

## EITF ABSTRACTS

Issue No. 07-5

**Title:** Determining Whether an Instrument (or Embedded Feature) Is Indexed to an Entity's Own Stock

**Dates Discussed:** September 11, 2007; November 29, 2007; March 12, 2008; June 12, 2008

**References:** FASB Statement No. 123 (revised 2004), *Share-Based Payment*  
FASB Statement No. 128, *Earnings per Share*  
FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*  
FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*  
FASB Statement No. 154, *Accounting Changes and Error Corrections*  
Statement 133 Implementation Issue No. C8, "Derivatives That Are Indexed to both an Entity's Own Stock and Currency Exchange Rates"  
Statement 133 Implementation Issue No. K1, "Determining Whether Separate Transactions Should Be Viewed as a Unit"  
EITF Issue No. 00-19, "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock"  
EITF Issue No. 01-6, "The Meaning of 'Indexed to a Company's Own Stock'"  
EITF Issue No. 05-2, "The Meaning of 'Conventional Convertible Debt Instrument' in Issue No. 00-19"

### Objective

1. **The objective of this Issue is to provide guidance for determining whether an equity-linked financial instrument (or embedded feature) is indexed to an entity's own stock.**

<p><b>All paragraphs in this Issue have equal authority. Paragraphs in bold set out the main principles.</b></p>
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## Background

2. Paragraph 11(a) of Statement 133 specifies that a contract that would otherwise meet the definition of a derivative under that Statement 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 Statement 133, it is classified as an equity instrument and is not accounted for as a derivative instrument.

3. Paragraph 12 of Statement 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 Statement 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 Statement 133, it would not be separated from the host contract and accounted for as a derivative by the issuer.

4. This Issue addresses the determination of whether an instrument (or an embedded feature) is indexed to an entity's own stock, which is the first part of the scope exception in paragraph 11(a) of Statement 133. If an instrument (or an embedded feature) that has the characteristics of a derivative instrument under paragraphs 6–9 of Statement 133 is

indexed to an entity's own stock, it is still necessary to evaluate whether it is classified in stockholders' equity (or would be classified in stockholders' equity if it were a freestanding instrument). For example, a net-cash-settled stock purchase warrant may be indexed to an entity's own stock, but it is not classified in stockholders' equity. Other applicable authoritative accounting literature, including Issues 00-19 and 05-2, provides guidance for determining whether an instrument (or an embedded feature) is classified in stockholders' equity (or would be classified in stockholders' equity if it were a freestanding instrument). This Issue does not address that second part of the scope exception in paragraph 11(a) of Statement 133.

5. In addition, some instruments that are potentially subject to the guidance in Issue 00-19 do not have all the characteristics of a derivative instrument under paragraphs 6–9 of Statement 133. For example, a physically settled forward contract to issue an entity's own equity shares in exchange for cash would not meet the net-settlement characteristic of a derivative instrument, as described in paragraphs 6(c) and 9 of Statement 133, if the underlying equity shares are not readily convertible to cash. If the forward contract is considered to be indexed to the entity's own stock, it would be evaluated under Issue 00-19 to determine whether it should be classified in equity or as an asset or a liability. However, if the terms of that forward contract are such that it is not considered to be indexed to the entity's own stock, equity classification would be precluded and the instrument would not be within the scope of Issue 00-19 (that Issue provides accounting guidance for instruments that are **indexed to**, and potentially settled in, the issuer's own stock). Consequently, for certain freestanding instruments that do not have all the characteristics of a derivative instrument under paragraphs 6–9 of Statement 133 but are

potentially settled in an entity's own equity shares, this Issue would apply for evaluating whether they are within the scope of Issue 00-19.

6. Issue 01-6 is superseded by this Issue. However, some of the guidance previously contained in Issue 01-6 has been carried forward and codified in paragraphs 12 and 13 of this Issue.

7. The guidance in this Issue shall be applied to the appropriate unit of accounting, as determined under other applicable U.S. generally accepted accounting principles. For example, if an entity issues two freestanding financial instruments and concludes that those two instruments are required to be accounted for separately, then the guidance in this Issue would be applied separately to each instrument. In contrast, if an entity issues two freestanding financial instruments and concludes that those two instruments are required to be linked and accounted for on a combined basis as a single financial instrument (for example, pursuant to the guidance in Statement 133 Implementation Issue K1), then the guidance in this Issue would be applied to the combined financial instrument.

### **Scope**

8. **This Issue applies to any freestanding financial instrument or embedded feature that has all the characteristics of a derivative in paragraphs 6–9 of Statement 133, for purposes of determining whether that instrument or embedded feature qualifies for the first part of the scope exception in paragraph 11(a) of Statement 133. This Issue also applies to any freestanding financial instrument that is potentially settled in an entity's own stock, regardless of whether the instrument**

**has all the characteristics of a derivative in paragraphs 6–9 of Statement 133, for purposes of determining whether the instrument is within the scope of Issue 00-19.**

9. This Issue does not apply to share-based payment awards within the scope of Statement 123(R) for purposes of determining whether instruments are classified as liability awards or equity awards under that Statement. Equity-linked financial instruments issued to investors for purposes of establishing a market-based measure of the grant-date fair value of employee stock options are not within the scope of Statement 123(R) themselves. Consequently, this Issue applies to such market-based employee stock option valuation instruments for purposes of making the determinations described in the preceding paragraph.

10. The guidance in paragraph 12 of this Issue applies to both the issuer and the holder of instruments within the scope of this Issue (as set forth in paragraphs 8 and 9).

### **Recognition**

**11. An entity shall evaluate whether an equity-linked financial instrument (or embedded feature) is indexed to its own stock using the following two-step approach:**

**Step 1: Evaluate the instrument's contingent exercise provisions, if any.**

**Step 2: Evaluate the instrument's settlement provisions.**

12. Outstanding instruments within the scope of this Issue are always considered issued for accounting purposes, except as discussed in the remainder of this paragraph. In some cases, parties to a business combination exchange contingently exercisable options to purchase equity securities of the other entity, at favorable prices, to encourage successful

completion of that combination. If the merger is consummated as proposed, the options expire unexercised. If, however, a specified event occurs that interferes with the planned business combination, the options become exercisable. Such "lock-up options" are not considered issued for accounting purposes unless and until the options become exercisable.

#### **Evaluation of Contingent Exercise Provisions (Step 1)**

13. An exercise contingency would not preclude an instrument (or embedded feature) from being considered indexed to an entity's own stock provided that it is not based on (a) an observable market, other than the market for the issuer's stock (if applicable), or (b) an observable index, other than an index calculated or measured solely by reference to the issuer's own operations (for example, sales revenue of the issuer, EBITDA [earnings before interest, taxes, depreciation, and amortization] of the issuer, net income of the issuer, or total equity of the issuer). If the evaluation of Step 1 does not preclude an instrument from being considered indexed to the entity's own stock, the analysis would proceed to Step 2.

14. For purposes of applying the guidance in this Issue, an *exercise contingency* is a provision that entitles the entity (or the counterparty) to exercise an equity-linked financial instrument (or embedded feature) based on changes in an underlying,<sup>1</sup> including the occurrence (or nonoccurrence) of a specified event. Provisions that accelerate the timing of the entity's (or the counterparty's) ability to exercise an instrument and provisions that extend the length of time that an instrument is exercisable are examples of

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<sup>1</sup>Statement 133 defines an underlying as "A specified interest rate, security price, commodity price, foreign exchange rate, index of prices or rates, or other variable (including the occurrence or nonoccurrence of a

exercise contingencies. If an instrument's strike price or the number of shares used to calculate the settlement amount would be adjusted upon the occurrence of an exercise contingency, the exercise contingency would be evaluated under Step 1 and the potential adjustment to the instrument's settlement amount would be evaluated under Step 2.

**Evaluation Provisions (Step 2)**

15. An instrument (or embedded feature) would be considered indexed to an entity's own stock if its settlement amount will equal the difference between the fair value of a fixed number of the entity's equity shares and a fixed monetary amount or a fixed amount of a debt instrument issued by the entity. For example, an issued share option that gives the counterparty a right to buy a fixed number of the entity's shares for a fixed price or for a fixed stated principal amount of a bond issued by the entity would be considered indexed to the entity's own stock. An instrument's strike price or the number of shares used to calculate the settlement amount are not fixed if its terms provide for any potential adjustment, regardless of the probability of such adjustment(s) or whether such adjustments are in the entity's control. If the instrument's strike price or the number of shares used to calculate the settlement amount are not fixed, the instrument (or embedded feature) would still be considered indexed to an entity's own stock if the only variables that could affect the settlement amount would be inputs to the fair value of a "fixed-for-fixed" forward or option on equity shares.

16. A fixed-for-fixed forward or option on equity shares has a settlement amount that is equal to the difference between the price of a fixed number of equity shares and a fixed strike price. The fair value inputs of a fixed-for-fixed forward or option on equity shares

may include the entity's stock price and additional variables, including the strike price of the instrument, term of the instrument, expected dividends or other dilutive activities, stock borrow cost, interest rates, stock price volatility, the entity's credit spread, and the ability to maintain a standard hedge position in the underlying shares. Determinations and adjustments related to the settlement amount (including the determination of the ability to maintain a standard hedge position) must be commercially reasonable. An instrument (or embedded feature) would not be considered indexed to the entity's own stock if its settlement amount is affected by variables that are extraneous to the pricing of a fixed-for-fixed option or forward contract on equity shares. If an instrument's settlement calculation incorporates variables other than those used to determine the fair value of a fixed-for-fixed forward or option on equity shares, or if the instrument contains a feature (such as a leverage factor) that increases exposure to the additional variables listed above in a manner that is inconsistent with a fixed-for-fixed forward or option on equity shares, the instrument (or embedded feature) would not be considered indexed to the entity's own stock.

17. Standard pricing models for equity-linked financial instruments contain certain implicit assumptions. One such assumption is that the stock price exposure inherent in those instruments can be hedged by entering into an offsetting position in the underlying equity shares. For example, the Black-Scholes-Merton option-pricing model assumes that the underlying shares can be sold short without transaction costs and that stock price changes will be continuous. Accordingly, for purposes of applying Step 2, fair value inputs include adjustments to neutralize the effects of events that can cause stock price

discontinuities. For example, a merger announcement may cause an immediate jump (up or down) in the price of shares underlying an equity-linked option contract. A holder of that instrument would not be able to continuously adjust its hedge position in the underlying shares due to the discontinuous stock price change. As a result, changes in (a) the fair value of an equity-linked instrument and (b) the fair value of an offsetting hedge position in the underlying shares will differ, creating a gain or loss for the instrument holder as a result of the merger announcement. Therefore, inclusion of provisions that adjust the terms of the instrument to offset the net gain or loss resulting from a merger announcement or similar event do not preclude an equity-linked instrument (or embedded feature) from being considered indexed to an entity's own stock.

18. Some equity-linked financial instruments contain provisions that provide an entity with the ability to unilaterally modify the terms of the instrument at any time, provided that such modification benefits the counterparty. For example, the terms of a convertible debt instrument may explicitly permit the issuer to reduce the conversion price at any time to induce conversion of the instrument. For purposes of applying Step 2, such provisions do not affect the determination of whether an instrument (or embedded feature) is considered indexed to an entity's own stock.

## **Evaluation of Settlement Provisions (Step 2) When the Strike Price of an Equity-Linked Financial Instrument Is Denominated In a Foreign Currency**

19. The issuer of an equity-linked financial instrument incurs an exposure to changes in currency exchange rates if the instrument's strike price is denominated in a currency other than the functional currency of the issuer. An equity-linked financial instrument (or embedded feature) would not be considered indexed to the entity's own stock if the strike price is denominated in a currency other than the issuer's functional currency (including a conversion option embedded in a convertible debt instrument that is denominated in a currency other than the issuer's functional currency). The determination of whether an equity-linked financial instrument is indexed to an entity's own stock is not affected by the currency (or currencies) in which the underlying shares trade.

### **Transition**

20. This Issue is effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years. Earlier application by an entity that has previously adopted an alternative accounting policy is not permitted.

21. The guidance in this Issue shall 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 shall 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 as a result of the 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). However, in circumstances in which a previously bifurcated embedded conversion option in a convertible debt instrument no longer meets the bifurcation criteria in Statement 133 at initial application of this Issue, the carrying amount of the liability for the conversion option (that is, its fair value on the date of adoption) shall be reclassified to shareholders' equity. Any debt discount that was recognized when the conversion option was initially bifurcated from the convertible debt instrument shall continue to be amortized.

22. Paragraphs 12 and 13 of this Issue shall not result in a transition adjustment at the effective date because that guidance is consistent with guidance previously contained in Issue 01-6, which is nullified by this Issue.

23. The transition disclosures in paragraphs 17 and 18 of Statement 154 shall be provided.

<p><b>The provisions of this Issue need not be applied to immaterial items.</b></p>
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### **Board Ratification**

24. At its June 25, 2008 meeting, the Board ratified the consensus reached by the Task Force in this Issue.

### **Status**

25. No further EITF discussion is planned.

## **Exhibit 07-5A**

### **ILLUSTRATIVE EXAMPLES OF ISSUE 07-5**

The following examples illustrate the application of this Issue for purposes of determining whether an instrument (or embedded feature) is indexed to an entity's own stock, which is the first part of the scope exception in paragraph 11(a) of Statement 133. These examples do not address whether the instrument (or embedded feature) is classified in equity (or would be classified in equity if freestanding), which is the second part of the scope exception in paragraph 11(a) of Statement 133. These examples also do not address whether the instrument is within the scope of other accounting literature such as Statement 150 or whether the instrument would be subject to the two-class method under Statement 128.

#### **Example 1**

Company A issues warrants that permit the holder to buy 100 shares of its common stock for \$10 per share. The warrants have 10-year terms; however, they only become exercisable if Company A completes an initial public offering.

*Analysis:* The warrants are considered indexed to Company A's own stock based on the following evaluation:

Step 1: The exercise contingency (that is, the initial public offering) is not an observable market or an observable index, so the evaluation of Step 1 does not preclude the warrants from being considered indexed to the entity's own stock. Proceed to Step 2.

Step 2: Upon exercise, the settlement amount would equal the difference between the fair value of a fixed number of the entity's equity shares (100 shares) and a fixed strike price (\$10 per share).

#### **Example 2**

Company A issues warrants that permit the holder to buy 100 shares of its common stock for \$10 per share. The warrants have 10-year terms; however, they only become exercisable after Company A accumulates \$100 million in sales to third parties.

*Analysis:* The warrants are considered indexed to Company A's own stock based on the following evaluation:

Step 1: The exercise contingency (that is, the accumulation of \$100 million in sales to third parties) is an observable index. However, it can only be calculated or measured by reference to Company A's sales, so the evaluation of Step 1 does not preclude the warrants from being considered indexed to the entity's own stock. Proceed to Step 2.

Step 2: Upon exercise, the settlement amount would equal the difference between the fair value of a fixed number of the entity's equity shares (100 shares) and a fixed strike price (\$10 per share).

### **Example 3**

Company A issues warrants that permit the holder to buy 100 shares of its common stock for \$10 per share. The warrants have 10-year terms; however, they only become exercisable if the S&P 500 index increases 500 points within any given calendar year during that 10-year period.

*Analysis:* The warrants are not considered indexed to Company A's own stock based on the following evaluation:

Step 1: The exercise contingency (that is, the increase of 500 points in the S&P 500 index) is based on an observable index that is not measured solely by reference to the issuer's own operations. It is not necessary to evaluate Step 2.

Step 2: N/A

#### **Example 4**

Company A issues warrants that permit the holder to buy 100 shares of its common stock in exchange for one ounce of gold. The warrants have 10-year terms; however, they only become exercisable if Company A completes an initial public offering.

*Analysis:* The warrants are not considered indexed to Company A's own stock based on the following evaluation:

Step 1: The exercise contingency (that is, the initial public offering) is not an observable market or an observable index, so the evaluation of Step 1 does not preclude the warrants from being considered indexed to the entity's own stock. Proceed to Step 2.

Step 2: The settlement amount would not equal the difference between the fair value of a fixed number of the entity's equity shares (100 shares) and a fixed strike price. Although the number of shares that would be issued at settlement is fixed, the strike price varies based on the price of one ounce of gold. The price of gold is not an input to the fair value of a fixed-for-fixed option on equity shares.

#### **Example 5**

Company A issues warrants that permit the holder to buy 100 shares of its common stock for \$10 per share. The warrants have 10-year terms and are exercisable at any time. However, the terms of the warrants specify that if there is an announcement of a merger involving Company A, the strike price of the warrants will be adjusted to offset the effect of the merger announcement on the net change in the fair value of (a) the warrants and (b) an offsetting hedge position in the underlying shares. The strike price adjustment must be determined using commercially reasonable means based on an assumption that the counterparty has entered into a hedge position in the underlying shares to offset the share price exposure from the warrants. That strike price adjustment is not affected by the

counterparty's actual hedging position (for example, the strike price adjustment does not differ in circumstances when the counterparty is over-hedged or under-hedged).

*Analysis:* The warrants are considered indexed to Company A's own stock based on the following evaluation:

Step 1: The instruments do not contain an exercise contingency. Proceed to Step 2.

Step 2: The settlement amount would equal the difference between the fair value of a fixed number of the entity's equity shares (100 shares) and a fixed strike price (\$10 per share), unless there is a merger announcement. If there is a merger announcement, the settlement amount would be adjusted to offset the effect of the merger announcement on the fair value of the warrants. In that circumstance, the only variables that could affect the settlement amount would be inputs to the fair value of a fixed-for-fixed option on equity shares. Refer to paragraphs 16 and 17 of this Issue for further discussion.

### **Example 6**

Company A issues warrants that permit the holder to buy 100 shares of its common stock for an initial price of \$10 per share. The warrants have 10-year terms and are exercisable at any time. However, the terms of the warrants specify that the strike price is reduced by \$0.50 after any year in which Company A does not achieve revenues of at least \$100 million.

*Analysis:* The warrants are not considered indexed to Company A's own stock based on the following evaluation:

Step 1: The instruments do not contain an exercise contingency. Proceed to Step 2.

Step 2: The settlement amount would not equal the difference between the fair value of a fixed number of the entity's equity shares (100 shares) and a fixed strike price. Although the number of shares that would be issued at settlement is fixed, the strike price would be adjusted after any year in which Company A does not achieve revenues of at least \$100 million. The amount of an entity's annual revenues is not an input to the fair value of a fixed-for-fixed option on equity shares.

### **Example 7**

Company A purchases net-settled call options that permit it to buy 100 shares of its common stock for \$10 per share. However, the maximum appreciation on the call options is capped when Company A's stock price reaches \$15 per share (that is, the counterparty's maximum obligation is \$500 [ $(\$15 - \$10) \times 100$  shares]). The call options have 10-year terms and are exercisable at any time.

*Analysis:* The call options are considered indexed to Company A's own stock based on the following evaluation:

Step 1: The instruments do not contain an exercise contingency. Proceed to Step 2.

Step 2: The settlement amount would equal the difference between the fair value of a fixed number of the entity's equity shares (100 shares) and a fixed strike price when Company A's stock price is between the \$10 stated exercise price and the \$15 price cap. However, whenever Company A's stock price exceeds \$15, the strike price of the call options increases and decreases in amounts equal to the corresponding increases and decreases in Company A's stock price, such that the intrinsic value of each call option always equals \$5. Because the only variable that can affect the settlement amount is the entity's stock price, which is an input to the fair value of a fixed-for-fixed option contract, the call options are considered indexed to the entity's own stock.

### **Example 8**

Company A issues warrants that permit the holder to buy 100 shares of its common stock for \$10 per share. The warrants have 10-year terms and are exercisable at any time. However, the terms of the warrants specify that (a) if the entity sells shares of its common stock for an amount less than \$10 per share, the strike price of the warrants is reduced to equal the issuance price of those shares, and (b) if the entity issues an equity-linked financial instrument with a strike price below \$10 per share, the strike price of the

warrants is reduced to equal the strike price of the newly issued equity-linked financial instrument.

*Analysis:* The warrants are not considered indexed to Company A's own stock based on the following evaluation:

Step 1: The instruments do not contain an exercise contingency. Proceed to Step 2.

Step 2: The settlement amount would not equal the difference between the fair value of a fixed number of the entity's equity shares and a fixed strike price. The strike price would be adjusted if Company A (a) sells shares of its common stock for an amount less than \$10 per share or (b) issues an equity-linked financial instrument with a strike price below \$10 per share. Consequently, the settlement amount of the warrants can be affected by (a) future equity offerings undertaken by Company A at the then-current market price of the related shares or (b) the contractual terms of other equity-linked financial instruments issued in a subsequent period. The occurrence of a sale of common stock by the entity at market is not an input to the fair value of a fixed-for-fixed option on equity shares. Similarly, the occurrence of a sale of an equity-linked financial instrument is not an input to the fair value of a fixed-for-fixed option on equity shares, if the transaction was priced at market.

### **Example 9**

Company A issues warrants that permit the holder to buy 100 shares of its common stock for \$10 per share. The warrants have 10-year terms and are exercisable at any time. However, the terms of the warrants specify that if Company A does not obtain regulatory approval of a particular drug compound within 5 years, the holder can surrender the warrants to Company A for \$2 per warrant (settleable in shares).

*Analysis:* The contingently puttable warrants are not considered indexed to Company A's own stock based on the following evaluation:

Step 1: The instruments do not contain an exercise contingency. Proceed to Step 2.

Step 2: The settlement amount would equal the difference between the fair value of a fixed number of the entity's equity shares (100 shares) and a fixed strike price (\$10

per share), unless regulatory approval of a particular drug compound is not obtained within 5 years. If that approval is not obtained within the allotted time period, the holder could elect to surrender the warrants to Company A in exchange for \$2 per warrant. The contingent obligation to settle the warrants by transferring consideration with a fixed monetary value if regulatory approval of a particular drug compound is not obtained within a specified time period does not represent an input to the fair value of a fixed-for-fixed option on equity shares. A freestanding equity-linked instrument that provides for a fixed payoff upon the occurrence of a contingent event which is not based on the issuer's share price is not indexed to an entity's own stock.

### **Example 10**

Company A, whose functional currency is U.S. dollars (US\$), issues warrants with a strike price denominated in Canadian dollars (CAN\$). The warrants permit the holder to buy 100 shares of its common stock for CAN\$10 per share. Company A's shares trade on an exchange on which trades are denominated in CAN\$. The warrants have 10-year terms and are exercisable at any time.

*Analysis:* The warrants are not considered indexed to Company A's own stock based on the following evaluation:

Step 1: The instruments do not contain an exercise contingency. Proceed to Step 2.

Step 2: The strike price of the warrants is denominated in a currency other than the entity's functional currency, so the warrants are not considered indexed to the entity's own stock.

### **Example 11**

Company A enters into a forward contract to sell 100 shares of its common stock for \$10 per share in 1 year. Historically, Company A has paid a dividend of \$0.10 per quarter on its common shares. Under the terms of the forward contract, if dividends per common share differ from \$0.10 during any 3-month period, the strike price of the forward contract will be adjusted to offset the effect of the dividend differential (actual dividend versus \$0.10) on the fair value of the instrument. Additionally, the terms of the forward

contract provide for an adjustment to the strike price, using commercially reasonable means, to offset the effect of any increased cost of borrowing Company A's shares in the stock loan market on the fair value of the instrument.

*Analysis:* The forward contract is considered indexed to Company A's own stock based on the following evaluation:

Step 1: The instrument does not contain an exercise contingency. Proceed to Step 2.

Step 2: The only circumstances in which the settlement amount will not equal the difference between the fair value of 100 shares and \$1,000 (\$10 per share) are (a) if dividends per common share differ from \$0.10 during any 3-month period or (b) there is an increased cost of borrowing Company A's shares in the stock loan market. The adjustments to the strike price resulting from those events are intended to offset their effects on the instrument's fair value. In those circumstances, the only variables that could affect the settlement amount (dividends and stock borrow cost) would be inputs to the fair value of a fixed-for-fixed forward contract on equity shares.

### **Example 12**

Company A enters into a net-settleable forward contract to sell 100 shares of its common stock in 1 year for an amount equal to \$10 per share plus interest calculated at a variable interest rate (Federal Funds rate plus a fixed spread). The share price used to determine the settlement amount is based on the volume-weighted average daily market price of Company A's common stock for the 30-day period prior to the settlement date.

*Analysis:* The forward contract is considered indexed to Company A's own stock based on the following evaluation:

Step 1: The instrument does not contain an exercise contingency. Proceed to Step 2.

Step 2: The settlement amount will not equal the difference between the fair value of a fixed number of the entity's equity shares (100 shares) and a fixed strike price. However, the only variables that cause the settlement amount to differ from a fixed-for-fixed settlement amount are the 30-day volume-weighted average daily market

price of Company A's common stock and an interest rate index. The pricing inputs of a fixed-for-fixed forward contract include the entity's stock price and interest rates. Additionally, the floating interest rate feature does not introduce a leverage factor or otherwise increase the effects of interest rate changes on the instrument's fair value.

### **Example 13**

Company A enters into a forward contract to sell 100 shares of its common stock in 1 year for an amount equal to \$10 per share plus interest calculated at a variable interest rate that varies inversely with changes in the London Interbank Offered Rate (LIBOR) (similar to an "inverse floater," as described in paragraph 178 of Statement 133).

*Analysis:* The forward contract is not considered indexed to Company A's own stock based on the following evaluation:

Step 1: The instrument does not contain an exercise contingency. Proceed to Step 2.

Step 2: The settlement amount will not equal the difference between the fair value of a fixed number of the entity's equity shares (100 shares) and a fixed strike price. Although the number of shares that would be issued at settlement is fixed, the strike price varies inversely with changes in an interest rate index. The inverse floating interest rate feature increases the effects of interest rate changes on the instrument's fair value (that is, the feature increases the instrument's fair value exposure to interest rate changes) when compared to the exposure to interest rate changes of a fixed-for-fixed forward contract.

### **Example 14**

Company A enters into a net-settled forward contract to sell 100 shares of its common stock in 1 year for \$1,000. However, the maximum amount payable to the counterparty at maturity is capped when Company A's stock price is greater than or equal to \$15 per share (that is, Company A's maximum obligation is \$500  $[(\$15 - \$10) \times 100 \text{ shares}]$ ). Additionally, the maximum amount receivable from the counterparty at maturity is capped when Company A's stock price is less than or equal to \$5 per share (that is, the counterparty's maximum obligation is \$500  $[(\$5 - \$10) \times 100 \text{ shares}]$ ).

*Analysis:* The forward contract is considered indexed to Company A's own stock based on the following evaluation:

Step 1: The instrument does not contain an exercise contingency. Proceed to Step 2.

Step 2: The settlement amount would equal the difference between the fair value of a fixed number of the entity's equity shares (100 shares) and a fixed strike price (\$1,000) when Company A's stock price is between \$5 and \$15. However, whenever Company A's stock price is greater than or equal to \$15 at maturity, the amount payable to the counterparty always equals \$500. Additionally, whenever Company A's stock price is less than or equal to \$5 at maturity, the amount receivable from the counterparty always equals \$500. Because the only variable that can affect the settlement amount is the entity's stock price, which is an input to the fair value of a fixed-for-fixed forward contract, the instrument is considered indexed to the entity's own stock.

### **Example 15**

Company A enters into a forward contract to sell a variable number of its common shares in 1 year for \$1,000. If Company A's stock price is equal to or less than \$10 at maturity, Company A will issue 100 shares of its common stock to the counterparty. If Company A's stock price is greater than \$10 but equal to or less than \$12 at maturity, Company A will issue a variable number of its common shares worth \$1,000. Finally, if the share price is greater than \$12 at maturity, Company A will issue 83.33 shares of its common stock.

*Analysis:* The forward contract is considered indexed to Company A's own stock based on the following evaluation:

Step 1: The instrument does not contain an exercise contingency. Proceed to Step 2.

Step 2: The settlement amount will not equal the difference between the fair value of a fixed number of the entity's equity shares and a fixed strike price (\$1,000). Although the strike price to be received at settlement is fixed, the number of shares to be issued to the counterparty varies based on the entity's stock price on the settlement date. Because the only variable that can affect the settlement amount is the entity's

stock price, which is an input to the fair value of a fixed-for-fixed forward contract on equity shares, the instrument is considered indexed to the entity's own stock.

### **Example 16**

Company A enters into a forward contract to sell 100 shares of its common stock for \$10 per share in 1 year. Under the terms of the forward contract, if Company A (a) distributes a stock dividend or ordinary cash dividend, (b) executes a stock split, spinoff, rights offering, or recapitalization through a large, nonrecurring cash dividend, (c) issues shares for an amount below the then-current market price, or (d) repurchases shares for an amount above the then-current market price, the strike price of the forward contract would be adjusted to offset the resulting dilution (except for issuances and repurchases that occur upon settlement of outstanding option or forward contracts on equity shares).

[Note: This term adjusts for the dilution to the forward contract counterparty resulting from the occurrence of specified dilutive events. The adjustment to the strike price of the forward contract is based on a mathematical calculation that determines the direct effect that the occurrence of such dilutive events should have on the price of the underlying shares; it does not adjust for the actual change in the market price of the underlying shares upon the occurrence of those events, which may increase or decrease for other reasons.]

*Analysis:* The forward contract is considered indexed to Company A's own stock based on the following evaluation:

Step 1: The instrument does not contain an exercise contingency. Proceed to Step 2.

Step 2: The only circumstances in which the settlement amount will not equal the difference between the fair value of 100 shares and \$1,000 (\$10 per share) are upon the (a) distribution of a stock dividend or ordinary cash dividend, (b) execution of a

stock split, spinoff, rights offering, or recapitalization through a large, nonrecurring cash dividend, (c) issuance of shares for an amount below the then-current market price, or (d) repurchase of shares for an amount above the then-current market price. An implicit assumption in standard pricing models for equity-linked financial instruments is that such events will not occur (or that the strike price of the instrument will be adjusted to offset the dilution caused by such events). Therefore, the only variables that could affect the settlement amount in this example would be inputs to the fair value of a fixed-for-fixed option on equity shares.

### **Example 17**

Company A, whose functional currency is US\$, enters into a forward contract that requires Company A to sell 100 shares of its common stock for 120 euros (EUR) per share in 1 year.

*Analysis:* The forward contract is not considered indexed to Company A's own stock based on the following evaluation:

Step 1: The instrument does not contain an exercise contingency. Proceed to Step 2.

Step 2: The strike price of the forward contract is denominated in a currency other than the entity's functional currency, so the forward contract is not considered indexed to the entity's own stock.

### **Example 18**

Company A issues a contingently convertible debt instrument (CoCo) with a par value of \$1,000 that is convertible into 100 shares of its common stock. The convertible debt instrument has a 10-year term and is convertible at any time after one of the following events occurs: (a) Company A's stock price exceeds \$13 per share (market price trigger), (b) the convertible debt instrument trades for an amount that is less than 98 percent of its if-converted value (parity provision), or (c) there is an announcement of a merger involving Company A. The terms of the convertible debt instrument also include a "make-whole" provision. Under that provision, if Company A is acquired for cash before

a specified date, the holder of the convertible debt instrument can convert into a number of shares equal to the sum of (a) the fixed conversion ratio (100 shares per bond) and (b) the make-whole shares. The number of make-whole shares is determined by reference to a table with axes of stock price and time. That table was designed such that the aggregate fair value of the shares deliverable (that is, the fair value of 100 shares per bond plus the make-whole shares) would be expected to approximate the fair value of the convertible debt instrument at the settlement date, assuming no change in relevant pricing inputs (other than stock price and time) since the instrument's inception.

*Analysis:* The embedded conversion option is considered indexed to Company A's own stock based on the following evaluation:

Step 1: The market price trigger and parity provision exercise contingencies are based on observable markets; however, those contingencies relate solely to the market prices of the entity's own stock and its own convertible debt. Also, the merger announcement exercise contingency is not an observable market or an index. Therefore, Step 1 does not preclude the warrants from being considered indexed to the entity's own stock. Proceed to Step 2.

Step 2: An acquisition for cash prior to the specified date is the only circumstance in which the settlement amount will not equal the difference between the fair value of 100 shares and a fixed strike price (\$1,000 fixed par value of the debt). The settlement amount if Company A is acquired for cash prior to the specified date is equal to the sum of (a) the fixed conversion ratio (100 shares per bond) and (b) the make-whole-shares. The number of make-whole shares is determined based on a table with axes of stock price and time, which would both be inputs in a fair value measurement of a fixed-for-fixed option on equity shares.

### **Example 19**

Company A, whose functional currency is the Chinese yuan (CNY), issues a debt instrument denominated in CNY with a par value of CNY1,000 that is convertible into 100 shares of its common stock. Company A's shares only trade on an exchange in which trades are denominated in US\$. Those shares do not trade on an exchange (or other established marketplace) in which trades are denominated in CNY. The convertible debt instrument has a 10-year term and is convertible at any time.

*Analysis:* The embedded conversion option is considered indexed to Company A's own stock based on the following evaluation:

Step 1: The embedded conversion option does not contain an exercise contingency. Proceed to Step 2.

Step 2: Upon exercise of the embedded conversion option, the settlement amount would equal the difference between the fair value of a fixed number of the entity's equity shares (100 shares) and a fixed strike price denominated in its functional currency (CNY1,000 fixed par value of the debt). The determination of whether the embedded conversion option is indexed to the entity's own stock is not affected by the currency (or currencies) in which the underlying shares trade.

### **Example 20**

Company A issues a security to investors for purposes of establishing a market-based measure of the grant-date fair value of a grant of employee stock options. Under the terms of that market-based employee stock option valuation instrument, Company A is obligated to make variable quarterly payments to the investors that are a function of the net intrinsic value received by a pool of Company A's employees, based on actual stock option exercises by those employees each period. The market-based employee stock

option valuation instrument has a 10-year term, consistent with the contractual term of the underlying employee stock options.

*Analysis:* The market-based employee stock option valuation instrument is not considered indexed to Company A's own stock based on the following evaluation:

Step 1: The analysis of the exercise contingency (or contingencies) depends on the particular terms and features of the instrument. However, as indicated in Step 2 below, a market-based employee stock option valuation instrument would not be considered indexed to the entity's own stock.

Step 2: The settlement amount will not equal the difference between the fair value of a fixed number of the entity's equity shares and a fixed strike price. The instrument provides for variable quarterly payments to investors that are based on actual employee stock option exercises for the period. Because a variable that affects the instrument's settlement amount is employee stock option exercise behavior, which is not an input to the fair value of a fixed-for-fixed option or forward contract on equity shares, the instrument is not considered indexed to the entity's own stock.

