FASB Emerging Issues Task Force

Issue No. 08-8

Title: Accounting for an Instrument (or an Embedded Feature) with a Settlement Amount That Is Based on the Stock of an Entity's Consolidated Subsidiary

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Previously distributed EITF materials: None

References:

FASB Statement No. 123 (revised 2004), *Share-Based Payment* (FAS 123(R))

FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities* (FAS 133)

FASB Statement No. 141 (revised 2007), *Business Combinations* (FAS 141(R))

FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity* (FAS 150)

FASB Statement No. 154, *Accounting Changes and Error Corrections* (FAS 154)

FASB Statement No. 160, *Noncontrolling Interests in Consolidated Financial Statements* (FAS 160)

International Accounting Standard 32, *Financial Instruments: Disclosure and Presentation* (IAS 32)

International Accounting Standard 27, *Consolidated and Separate Financial Statements* (IAS 27)

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* **The alternative views presented in this Issue Summary are for purposes of discussion by the EITF. No individual views are to be presumed to be acceptable or unacceptable applications of Generally Accepted Accounting Principles until the Task Force makes such a determination, exposes it for public comment, and it is ratified by the Board.**

EITF Issue No. 99-1, "Accounting for Debt Convertible into the Stock of a Consolidated Subsidiary" (Issue 99-1)

EITF Issue No. 00-6, "Accounting for Freestanding Derivative Financial Instruments Indexed to, and Potentially Settled in, the Stock of a Consolidated Subsidiary" (Issue 00-6)

EITF Issue No. 00-19, "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock" (Issue 00-19)

EITF Issue No. 07-5, "Determining Whether an Instrument (or an Embedded Feature) Is Indexed to an Entity's Own Stock" (Issue 07-5)

Background

1. Paragraph 11(a) of FAS 133 specifies that a contract issued or held by the reporting entity that is **both** (a) indexed to its own stock **and** (b) classified in stockholders' equity in its statement of financial position shall not be considered a derivative financial instrument for purposes of applying that Statement. If a freestanding financial instrument (for example, a stock purchase warrant) meets the scope exception in paragraph 11(a) of FAS 133, it is classified as an equity instrument and is not accounted for as a derivative instrument.

2. Paragraph 12 of FAS 133 requires that an embedded derivative instrument be separated from the host contract and accounted for as a derivative instrument pursuant to that Statement if certain criteria are met. One of those criteria, set forth in paragraph 12(c), is that a separate instrument with the same terms as the embedded derivative instrument would, pursuant to paragraphs 6-11 of that Statement, be a derivative instrument subject to the requirements of FAS 133. Consequently, if an embedded feature (for example, the conversion option embedded in a convertible debt instrument) meets the scope exception in paragraph 11(a) of FAS 133, it would not be separated from the host contract and accounted for as a derivative by the issuer.

3. Questions have arisen, particularly after the finalization of FAS 160, as to whether financial instruments (and embedded features) for which the payoff to the counterparty is based, in whole or in part, on the stock of a consolidated subsidiary should be precluded from being considered indexed to the entity's own stock in the consolidated financial statements of the parent. Existing U.S. GAAP is inconsistent regarding the application of the scope exception in paragraph 11(a) of FAS 133 to a financial instrument (or embedded feature) for which the payoff to the counterparty is based, in whole or in part, on the stock of an entity's consolidated subsidiary. In Issue 00-6, which applies to freestanding derivative instruments entered into by the parent, the Task Force reached a consensus that the stock of a subsidiary is not considered equity of the parent (reporting entity) and therefore that derivatives indexed to and potentially settled in the stock of a consolidated subsidiary do not meet the scope exception in paragraph 11(a) of FAS 133. However, in Issue 99-1, the Task Force concluded that debt that is convertible into the stock of a consolidated subsidiary should be accounted for in accordance with APB 14 because the

embedded conversion option does meet the scope exception in paragraph 11(a) of FAS 133. A summary of the application of current GAAP is included as Exhibit 08-8A.

4. Prior to FAS 160, which is effective for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2008, entities have generally reported the noncontrolling interest in a subsidiary as a "mezzanine" item (between liabilities and equity) in the consolidated statement of financial position. A noncontrolling interest is the portion of equity (net assets) in a subsidiary not attributable, directly or indirectly, to a parent. Upon the adoption of FAS 160, the noncontrolling interest will be reported in the consolidated statement of financial position within equity, separately from the parent's equity. However, the guidance in FAS 160 did not amend the accounting guidance for financial instruments that are linked to the shares of a consolidated subsidiary (for example, warrants to purchase shares of a consolidated subsidiary), including the consensus in Issue 00-6.

5. FAS 160 clarifies that the portion of subsidiary stock that is held by owners other than the parent will be classified in equity as it does not meet the definition of a liability. Therefore, it appears that after the effective date of FAS 160, financial instruments (and embedded features) for which the payoff to the counterparty is based, in whole or in part, on the stock of a consolidated subsidiary should qualify for the second part of the scope exception in paragraph 11(a) of FAS 133, as long as they are not required to be classified as liabilities under other applicable literature, such as FAS 150 or Issue 00-19. However, FAS 160 did not address whether financial instruments (or embedded features) for which the payoff to the counterparty is based, in whole or in part, on the stock of a consolidated subsidiary should qualify for the first part of the scope exception in paragraph 11(a) of FAS 133, being indexed to the reporting entity's own stock. In the basis for conclusions of FAS 160, the Board acknowledged that there is an inconsistency between its decision in FAS 160 and the guidance in Issue 00-6 because in Issue 00-6 the Task Force reached a consensus that "stock of a subsidiary is not considered equity of the parent (reporting entity)." The Board did not address that inconsistency as part of FAS 160, but noted it may do so in the future in a separate project.

6. This Issue addresses the determination of whether a financial instrument for which the payoff to the counterparty is based on, in whole or in part, the stock of an entity's consolidated subsidiary, is indexed to the reporting entity's own stock and therefore should not be precluded from qualifying for the first part of the scope exception in paragraph 11(a) of FAS 133.

Scope

7. This Issue applies to freestanding financial instruments (and embedded features) for which the payoff to the counterparty is based, in whole or in part, on the stock of a consolidated subsidiary for purposes of determining whether such instruments (or embedded features) are precluded from being considered indexed to the entity's own stock in the consolidated financial statements of the parent. This Issue applies to those instruments (and embedded features) in the consolidated financial statements of the parent, regardless of whether the instrument was entered into by the parent or the subsidiary.

8. This Issue does not affect the accounting for instruments that would not otherwise qualify for the scope exception in paragraph 11(a) of FAS 133 (for example, instruments that are classified as assets or liabilities pursuant to FAS 150).

Accounting Issues and Alternatives

Issue 1: Whether freestanding financial instruments (or embedded features) within the scope of this Issue are precluded from being considered indexed to the entity's own stock in the consolidated financial statements of the parent.

View A: Provided that the consolidated subsidiary meets the definition of a business in FAS 141R,[1] a freestanding financial instrument (or embedded feature) within the scope of this Issue is not precluded *from being considered indexed to the entity's own stock in the consolidated financial statements of the parent. The consensus in Issue 07-5 should be applied to make that determination and should be considered in conjunction with other applicable U.S. GAAP (for example, Issue 00-19) in determining classification of the instrument. However, equity*

[1] FAS 141R defines a *business* as an integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return in the form of dividends, lower costs, or other economic benefits directly to investors or other owners, members, or participants.

classification would be precluded for a freestanding financial instrument (or embedded feature) within the scope of this Issue if the consolidated subsidiary does not meet the definition of a business.

9. Proponents of View A observe that it would align Issue 00-6 with the existing guidance in Issue 99-1 and FAS 150, both of which treat the stock of a consolidated subsidiary in the same manner as stock of the parent for purposes of evaluating equity-linked financial instruments and embedded features within their respective scopes. Those proponents observe that such treatment is also consistent with the guidance in FAS 123(R), which does not require liability classification in the consolidated financial statements for employee option awards on shares of a consolidated subsidiary as long as the employee who receives the award qualifies as a common law employee of the consolidated entity. View A proponents observe that under this view, entities would be required to evaluate contracts indexed to the stock of a consolidated subsidiary under the same guidance that is applied to similar contracts indexed to the parent company's stock (for example, FAS 133, FAS 150, Issue 00-19, and Issue 07-5) before concluding that equity treatment is appropriate.

10. View A proponents acknowledge that the nullification of Issue 00-6 could potentially enable entities to circumvent the objectives of FAS 133 in some cases. For example, instead of entering into a forward contract to sell a specified quantity of gold, an entity could enter into a forward contract to sell shares of a subsidiary that has no operations and contains no assets other than gold. To minimize the potential for those types of structuring opportunities, View A proponents believe that it is necessary to clarify that equity classification is precluded for contracts linked to the stock of a subsidiary that does not meet the definition of a business.

View B: A freestanding financial instrument (or embedded feature) within the scope of this Issue is not indexed to the reporting entity's own stock in the consolidated financial statements of the parent.

11. Proponents of View B believe that the scope exception in paragraph 11(a) of FAS 133 should be interpreted narrowly and should be applied only to contracts indexed to the stock of

the parent (the consolidating entity). View B proponents do not believe that the classification of the noncontrolling interest under FAS 160 is the determining factor in qualifying for the scope exception under paragraph 11(a) of FAS 133. Those proponents observe that the scope exception requires that a contract issued or held by the reporting entity that is **both** (a) indexed to its own stock **and** (b) classified in stockholders' equity in its statement of financial position shall not be considered a derivative financial instrument for purposes of applying that Statement. View B proponents acknowledge that FAS 160 clarifies that contracts with a settlement amount based on noncontrolling interests would be eligible for the **second** part of the scope exception. However, those proponents believe that FAS 160 does not affect the determination of whether contracts with a settlement amount based on a subsidiary's stock are indexed to the *reporting entity's own stock*. Proponents of View B note that a contract that derives its settlement value from the stock of a subsidiary is not economically equivalent to one based on the parent's own stock.

12. View B opponents observe that if the scope exception in paragraph 11(a) is not permitted, embedded conversion options that meet the definition of a derivative in paragraphs 6-9 of FAS 133 and enable the holder to convert into the stock of a consolidated subsidiary would be bifurcated and accounted for as derivative liabilities. Those opponents observe that the EITF previously deliberated that question in Issue 99-1 and there have been no changes in U.S. GAAP that would appear to contradict that earlier conclusion, other than the consensus on Issue 00-6. In contrast, View B opponents believe that subsequent pronouncements that treat the stock of a consolidated subsidiary in a similar manner to stock of the parent (for example, FAS 160, FAS 123(R), and FAS 150) further support the consensus in Issue 99-1.

Issue 2: If the Task Force reaches a consensus on View A of Issue 1, where a freestanding financial instrument within the scope of this Issue that is an equity instrument (including an embedded feature that is separately recorded in equity) should be classified within consolidated stockholders' equity of the parent.

View A: An equity-classified instrument (including an embedded feature that is separately recorded in equity under applicable U.S. GAAP) entered into by a subsidiary would be presented as a component of noncontrolling interest in the consolidated financial statements of the parent.

However, an equity-classified instrument entered into by the parent would be presented as a component of controlling interest in the consolidated financial statements of the parent. Upon settlement of an equity-classified instrument entered into by the parent, the issuance of noncontrolling interests would be accounted for pursuant to the guidance in FAS 160.

13. Proponents of View A believe that equity-classified financial instruments (including embedded features that are separately recorded in equity under applicable U.S. GAAP) within the scope of this Issue that were entered into by the parent do not meet the definition of noncontrolling interest under FAS 160. FAS 160 defines noncontrolling interest as the portion of equity (net assets) in a subsidiary not attributable, directly or indirectly, to a parent. Paragraph 27 of FAS 160 states that "only a financial instrument **issued by a subsidiary** that is classified in equity in the subsidiary's financial statements can be a noncontrolling interest in the consolidated financial statements" (emphasis added). Because instruments within the scope of this Issue entered into by the parent were not issued by the subsidiary and are not equity in the subsidiary's standalone financial statements, the requirements for presentation within noncontrolling interest in the consolidated financial statements have not been met. View A proponents believe that recording a change in noncontrolling interest in the consolidated financial statements upon *exercise* of the instrument is required by the guidance in FAS 160 on changes in a parent's ownership interest in a subsidiary.

View B: An equity-classified instrument (including an embedded feature that is separately recorded in equity under applicable U.S. GAAP) within the scope of this Issue would be presented as a component of noncontrolling interest in the consolidated financial statements, regardless of whether the instrument was entered into by the parent or the subsidiary. However, if an equity-classified instrument within the scope of this Issue was entered into by the parent and expires unexercised, the carrying amount of the instrument would be reclassified from the noncontrolling interest to the controlling interest.

14. Proponents of View B believe that all equity-classified financial instruments (including embedded features that are separately recorded in equity under applicable U.S. GAAP) that are within the scope of this Issue should be classified as a component of noncontrolling interest in

the consolidated financial statements. Regardless of whether the parent or subsidiary entered into the contract, there are no possible outcomes in which the parent would issue its own shares. Consequently, proponents of View B believe that classification of an instrument within the scope of this Issue as a component of controlling interest if it was entered into by the parent would be inappropriate. However, if an equity-classified instrument within the scope of this Issue was issued by the parent and expires unexercised, no shares of the subsidiary would be exchanged and the carrying amount of the instrument would be reclassified to the controlling interest at that time.

[Note: Views A and B of Issue 2 are identical for equity-classified instruments **issued by a subsidiary on its own shares**, which would be presented within noncontrolling interest in the consolidated financial statements. For equity-classified instruments **issued by a parent on a subsidiary's shares**, View A would require classification in controlling interest until the instrument is exercised, at which time a noncontrolling interest would be recognized and measured in accordance with the guidance in FAS 160. In contrast, View B would require that such instruments be initially classified as a component of noncontrolling interest. If the instruments are exercised, there would be an adjustment recorded to the noncontrolling interest, measured in accordance with the guidance in FAS 160. However, if the instruments expire unexercised, the carrying amount would be reclassified to the controlling interest. Under either View A or View B, the ultimate outcome of the accounting treatment upon exercise or expiration would be the same. However, the presentation of the equity-classified instrument within controlling interest or noncontrolling interest would differ while the instrument is outstanding.]

Earnings per Share

15. Paragraphs 62 and 63 of FAS 128 address how options, warrants, and convertible securities that are potentially settled in subsidiary stock are reflected in consolidated EPS. Paragraph 63 specifies that securities issued by the parent that are convertible into a subsidiary's common stock shall be included in computing the subsidiary's EPS data using the if-converted method. Paragraph 62 specifies that securities issued by a subsidiary that enable their holders to obtain the subsidiary's common stock shall be included in the computation of the subsidiary's EPS data. Those diluted per-share earnings of the subsidiary shall then be included in the consolidated EPS

computation based on the consolidated entity's holdings, on a diluted basis, of the subsidiary's securities. Illustration 7 of FAS 128 provides an example illustrating the application of that guidance. The EPS treatment required by FAS 128 would not be affected by a consensus on this Issue as the treatment would continue to be based on the issuer of the instrument.

International Convergence

16. Neither of the alternate views on Issue 1 would converge with IFRS. The staff understands that, in practice, classification within equity at the subsidiary level carries through in consolidation and that the requirements of IAS 32 relating to contracts over an entity's own equity instruments, also generally apply in consolidated financial statements to forward contracts and put and call options over noncontrolling interests. However, the requirements in IAS 32 to qualify for equity treatment are different from those of U.S. GAAP. IAS 32 requires that a derivative instrument that will or might be settled in the issuer's own equity instruments may be classified in equity if it can be settled only by the issuer exchanging a fixed amount of cash or another financial asset for a fixed number of its own equity instruments. Therefore, View A of Issue 1 would result in more contracts being classified in equity when compared with IFRS due to the broader scope exception in U.S. GAAP. View B would preclude any contracts within the scope of this Issue from being classified in equity. The IFRIC considered in November 2006 a request to clarify the accounting treatment of contracts to acquire noncontrolling interests. At that time, the IFRIC agreed that there was likely to be divergence in practice in how the related equity is classified but did not believe that it could reach a consensus on a timely basis. IAS 27 requires a noncontrolling interest to be classified within equity in consolidated financial statements.

Interaction with Other Board Agenda Projects

17. The objective of the liabilities and equity project is to develop a comprehensive standard of accounting and reporting for financial instruments with characteristics of equity, liabilities, or both, and assets. Such a standard would likely replace existing accounting guidance for financial instruments having those characteristics, including instruments such as those within the scope of this Issue.

18. The liabilities and equity project is being conducted under a modified joint approach with the IASB. Under that approach, the FASB's initial due process document in the form of a Preliminary Views, was issued on November 20, 2007. That document was 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 proposed statement, which will be followed by joint redeliberations and development of a common final statement. A final statement resulting from the liabilities and equity project is not expected to have an effective date earlier than January 1, 2012, for calendar year-end companies.

Transition and Effective Date

19. The FASB staff believes that a consensus on this Issue should ideally have the same effective date as FAS 160, which is effective for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2008. However, the staff is concerned that that may not provide preparers with sufficient time to adopt particularly if the consensus requires retrospective application. Therefore, the staff is providing the Task Force with some alternatives for transition and effective date.

Issue 3: What the effective date and transition for a consensus on this Issue should be.

View A: A consensus should be effective for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2008. Early adoption would not be permitted. The consensus should be applied to outstanding instruments as of the beginning of the fiscal year in which this Issue is initially applied. The cumulative effect of the change in accounting principle would be recognized 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) for that fiscal year, presented separately.

20. Under View A, the consensus would have the same effective date as FAS 160, however, retrospective adoption to earlier periods would not be required or permitted. The consensus

would be applied to outstanding instruments as of the beginning of the fiscal year in which this Issue is initially applied. The cumulative effect of the change in accounting principle would be recognized 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) for that fiscal year, presented separately. The cumulative-effect adjustment is the difference between the amounts recognized in the statement of financial position before initial application of this Issue and the amounts recognized in the statement of financial position at initial application of this Issue. The amounts recognized in the statement of financial position at initial application of this Issue shall be determined based on the amounts that would have been recognized if the guidance in this Issue had been applied from the issuance date of the instrument(s).

View B: A consensus should be effective for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2009. Early adoption would not be permitted. The consensus would be applied retrospectively to all prior periods, consistent with the requirements of paragraph 7 of FAS 154.

21. Under View B, the consensus would not have the same effective date as FAS 160; however, retrospective application to earlier periods would be required. The cumulative effect of the change on periods prior to those presented would be reflected in the carrying amounts of assets and liabilities as of the beginning of the first period presented, with an offsetting adjustment reflected in the opening balance of retained earnings (or other appropriate components of equity or net assets in the statement of financial position).

22. The consensus would not be applied retrospectively to instruments that were not outstanding during **any** of the periods that will be presented in the annual financial statements for the period of adoption but were outstanding during an earlier period. Therefore, an entity would not reclassify amounts between its opening equity accounts in those circumstances.

23. The disclosure requirements in paragraphs 17 and 18 of FAS 154 would be required under both View A and View B.

Exhibit 08-8A

The following table summarizes the accounting treatment under current U.S. GAAP for contracts within the scope of this Issue. The guidance described in this table (Issues 99-1 and 00-6) would be replaced by a consensus on this Issue. [Note: This table does not include instruments that are within the scope of FAS 150. Such instruments, which include freestanding put options and forward purchase contracts on a subsidiary's equity shares, are not within the scope of this Issue because they are accounted for as liabilities (or, in some cases, assets) and would not be eligible for equity classification. Additionally, this table does not include the guidance in Issue 00-4. That consensus was partially nullified by FAS 150. However, it continues to apply to arrangements with an embedded written put option and an embedded purchased call option on shares of a consolidated subsidiary that are exercisable for a fixed price at a stated future date. Issue 00-4 specifies that such arrangements should be accounted for as a financing of the parent's acquisition of the noncontrolling interest.]

	Freestanding Financial Instruments	**Embedded Features**
Issued by the Parent	Issue 00-6 specifies that such instruments do **not** qualify for the scope exception in paragraph 11(a) of FAS 133 (that is, they are not considered indexed to the reporting entity's own stock). Such instruments would be accounted for as derivatives if they have the characteristics of a derivative in FAS 133.	For debt issued by a parent that is convertible into the stock of a consolidated subsidiary, Issue 99-1 specifies that the embedded conversion option can qualify for the scope exception in paragraph 11(a) of FAS 133 in the consolidated financial statements.
Issued by the Subsidiary	U.S. GAAP does not explicitly address this circumstance.*	For debt issued by a subsidiary that is convertible into its own stock, Issue 99-1 specifies that the embedded conversion option can qualify for the scope exception in paragraph 11(a) of FAS 133 in the consolidated financial statements.

* The FASB staff understands that, in practice, entities do not "unwind" equity classification in consolidation and account for instruments that qualified for equity in the subsidiary's standalone financial statements as derivative assets or liabilities in the consolidated financial statements. For example, if a subsidiary issues a warrant that meets the scope exception in paragraph 11(a) of FAS 133, the equity-classified instrument would be a component of noncontrolling interest in consolidation (presented in the mezzanine prior to adoption of FAS 160). However, the staff is not aware of guidance that would preclude that parent company from adopting a policy of accounting for the warrant as a liability in its consolidated financial statements.