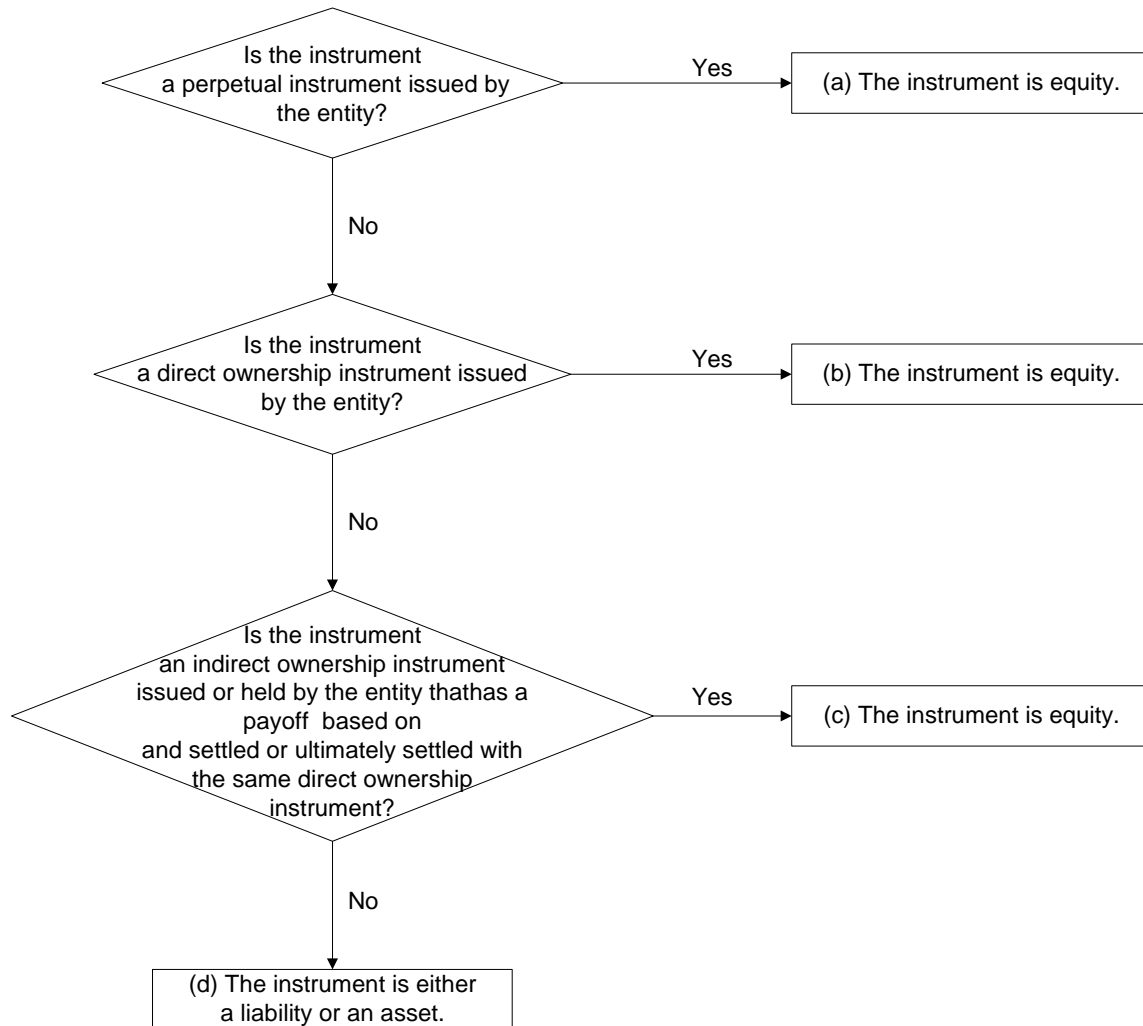
A2. The classification of an instrument in the scope of this draft is determined by whether that instrument (a) has a settlement requirement or (b) is an ownership instrument.

#### **Flowchart and Table for Classification of Single-Component Instruments**

A3. Chart 1 and Table 1 depict the requirements described in this draft for determining whether an instrument would be classified as an asset, liability, or equity. Table 2 (paragraph A31) illustrates examples, counterparty payoffs, and classification of certain single-component instruments.

**Chart 1: Flowchart for Classification of Single-Component Instruments**

Lettered annotations indicate the classification in Table 1.



**Table 1: Classification of Single-Component Instruments**

	Does the Instrument Have a Settlement Requirement?		
	Yes—Ultimate Settlement Does Not Require Delivery of Direct Ownership Instruments	Yes—Ultimate Settlement Requires Delivery of Direct Ownership Instruments*	No
Is the Instrument a Direct or Indirect Ownership Instrument?			
No	Liability or Asset (d)	Liability or Asset (d)	Equity (a)
Yes—Indirect	Liability or Asset (d)	Equity (c)	Equity (a)
Yes—Direct	Equity (b)	Equity (b)	Equity (a)

Lettered annotations indicate the classification in Chart 1.

\*As required by paragraph 23, an indirect ownership instrument is classified as equity only if it would be settled with the same direct ownership instrument that its payoff is based on.

### **Settlement Requirement**

A4. A settlement requirement obligates, or could obligate, one party to make a settlement and gives or could give the other party the right to receive a settlement by:

- a. Delivering or receiving assets or use of assets
- b. Providing or receiving services
- c. Delivering or receiving a fixed or variable number of shares or other instruments.

A5. Some instruments embody both a settlement obligation and a right of the reporting entity, such as a forward contract. In addition, some instruments embody an obligation to stand ready to provide assets. That stand-ready obligation could require one party to make a settlement and give the other party the right to receive a settlement, as would be the case with an option or a guarantee.

### **Perpetual Instruments**

A6. Instruments that have no settlement requirements are perpetual instruments and are classified as equity. Perpetual instruments are not required to meet the direct ownership characteristics to be equity. For example, perpetual preferred shares are not direct ownership instruments if the holder's claim in liquidation has priority over common shares.

A7. Perpetual preferred shares and perpetual common shares (Example 1 in Table 2) of the reporting entity that meet the two necessary characteristics in paragraph 20 are direct ownership instruments of the reporting entity. Perpetual instruments may or may not be direct ownership instruments. However, because indirect ownership instruments have counterparty payoffs that are based on and vary in the same direction as the fair value of direct ownership instruments, knowing whether perpetual instruments are direct ownership instruments is important.

### **Direct Ownership Instruments**

A8. Direct ownership instruments are classified as equity regardless of whether they are perpetual. Determining whether an instrument is a direct ownership instrument

entails examining the holder's claim to a share of the net assets of the issuing entity (or consolidated subsidiary) by considering both the returns the holder receives during the instrument's life and the instrument's return if the reporting entity (or consolidated subsidiary) is liquidated. The holder's liquidation claim is evaluated as if the reporting entity were to liquidate at the date the classification decision is made (the assessment date).

***Proportional Claims to Shares of the Net Assets without Limits***

A9. As described in paragraph 20(a), a necessary characteristic of a direct ownership instrument is that the instrument represents a proportional claim to a share of the net assets of the entity or consolidated subsidiary that is neither limited nor guaranteed (that is, the holder's claim has no ceiling or floor other than zero net assets) either before or at liquidation. Instruments with fixed or specified terms that do not share in the net assets upon liquidation without limits or guarantees do not meet this characteristic. For example, an instrument has a limited return if it pays a fixed dividend plus par at settlement or at liquidation (Example 2 in Table 2). That instrument does not meet the characteristic of a direct ownership instrument in paragraph 20(a).<sup>12</sup>

***Priority of the Holder's Claim***

A10. As described in paragraph 20(b), a necessary characteristic of a direct ownership instrument is a claim on the entity's net assets with no priority over any other claim if the entity or consolidated subsidiary were to liquidate at the assessment date. In other words, no other instruments would be subordinated to direct ownership instruments in a hypothetical liquidation at the assessment date. An entity may have more than one class of direct ownership instruments as long as all classes meet both characteristics in paragraph 20. For example, an entity's mandatorily redeemable shares and its perpetual shares can both be direct ownership instruments if both instruments have the same priority in a hypothetical liquidation at the assessment date (and meet the requirements of paragraph 20(a)). Also, an entity may have two classes of perpetual shares that are direct

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<sup>12</sup> However, the instrument would be classified as equity if it is a perpetual instrument.

ownership instruments, provided that both classes meet the characteristics in paragraph 20.

***Mandatorily Redeemable Shares at Fair Value***

A11. An instrument that is mandatorily redeemable for its proportionate share of the fair value of the entity's net assets (Example 3 in Table 2) may be the most subordinated and have a claim to a share of the entity's net assets that is not guaranteed and that is limited only by the amount of the entity's net assets. If so, the instrument is classified as equity regardless of the settlement requirement.

***Mandatorily Redeemable Shares at Book Value***

A12. An instrument redeemable at book value or a formula based on book value is deemed to meet the criterion in paragraph 20(a) if there is no active market for the instrument or the instrument can be exchanged only with the reporting entity. For example, a nonpublic entity that issues partnership interests redeemable at book value upon the earlier of retirement or death of each partner meets this criterion (Example 4 in Table 2). That is because the holder of the instrument has a proportional claim on the entity's net assets without a ceiling or floor similar to a fair value redemption and the instrument can be exchanged only within the partnership. If the partnership interests meet both characteristics in paragraph 20, the instruments would be classified as equity regardless of a settlement requirement.<sup>13</sup>

***Instruments That Are Settled With Direct Ownership Instruments***

A13. An indirect ownership instrument that is settled with direct ownership instruments would not be a direct ownership instrument even if the settlement is triggered by liquidation. For example, a written call option or forward sale contract on the reporting entity's direct ownership shares that must be exercised into those shares upon liquidation would not meet the two necessary characteristics in paragraph 20 because the holder does not have a claim until the instrument is exercised into shares. Thus, options and other instruments that are indexed to the reporting entity's direct ownership instruments are not

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<sup>13</sup>An instrument must meet both characteristics in paragraph 20 to be a direct ownership instrument.

direct ownership instruments. However, those options and other instruments might be indirect ownership instruments for which classification depends on their settlement terms. Example 10 in Table 2 illustrates an indirect ownership instrument that mandatorily converts (settles) into direct ownership instruments.

*Employee Stock Ownership Plans (ESOPs)*

A14. Many ESOPs are required by law to provide redemption rights for shares that are not readily tradable. Because the employer must redeem the shares upon an event certain to occur (such as death or retirement), those shares are considered mandatorily redeemable.

A15. Mandatorily redeemable ESOP shares would be classified as equity if they are direct ownership instruments as described in paragraph 20. Otherwise, they would be classified as liabilities.

*Instruments of a Consolidated Subsidiary*

A16. Direct ownership instruments of a subsidiary within a consolidated group, including noncontrolling direct ownership interests, are generally direct ownership instruments of the consolidated entity. Those instruments are classified as equity in both the subsidiary's financial statements and the consolidated financial statements (Example 6 in Table 2).

A17. However, perpetual instruments of a subsidiary may not be perpetual instruments of the consolidated entity. If a subsidiary's perpetual instruments are not direct ownership instruments of that subsidiary, the instruments generally would be classified as liabilities by the consolidated entity. An example is noncontrolling interests of a subsidiary that will be redeemed for fixed amounts on the subsidiary's stated liquidation date, and the consolidated entity does not have a known liquidation date (Example 5 in Table 2). Those instruments would be classified as liabilities by the consolidated entity. However, if those instruments were settled for their proportionate share of the subsidiary's fair value on the liquidation date and are subordinated to other instruments of the subsidiary (Example 6 in Table 2), the instruments would be direct ownership

instruments, and thus, be classified as equity for both the subsidiary and the consolidated entity.

A18. Additionally, if the consolidated entity changes the settlement requirements of a subsidiary's direct ownership instruments such that those instruments would cease to be direct ownership instruments, for example, because the holders' returns would become limited or guaranteed by the consolidated entity, then the consolidated entity would classify those instruments as liabilities.

#### **Indirect Ownership Instruments**

A19. Indirect ownership instruments must meet the three characteristics described in paragraph 23.

A20. Indirect ownership instruments issued or held by the reporting entity or its consolidated subsidiary are classified as equity if either settlement or ultimate settlement requires one party to deliver the same direct ownership instruments on which the indirect instruments' payoffs are based. Otherwise, those instruments are classified as liabilities or assets. For example, if an indirect ownership instrument has a counterparty payoff that is based on Series A common stock and would be settled with Series B common stock, the indirect ownership instrument would not be classified as equity, even if both series of stock are direct ownership instruments. Additionally, an indirect ownership instrument with a payoff based on a subsidiary's shares that would be settled with the parent's shares would not be classified as equity.

#### ***Settlement or Ultimate Settlement***

A21. Some instruments may be either settled or ultimately settled with an entity's direct ownership instruments. For example, an entity that issues a physically settled option to issue its mandatorily redeemable direct ownership shares would classify that option as equity if the option is an indirect ownership instrument and the shares to be delivered are the same direct ownership instruments on which the option's payoff is based. Other indirect ownership instruments may not initially be settled with the same direct ownership instruments on which their payoffs are based but would be ultimately settled

that way. Ultimate settlement with those direct ownership instruments also results in equity classification for indirect ownership instruments. An example is a forward sale contract (with a payoff based on common shares) that requires settlement by delivering warrants with payoffs based on and settled with those same common shares. The forward contract would be classified as equity if the forward contract is an indirect ownership instrument and the common shares are direct ownership instruments. In this example, the warrant has no effect on the classification because it is an interim settlement. The ultimate settlement of the instrument in common shares determines the classification in this circumstance.

A22. Settlement requirements of a consolidated subsidiary's indirect ownership instruments should be reevaluated by the consolidated entity to determine the settlement for classification purposes. For example, if a parent of a consolidated subsidiary adds a cash settlement feature to a subsidiary's indirect ownership instrument settled with direct ownership instruments, that instrument would no longer be classified as equity by that parent.

#### *Counterparty Payoff*

A23. One of the necessary characteristics of an indirect ownership instrument is that the counterparty's payoff at settlement is based on and varies in the same direction as the fair value of direct ownership instruments. An indirect ownership instrument's payoff need not vary for all changes in the fair value of a direct ownership instrument.

A24. In analyzing the counterparty's payoff at settlement, any initial consideration is disregarded. For example, if an entity issues shares in exchange for a full recourse<sup>14</sup> note receivable from the counterparty, the value of those shares would be disregarded in considering the counterparty's payoff on the note. The counterparty's payoff is the fair value of the note at settlement. If the note receivable requires that the counterparty pay a fixed amount of cash upon settlement, the counterparty's payoff is fixed, and the note receivable would be classified as an asset, not as contra-equity (similar to Example 21 in

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<sup>14</sup>Shares issued in exchange for a non-recourse note receivable, an arrangement in which the issuer would receive either assets or the return of shares, will be addressed along with other multiple-component instruments in the next milestone of this project.

Table 2). Such a note does not have characteristics of equity. In contrast, if the counterparty were required to settle the note receivable by delivering a fixed number of the reporting entity's own direct ownership instruments or cash equal to the fair value of those instruments on the date delivered, the counterparty's payoff would vary with the reporting entity's share price. However, the counterparty's payoff would vary inversely to the share price (similar to Example 13 in Table 2) and the note would be classified as an asset because it is not an ownership instrument.

A25. A contingent exercise provision is the type of contingent provision described in paragraph 23(c). An instrument with a contingency that affects payoff (such as a payoff indexed to sales) is not intended to be analyzed under paragraph 23(c). That instrument does not have a payoff that is indexed to the entity's direct ownership instruments and would, therefore, fail to meet the indirect ownership characteristic in paragraph 23(b) that counterparty payoffs are based on and vary in the same direction as the fair value of direct ownership instruments.

*Contracts for the Reporting Entity to Issue Its Shares at a Fixed Price*

A26. An option that gives the counterparty the right to require an entity to issue a fixed number of its direct ownership instruments at a fixed price is an indirect ownership instrument (for example, a written call option on an entity's own shares). This instrument meets the three characteristics of an indirect ownership instrument: (a) the reporting entity would be required to issue shares if the holder exercises the option, (b) as the fair value of the entity's shares increases, the counterparty's payoff of the option also increases, and (c) it does not include any contingent exercise provisions.<sup>15</sup> A written call option is not a direct ownership instrument because it does not have a claim to a share of the reporting entity's net assets until the option is exercised.

A27. Similarly, other instruments that require an entity to deliver a fixed number of direct ownership instruments at a fixed price have counterparty payoffs that vary in the same direction as the fair value of the reporting entity's direct ownership instruments and,

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<sup>15</sup>This example assumes the option has no contingency provision. An example of such a contingency provision is a provision in which an option to purchase the reporting entity's shares can be exercised only if the S&P 500 reaches a certain specified level.

therefore, are indirect ownership instruments (if characteristics (a) and (c) in paragraph 23 are met). Examples are forward sale contracts in which an entity issues its shares and purchased put options in which an entity has the right to issue its shares to the counterparty.

A28. Indirect ownership instruments settled by either party delivering the same direct ownership instruments that those indirect ownership instruments' payoffs are based on are equity under paragraph 24 (Examples 9, 10, 12, 14, 16, and 18 in Table 2). If those instruments could be settled by either party delivering assets (for example, net cash settlement) or other instruments (for example, a different class of shares), the instruments are classified as liabilities or assets under paragraph 24 (Examples 11, 15, and 19 in Table 2).

A29. An instrument is not an indirect ownership instrument if the counterparty's payoff is based on and varies in the same direction as the fair value of an instrument that is not a direct ownership instrument, for example, a written call option indexed to the fair value of the entity's perpetual preferred shares that are not direct ownership instruments. Such an instrument is classified as a liability.

#### **Other Instruments**

A30. Instruments with settlement requirements that are not direct or indirect ownership instruments are classified as liabilities or assets, even if they are settled by delivery of direct ownership instruments. Instruments with counterparty payoffs that (a) vary inversely to changes in the fair value of the entity's direct ownership instruments, (b) are based on amounts fixed at inception, or (c) are based on something other than the issuer's direct ownership instruments are not indirect ownership instruments. Examples are a written put option (Example 17 in Table 2), a forward contract to repurchase the entity's own shares (Example 13 in Table 2), and a purchased call option (Example 20 in Table 2). Those examples of contracts for the reporting entity to repurchase its shares at a fixed price illustrate inverse counterparty payoffs. That is, as the fair value of the reporting entity's shares decreases, the counterparty's payoff at settlement of the contract increases.

## Table of Examples

A31. The following table lists certain single-component instruments and their classification under this draft. Certain illustrations in the table are explained as follows:

- The graphs illustrate the counterparty's payoff at settlement for each instrument. The horizontal axis represents the common share price. The vertical axis represents the counterparty's payoff. The point at which the two axes meet is zero.
- Direct ownership instruments that do not have settlement requirements are graphed according to the instrument's fair value at the assessment date (Example 1).
- The classification decisions illustrated in the table assume that the characteristics to be equity are met (or, for liabilities and assets, are not met). Classification would depend on the facts and circumstances of each situation.

**Table 2: Examples of Classification and Payoff for Single-Component Instruments**

<u>Single-Component Instrument</u>	<u>Counterparty's Payoff</u>	<u>Classification under Draft</u>	<u>Explanation</u>
1. Common share (refer to paragraph A7)		Equity	<b>Perpetual instrument (also direct ownership instrument)</b>
2. Mandatorily redeemable share at a fixed price settled with assets (refer to paragraph A9)		Liability	<b>Settlement requirement and not an ownership instrument</b>
3. The most subordinated interest that is mandatorily redeemable at fair value settled with assets (refer to paragraph A11)		Equity	<b>Direct ownership instrument with a settlement requirement</b>
4. The most subordinated interest that is mandatorily redeemable at book value or a formula based on book value settled with assets (refer to paragraph A12)		Equity	<b>Direct ownership instrument with a settlement requirement</b>

<b><u>Single-Component Instrument</u></b>	<b><u>Counterparty's Payoff</u></b>	<b><u>Classification under Draft</u></b>	<b><u>Explanation</u></b>
5. Mandatorily redeemable noncontrolling interests at a fixed price settled with assets (refer to paragraph A17)	<p>The graph plots Payoff on the vertical axis (ranging from -10 to 10) against Share price on the horizontal axis. A horizontal red line is drawn at a payoff of 10, indicating that the instrument's value is constant regardless of the share price.</p>	Liability	<b>Settlement requirement and not an ownership instrument</b>
6. Mandatorily redeemable noncontrolling interests at fair value (of the subsidiary shares, most subordinate) settled with assets (refer to paragraph A16 and A17)	<p>The graph plots Payoff on the vertical axis (ranging from -10 to 10) against Share price on the horizontal axis. A red line starts at the origin (0,0) and increases linearly, representing a settlement based on the fair value of the shares.</p>	Equity	<b>Direct ownership instrument with a settlement requirement</b>
7. Note payable settled with cash or variable number of shares (refer to paragraph A30)	<p>The graph plots Payoff on the vertical axis (ranging from -10 to 10) against Share price on the horizontal axis. A horizontal red line is drawn at a payoff of 10, indicating a fixed price settlement.</p>	Liability	<b>Settlement requirement and not an ownership instrument</b>
8. Mandatorily converting instrument into a variable number of shares (refer to paragraph A30)	<p>The graph plots Payoff on the vertical axis (ranging from -10 to 10) against Share price on the horizontal axis. A horizontal red line is drawn at a payoff of 10, indicating a fixed price settlement.</p>	Liability	<b>Settlement requirement and not an ownership instrument</b>
9. Physically settled forward sale contract (at a fixed price) on the reporting entity's shares (refer to paragraph A28)	<p>The graph plots Payoff on the vertical axis (ranging from -10 to 10) against Share price on the horizontal axis. A red line starts at a payoff of -10 on the y-axis and increases linearly, crossing the x-axis at a share price of 10.</p>	Equity	<b>Indirect ownership instrument settled in same direct ownership instrument</b>
10. Mandatorily converting instrument into a fixed number of shares <sup>a</sup> (refer to paragraphs A13 and A28)	<p>The graph plots Payoff on the vertical axis (ranging from -10 to 10) against Share price on the horizontal axis. A red line starts at a payoff of -10 on the y-axis and increases linearly, crossing the x-axis at a share price of 10.</p>	Equity	<b>Indirect ownership instrument settled in same direct ownership instruments</b>

<b><u>Single-Component Instrument</u></b>	<b><u>Counterparty's Payoff</u></b>	<b><u>Classification under Draft</u></b>	<b><u>Explanation</u></b>
11. Net-cash-settled forward sale contract (at a fixed price) on the reporting entity's shares (refer to paragraph A28)		Liability/Asset	<b>Indirect ownership instrument settled in cash</b>
12. Net-share-settled forward sale contract (at a fixed price) on the reporting entity's shares (refer to paragraph A28)		Equity	<b>Indirect ownership instrument settled in same direct ownership instruments</b>
13. Physically or net-settled forward purchase contract (at a fixed price) on the reporting entity's shares (refer to paragraphs A24 and A30)		Liability/Asset	<b>Settlement requirement and not an ownership instrument</b>
14. Physically settled written call option on the reporting entity's shares (or stock option) (refer to paragraph A28)		Equity	<b>Indirect ownership instrument settled in same direct ownership instrument</b>
15. Net-cash-settled written call option on the reporting entity's shares (or cash SAR) (refer to paragraph A28)		Liability	<b>Indirect ownership instrument settled in cash</b>
16. Net-share-settled written call option on the reporting entity's shares (or stock SAR) (refer to paragraph A28)		Equity	<b>Indirect ownership instrument settled in same direct ownership instruments</b>

<b><u>Single-Component Instrument</u></b>	<b><u>Counterparty's Payoff</u></b>	<b><u>Classification under Draft</u></b>	<b><u>Explanation</u></b>
17. Physically or net-settled written put option on the reporting entity's shares (refer to paragraph A30)		Liability	<b>Settlement requirement and not an ownership instrument</b>
18. Physically or net-share-settled purchased put option on the reporting entity's shares (refer to paragraph A28)		Equity	<b>Indirect ownership instrument settled in same direct ownership instruments</b>
19. Net-cash-settled purchased put option on the reporting entity's shares (refer to paragraph A28)		Asset	<b>Indirect ownership instrument settled in cash</b>
20. Physically or net-settled purchased call option on the reporting entity's shares (refer to paragraph A30)		Asset	<b>Settlement requirement and not an ownership instrument</b>
21. Note receivable for cash or variable number of shares (refer to paragraph A24)		Asset	<b>Settlement requirement and not an ownership instrument</b>

<sup>a</sup>May be a multiple-component instrument.