

**Topic:** Classification and Measurement of Redeemable Securities

**Dates Discussed:** July 19, 2001; May 15, 2003; March 17–18, 2004; September 15, 2005; March 16, 2006; September 7, 2006; March 15, 2007; June 14, 2007; March 12, 2008; September 10, 2008

1. The SEC staff has received inquiries about the financial statement classification and measurement of securities subject to mandatory redemption requirements or whose redemption is outside the control of the issuer. [Note: See Subsequent Developments section below.]

### **Scope**

2. Rule 5-02.28 of Regulation S-X<sup>1</sup> requires preferred securities that are redeemable for cash or other assets to be classified outside of permanent equity if they are redeemable (1) at a fixed or determinable price on a fixed or determinable date, (2) at the option of the holder, or (3) upon the occurrence of an event that is not solely within the control of the issuer. Although the rule specifically describes and discusses preferred securities, the SEC staff believes that Rule 5-02.28 of Regulation S-X also provides analogous guidance for other equity instruments including, for example, common stock, derivative instruments, noncontrolling interests,<sup>2</sup> and share-based payment arrangements that are

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<sup>1</sup>Adopted in Accounting Series Release No. 268, *Presentation in Financial Statements of “Redeemable Preferred Stocks.”*

<sup>2</sup>Accounting Research Bulletin No. 51, *Consolidated Financial Statements* (as amended by FASB Statement No. 160, *Noncontrolling Interests in Consolidated Financial Statements*), defines *noncontrolling interest* as “The portion of equity (net assets) in a subsidiary not attributable, directly or indirectly, to a parent. A noncontrolling interest is sometimes called a minority interest.” As indicated in paragraphs 40–41, the classification and measurement guidance in this SEC staff announcement applies to redeemable noncontrolling interests (provided the redemption feature is not considered a freestanding option within the scope of FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*). Where relevant, specific guidance pertaining to redeemable noncontrolling interests has been included in this SEC staff announcement. Otherwise, the general guidance in this SEC staff announcement is applicable to redeemable noncontrolling interests.

classified as equity pursuant to FASB Statement No. 123 (revised 2004), *Share-Based Payment*. [Note: See Subsequent Developments section below.]

3. As noted in ASR 268, the Commission reasoned that “[t]here is a significant difference between a security with mandatory redemption requirements or whose redemption is outside the control of the issuer and conventional equity capital. The Commission believes that it is necessary to highlight the future cash obligations attached to this type of security so as to distinguish it from permanent capital.”<sup>3</sup> Upon a reporting entity’s adoption of FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*, certain instruments that previously were reported as part of shareholder’s equity (including temporary equity) will be reported as liabilities. [Note: See paragraphs 22–26 in the Subsequent Developments section below.] Consequently, the presentation requirements outlined in ASR 268 (Rule 5-02.28 of Regulation S-X), and the interpretive guidance in this SEC staff announcement, do not apply to those instruments after the effective date of Statement 150. ASR 268 and the interpretive guidance in this SEC staff announcement continue to be applicable for instruments that are not within the scope of Statement 150.

### **Classification**

4. Rule 5-02.28 of Regulation S-X requires securities with redemption features that are not solely within the control of the issuer to be classified outside of permanent equity. The SEC staff believes that all of the events that could trigger redemption should be evaluated separately and that the possibility that *any* triggering event that is not *solely*

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<sup>3</sup>See ASR 268, July 27, 1979.

within the control of the issuer could occur—without regard to probability—would require the security to be classified outside of permanent equity.

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

6. Determining whether an equity security is redeemable at the option of the holder or upon the occurrence of an event that is solely within the control of the issuer can be complex. Accordingly, the SEC staff believes that all of the individual facts and

circumstances should be considered in determining how an equity security should be classified. Some financial instruments issued in the form of shares that are not required to be classified as assets or liabilities under Statement 150 or other applicable GAAP are redeemable at the option of the holder or upon the occurrence of an event that is not solely within the control of the issuer. Upon redemption of these financial instruments (in other than an ordinary liquidation or deemed liquidation that meets the exception in paragraph 5), the issuer may be required or may have a choice to settle the contract by delivery of its own shares. For these instruments, the guidance in paragraphs 12–32 of Issue No. 00-19, “Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company’s Own Stock,” should be used to evaluate whether the issuer controls the actions or events necessary to issue the maximum number of shares that could be required to be delivered under share settlement of the contract. If the issuer does not control settlement by delivery of its own shares, cash settlement of the instrument would be presumed and the instrument would be classified as temporary equity. For example, if preferred shares are redeemable at the option of the holder (that is, puttable shares) and the issuer is permitted to settle the redemption amount in cash or by delivery of a variable number of its common shares with an equivalent value, the absence of a cap on the number of common shares that could be potentially issuable upon redemption requires classification of the preferred shares outside of permanent equity.

### **Examples in which permanent equity classification is not appropriate**

7. Assume that a preferred security has a redemption provision that states it may be called by the issuer upon an affirmative vote by the majority of its board of directors. While some might view the decision to call the security as an event that is within the

control of the company, the SEC staff believes that if the preferred security holders control a majority of the votes of the board of directors through direct representation on the board of directors or through other rights, the preferred security is redeemable at the option of the holder and its classification outside of permanent equity is required. In other words, any provision that requires approval by the board of directors cannot be assumed to be within the control of the issuer. All of the relevant facts and circumstances should be considered.

8. In another example, consider a preferred security with a deemed liquidation clause that provides that the security becomes redeemable if the common stockholders of the issuing company (that is, those immediately prior to a merger or consolidation) hold, immediately after such merger or consolidation, common stock representing less than a majority of the voting power of the outstanding common stock of the surviving corporation. This change-in-control provision would require the preferred security to be classified outside of permanent equity because a purchaser could acquire a majority of the voting power of the outstanding common stock, without company approval, thereby triggering redemption.

9. Securities with provisions that allow the holders to be paid upon the occurrence of events that are not solely within the issuer's control should be classified outside of permanent equity. Such events include:

- The failure to have a registration statement declared effective by the SEC by a designated date [Note: See paragraphs 33–35 in the Subsequent Developments section below.]
- The failure to maintain compliance with debt covenants
- The failure to achieve specified earnings targets
- A reduction in the issuer's credit rating.

### **Examples in which permanent equity classification is appropriate**

10. Other events are solely within the control of the issuer, and, accordingly, classification as part of permanent equity would be appropriate. For example, a preferred stock agreement may have a provision that the decision by the issuing company to sell all or substantially all of a company's assets and a subsequent distribution to common stockholders triggers redemption of the preferred equity security. In this case, the security would be appropriately classified as part of permanent equity if the preferred stockholders cannot trigger or otherwise require the sale of the assets through representation on the board of directors, or through other rights, because the decision to sell all or substantially all of the issuer's assets and the distribution to common stockholders is solely within the issuer's control. In other words, if there could not be a "hostile" asset sale whereby all or substantially all of the issuer's assets are sold, and a dividend or other distribution is declared on the issuer's common stock, without the issuer's approval, then classifying the security as part of permanent equity would be appropriate.

11. As another example, a preferred stock agreement may have a provision that provides for redemption of the preferred security if the issuing company is merged with or consolidated into another company, and pursuant to state law, approval of the board of directors is required before any merger or consolidation can occur. In that case, assuming the preferred stockholders cannot control the vote of the board of directors through direct representation or through other rights, the security would be appropriately classified as part of permanent equity because the decision to merge with or consolidate into another company is within the control of the issuer. Again, all of the relevant facts and

circumstances should be considered when determining whether the preferred stockholders can control the vote of the board of directors.

12. An equity security may become redeemable upon the disability of the holder. In addition, an equity security may become redeemable upon the death of the holder, at the option of the holder's heir or estate. In this narrow, limited exception in which the redemption upon death (at the option of the holder's heir or estate) or disability will be funded from the proceeds of an insurance policy that is currently in force and which the company has the intent and ability to maintain in force, classifying the security as part of permanent equity would be appropriate. This is a narrow exception that should not be analogized to for other transactions, including circumstances in which an equity security must be redeemed upon the death of the holder.<sup>4</sup>

### **Measurement**

13. In adopting ASR 268 in 1979, the Commission stated that it was not its "intention to deal with the conceptual issue of whether redeemable preferred stock is a liability." Further, the Commission stated that it was not its "intention to alter existing practice or authoritative guidelines relative to accounting for elements of stockholders' equity . . . (for example, the determination of the carrying value of redeemable preferred stock . . .). [ASR 268] is intended to represent only an interim solution until the FASB, in connection with its conceptual framework project, addresses the related conceptual issues."

14. In May 2003, the FASB issued Statement 150, which addresses how an issuer classifies in its statement of financial position and measures certain financial instruments

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<sup>4</sup>Pursuant to Statement 150, shares of stock that are required to be redeemed by the issuer upon the death of the holder are classified as a liability, because redemption is required upon an event (that is, death) that is certain to occur. Mandatorily redeemable shares are classified as liabilities under Statement 150 even if an insurance policy would fund the redemption.

that have characteristics of both liabilities and equity. [Note: See paragraphs 22–26 in the Subsequent Developments section below.] Statement 150 does not address all of the instruments to which ASR 268 (Rule 5-02.28 of Regulation S-X) and the interpretive guidance in this SEC staff announcement had originally applied. The SEC staff has the following observations about the measurement of redeemable equity securities that are not within the scope of Statement 150.

15. The SEC staff believes the initial carrying amount of a redeemable equity security should be its fair value at date of issue.<sup>5</sup> This SEC staff announcement does not change the accounting for derivative instruments or embedded derivatives that are within the scope of FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities* (as amended), which should be accounted for in accordance with the provisions of that Statement. If redeemable currently (for example, at the option of the holder), the security should be adjusted to its maximum redemption amount at each balance sheet date.<sup>6</sup> The redemption amount at each balance sheet date should include amounts representing dividends not currently declared or paid but which will be payable under the redemption features or for which ultimate payment is not solely within the control of the registrant (for example, dividends that will be payable out of future earnings).<sup>7</sup> If the security is not redeemable currently (for example, because a contingency has not been

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<sup>5</sup>FASB Statement No. 141 (revised 2007), *Business Combinations*, and ARB 51 (as amended by Statement 160) provide guidance on the initial carrying amount of a noncontrolling interest. For equity securities that are issued by a parent, consistent with paragraph 17 of FASB Statement No. 157, *Fair Value Measurements*, the transaction price will generally represent the initial fair value of the equity security when the issuance occurs in an arm's-length transaction with an unrelated party and there are no other unstated rights or privileges. Paragraph 31 of this SEC staff announcement addresses the initial measurement of share-based payment arrangements with employees.

<sup>6</sup>If the maximum redemption amount is contingent on the fair value of the equity security at the redemption date, the amount reported outside of permanent equity should be calculated based on the fair value of the equity security as of the balance sheet date.

<sup>7</sup>See also Topic No. D-82, "Effect of Preferred Stock Dividends Payable in Common Shares on Computation of Income Available to Common Stockholders."

met), and it is not probable that the security will become redeemable, subsequent adjustment is not necessary until it is probable that the security will become redeemable. In that case, the SEC staff would expect disclosure of why it is not probable that the security will become redeemable.

16. If it is probable that the security will become redeemable, the SEC staff will not object to either of the following accounting methods:

- a. Accrete changes in the redemption value over the period from the date of issuance (or from the date that it becomes probable that the security will become redeemable, if later) to the earliest redemption date of the security using an appropriate methodology, usually the interest method. Changes in the redemption value are considered to be changes in accounting estimates and accounted for, and disclosed, in accordance with FASB Statement No. 154, *Accounting Changes and Error Corrections*.
- b. Recognize changes in the redemption value (for example, fair value) immediately as they occur and adjust the carrying value of the security to equal the redemption value at the end of each reporting period. This method would view the end of the reporting period as if it were also the redemption date for the security.

16A. Regardless of the accounting method applied (see paragraphs 15 and 16), for a redeemable equity instrument that is not a share-based payment arrangement, the SEC staff believes that reductions in the carrying amount of an equity security from the application of this SEC staff announcement are appropriate only to the extent that the registrant has previously recorded increases in the carrying amount of the equity security from the application of this SEC staff announcement.

17. The SEC staff will expect consistent application of the accounting method selected, along with appropriate disclosure of the selected policy in the footnotes to the financial statements. Moreover, disclosure of the redemption value of the security as if it were

currently redeemable is required for registrants that elect to accrete changes in redemption value over the period from the date of issuance to the earliest redemption date.

### **Reclassifications into Permanent Equity**

17A. If classification of an equity security as temporary equity is no longer required (if, for example, a redemption feature lapses, or there is a modification of the terms of the security), the existing carrying amount of the equity security should be reclassified to permanent equity at the date of the event that caused the reclassification. Prior financial statements are not adjusted. Additionally, the SEC staff believes that it would be inappropriate to reverse any adjustments previously recorded to the carrying amount of the equity security (pursuant to paragraphs 13–17 of this SEC staff announcement) in conjunction with such reclassifications.

### **Deconsolidation of a Subsidiary**

17B. Paragraph 36 of Accounting Research Bulletin No. 51, *Consolidated Financial Statements* (as amended by FASB Statement No. 160, *Noncontrolling Interests in Consolidated Financial Statements*), provides guidance on the measurement of the gain or loss that is recognized in net income when a parent deconsolidates a subsidiary. As indicated in paragraph 36(a)(3) of ARB 51 (as amended by Statement 160), that gain or loss calculation is impacted by the carrying amount of any noncontrolling interest in the former subsidiary. Since adjustments to the carrying amount of a noncontrolling interest from the application of this SEC staff announcement do not initially enter into the determination of net income, the SEC staff believes that the carrying amount of the noncontrolling interest that is referred to in paragraph 36(a)(3) of ARB 51 (as amended by Statement 160) should similarly not include any adjustments made to that noncontrolling interest from the application of this SEC staff announcement. Rather, previously recorded

adjustments to the carrying amount of a noncontrolling interest from the application of this SEC staff announcement should be eliminated in the same manner in which they were initially recorded (that is, by recording a credit to equity of the parent). The SEC staff encourages registrants to disclose the amount credited to equity of the parent as part of the disclosures required by paragraph 39 of ARB 51 (as amended by Statement 160).

### **Earnings per Share**

18. *Preferred securities issued by a parent (or single reporting entity).* Regardless of the accounting method selected in paragraph 16 and the redemption terms (that is, fixed price or fair value), the resulting increases or decreases in the carrying amount of a redeemable security other than common stock should be treated in the same manner as dividends on nonredeemable stock and should be effected by charges against retained earnings or, in the absence of retained earnings, by charges against paid-in capital. Increases or decreases in the carrying amount should reduce or increase income available to common stockholders in the calculation of earnings per share and the ratio of earnings to combined fixed charges and preferred stock dividends. If charges or credits are material to income, separate disclosure of income available to common stockholders on the face of the income statement should be provided. Additionally, Topic No. D-42, “The Effect on the Calculation of Earnings per Share for the Redemption or Induced Conversion of Preferred Stock,” and Topic No. D-53, “Computation of Earnings per Share for a Period That Includes a Redemption or an Induced Conversion of a Portion of a Class of Preferred Stock,” provide guidance on the accounting at the date of a redemption or induced conversion of a preferred equity security.

19. *Common securities issued by a parent (or single reporting entity).* Regardless of the accounting method selected in paragraph 16, the resulting increases or decreases in the carrying amount of redeemable common stock should be treated in the same manner as dividends on nonredeemable stock and should be affected by charges against retained earnings or, in the absence of retained earnings, by charges against paid-in capital. However, increases or decreases in the carrying amount of a redeemable common stock should not affect income available to common stockholders. Rather, the SEC staff believes that to the extent that a common shareholder has a contractual right to receive at share redemption (in other than an ordinary liquidation or deemed liquidation that meets the exception in paragraph 5) an amount that is other than the fair value of such shares, then that common shareholder has, in substance, received a distribution different from other common shareholders. Under FASB Statement No. 128, *Earnings per Share*, paragraph 60(b), entities with capital structures that include a class of common stock with different dividend rates from those of another class of common stock but without prior or senior rights, should apply the two-class method of calculating earnings per share. Therefore, when a class of common stock is redeemable at other than fair value, increases or decreases in the carrying amount of the redeemable security should be reflected in earnings per share using the two-class method.<sup>8</sup> For common stock redeemable at fair

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<sup>8</sup>The two-class method of computing earnings per share is addressed in Statement 128 and Issue No. 03-6, “Participating Securities and the Two-Class Method under Statement No. 128.” The SEC staff believes that there are two acceptable approaches for allocating earnings under the two-class method when a common security is redeemable at other than fair value. The registrant may elect to: (a) treat the entire periodic adjustment to the security’s carrying amount (from the application of this SEC staff announcement) as being akin to an actual dividend or (b) treat only the portion of the periodic adjustment to the security’s carrying amount (from the application of this SEC staff announcement) that reflects a redemption in excess of fair value as being akin to an actual dividend. Under either approach, decreases in the security’s carrying amount should be reflected in the application of the two-class method only to the extent they represent recoveries of amounts previously reflected in the application of the two-class method.

value,<sup>9</sup> the SEC staff would not expect the use of the two-class method, as a redemption at fair value does not amount to a distribution different from other common shareholders.<sup>10</sup>

19A. *Noncontrolling interests.* Paragraph 33 of ARB 51 (as amended by Statement 160) indicates that changes in a parent's ownership interest while the parent retains control of its subsidiary are accounted for as equity transactions, and do not impact net income or comprehensive income in the consolidated financial statements. Consistent with paragraph 33 of ARB 51 (as amended by Statement 160), an adjustment to the carrying amount of a noncontrolling interest from the application of this SEC staff announcement does not impact net income or comprehensive income in the consolidated financial statements. Rather, such adjustments are treated akin to the repurchase of a noncontrolling interest (although they may be recorded to retained earnings instead of additional paid-in capital). The SEC staff believes the guidance in paragraphs 18 and 19 of this SEC staff announcement should be applied to noncontrolling interests as follows:

- a. *Noncontrolling interest in the form of preferred securities.* The impact on income available to common stockholders of the parent arising from adjustments to the carrying amount of a redeemable noncontrolling interest other than common stock depends upon whether the redemption feature in the equity security was issued, or is guaranteed, by the parent. If the redemption feature was issued, or is guaranteed, by the parent, the entire adjustment under paragraph 18 reduces or increases income available to common stockholders of the parent. Otherwise, the adjustment is attributed to the parent and the noncontrolling interest in accordance with paragraph 62 (and Illustration 7) of Statement 128.
- b. *Noncontrolling interest in the form of common securities.* Adjustments to the carrying amount of a noncontrolling interest issued in the form of a common

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<sup>9</sup>Common stock that is redeemable based on a specified formula is considered to be redeemable at fair value if the formula is designed to equal or reasonably approximate fair value. The SEC staff believes that a formula based solely on a fixed multiple of earnings (or other similar measure) is not considered to be designed to equal or reasonably approximate fair value.

<sup>10</sup>Similarly, this SEC staff announcement does not require application of the two-class method when share-based payment awards granted to employees are redeemable at fair value (provided those awards are in the form of common shares or options on common shares). However, those share-based payment awards may still be subject to the two-class method pursuant to the guidance in paragraph 60 of Statement 128 and Issue 03-6. [Note: See paragraphs 27–31 in the Subsequent Developments section below.]

security to reflect a fair value redemption feature do not impact earnings per share. Adjustments to the carrying amount of a noncontrolling interest issued in the form of a common security to reflect a non-fair value redemption feature do impact earnings per share; however, the manner in which those adjustments reduce or increase income available to common stockholders of the parent may differ.<sup>11</sup> If the terms of the redemption feature are fully considered in the attribution of net income under paragraph 30 of ARB 51 (as amended by Statement 160), application of the two-class method is unnecessary. If the terms of the redemption feature are not fully considered in the attribution of net income under paragraph 30 of ARB 51 (as amended by Statement 160) application of the two-class method at the subsidiary level is necessary in order to determine net income available to common stockholders of the parent.

### **Transition**

20. When this SEC staff announcement was made in July 2001, it was to be applied retroactively in the first fiscal quarter ending after December 15, 2001, by restating the financial statements of prior periods in accordance with the provisions of paragraphs 27–30 of APB Opinion No. 20, *Accounting Changes*.

21. At the September 15, 2005 meeting, the SEC staff also clarified the impact of certain redeemable securities on earnings per share calculations in paragraph 19. The guidance in paragraph 19 should be applied in the first fiscal period beginning after September 15, 2005 (the date of the SEC staff announcement). Prior period earnings per share amounts presented for comparative purposes should be retroactively adjusted to conform to the guidance.

21A. At the March 12, 2008 meeting, the SEC Observer announced that clarifications were made to this SEC staff announcement. Registrants should apply the SEC staff's

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<sup>11</sup>ARB 51 (as amended by Statement 160) does not provide detailed guidance on the attribution of net income to the parent and the noncontrolling interest. The SEC staff understands that when a noncontrolling interest is redeemable at other than fair value some registrants consider the terms of the redemption feature in the calculation of net income attributable to the parent (as reported on the face of the income statement), while others only consider the impact of the redemption feature in the calculation of income available to common stockholders of the parent (which is the control number for earnings per share purposes).

views in paragraphs 16A, 17A, and footnote 9 of this SEC staff announcement no later than the first fiscal year beginning on or after December 15, 2008. A change in a registrant's application of the two-class method (see footnote 8) should be accounted for in accordance with Statement 154. The SEC staff's views on the accounting for noncontrolling interests (paragraphs 17B and 19A) should be applied following the effective date of Statement 160. [Note: See paragraphs 40–41 in the Subsequent Developments section below.]

## **Subsequent Developments**

### **Statement 150**

22. In May 2003, the FASB issued Statement 150, which establishes standards for how an issuer classifies and measures in its statement of financial position certain financial instruments with characteristics of both liabilities and equity. It requires that an issuer classify a financial instrument that is within its scope as a liability (or as an asset in some circumstances) because that financial instrument embodies an obligation of the issuer. For public entities, Statement 150 is effective for all financial instruments entered into or modified after May 31, 2003, and otherwise effective at the beginning of the interim period beginning after June 15, 2003.

23. Statement 150 addresses three types of freestanding financial instruments that embody obligations of the issuer:

- **Mandatorily redeemable financial instruments:** Financial instruments issued in the form of shares that embody an unconditional obligation requiring the issuer to redeem the instruments by transferring its assets at a specified or determinable date (or dates) or upon an event that is certain to occur.
- **Obligations to repurchase the issuer's equity shares by transferring assets:** Financial instruments, other than outstanding equity shares, that at inception embody an obligation to repurchase the issuer's equity shares (or that are indexed to such an obligation) and that require or may require the issuer to settle the obligation by

transferring assets. Examples include forward purchase contracts or written put options on the issuer's equity shares that are to be physically settled or net cash settled.

- Certain obligations to issue a variable number of shares: Financial instruments that embody an unconditional obligation, or financial instruments other than outstanding equity shares that embody a conditional obligation, that the issuer must or may settle by issuing a variable number of its equity shares if, at inception, the monetary value of the obligation is based solely or predominantly on (a) a fixed monetary amount known at inception, (b) variations in something other than the fair value of the issuer's equity shares, or (c) variations inversely related to changes in the fair value of the issuer's equity shares. Examples include a payable settleable with a variable number of the issuer's equity shares, a financial instrument indexed to the S&P 500 and settleable with a variable number of the issuer's equity shares, and a written put option that could be net share settled.

24. Freestanding financial instruments within the scope of Statement 150 should be classified and measured in accordance with that Statement. ASR 268 (Rule 5-02.28 of Regulation S-X) and the interpretive guidance in this SEC staff announcement no longer apply for those instruments after the effective date of Statement 150. Additionally, freestanding financial instruments that were previously classified as temporary equity under Issue 00-19 are no longer subject to temporary equity classification under ASR 268 and this SEC staff announcement because those freestanding financial instruments are now within the scope of Statement 150. However, Issue 00-19 continues to apply to embedded derivative instruments indexed to, and potentially settled in, a company's own stock. Accordingly, when a hybrid financial instrument that is not classified as an asset or liability under Statement 150 or other applicable GAAP contains an embedded derivative within the scope of Issue 00-19, the registrant should consider ASR 268 and this SEC staff announcement to determine whether:

- The hybrid financial instrument is required to be classified and measured as temporary equity when the embedded derivative *is not* separated under Statement 133, or
- The host contract is required to be classified and measured as temporary equity when the embedded derivative *is* separated under Statement 133.

25. At the November 12–13, 2003 meeting, the SEC Observer announced the SEC staff’s position relating to the application of this SEC staff announcement to certain mandatorily redeemable securities for which the relevant portions of Statement 150 were recently deferred in FASB Staff Position 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.” The SEC Observer clarified that SEC registrants with instruments that qualify for the deferral should refer to this SEC staff announcement for guidance related to classification and/or measurement, as applicable, for those securities that, for the time being, will not be accounted for in accordance with Statement 150.

26. At the March 17–18, 2004 meeting, the SEC Observer clarified the SEC staff’s position relating to the interaction of this SEC staff announcement and Statement 150 for conditionally redeemable preferred shares. If a company issues preferred shares that are conditionally redeemable, for example, at the holder’s option or upon the occurrence of an uncertain event not solely within the company’s control, the shares are not within the scope of Statement 150 because there is no unconditional obligation to redeem the shares by transferring assets at a specified or determinable date or upon an event certain to occur. If the uncertain event occurs, the condition is resolved, or the event becomes certain to occur, then the shares become mandatorily redeemable under Statement 150 and would require reclassification to a liability. Paragraph 23 of that Statement requires the issuer to measure that liability initially at fair value and reduce equity by the amount of that initial measure, recognizing no gain or loss. This reclassification of shares to a liability is akin to the redemption of such shares by issuance of debt. Similar to the accounting for the

redemption of preferred shares (refer to Topic D-42), to the extent that the fair value of the liability differs from the carrying amount of the preferred shares, upon reclassification that difference should be deducted from or added to income available to common stockholders in the calculation of earnings per share.

**Statement 123(R)**

27. At the September 15, 2005 meeting, the SEC Observer announced the SEC staff's position on several issues and provided additional guidance related to the application of this SEC staff announcement to share-based payment arrangements with employees. These positions are included in paragraphs 28–30 below.

28. In Staff Accounting Bulletin No. 107, *Interaction Between FASB Statement No. 123(R), and Certain SEC Rules and Regulations Regarding the Valuation of Share-Based Payment Arrangements for Public Companies*, the SEC staff clarified that registrants should evaluate whether the terms of instruments granted in conjunction with share-based payment arrangements with employees that are not classified as liabilities under Statement 123(R) result in the need to present certain amounts outside of permanent equity in accordance with ASR 268 and this SEC staff announcement. The SEC staff expects that this guidance be applied concurrently with the adoption of Statement 123(R). Upon transition, awards previously classified as permanent equity that are now required to be classified outside of permanent equity should be reclassified at the amount required to be presented outside of permanent equity.

29. In SAB 107, the SEC staff clarified that instruments granted in conjunction with share-based payment arrangements with employees that do not by their terms require redemption for cash or other assets (at a fixed or determinable price on a fixed or

determinable date, at the option of the holder, or upon the occurrence of an event that is not solely within the control of the issuer) would not be assumed by the SEC staff to require net cash settlement for purposes of applying ASR 268 and this SEC staff announcement in circumstances in which paragraphs 14–18 of Issue 00-19 would otherwise require the assumption of net cash settlement.

30. Certain employee awards contain provisions for either direct or indirect repurchase of shares issued upon exercise of employee options in order to meet the employer's minimum statutory withholding requirement resulting from the exercise. Statement 123(R) does not require awards with this specific provision, described in paragraph 35, to be classified as liabilities. The SEC staff would not expect SEC registrants to classify such employee awards outside of permanent equity, if the direct or indirect repurchase of shares is done solely to satisfy the employer's minimum statutory tax withholding requirements.

31. At the March 16, 2006 meeting, the SEC Observer clarified the SEC staff's position on the application of this SEC staff announcement to certain share-based payment arrangements with employees. The SEC staff believes that for options or similar instruments granted in conjunction with share-based payment arrangements with employees for which the terms may permit redemption of the option or underlying share, the initial amount classified outside of permanent equity should be based on the redemption provisions of the instrument.<sup>12</sup> For example, upon issuance of a fully vested option that allows the holder to put the option back to the issuer at its intrinsic value upon

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<sup>12</sup>As discussed in the Interpretive Response to Question 2 in Section E of SAB 107, the amount presented in temporary equity at each balance sheet date should take into account the proportion of consideration received in the form of employee services.

a change in control, an amount representing the intrinsic value of the option at the date of issuance should be presented outside of permanent equity. The guidance in paragraphs 15–17 should be followed to determine the amount of any subsequent adjustments.<sup>13</sup>

#### **Statement 155**

32. In February 2006, the FASB issued Statement No. 155, *Accounting for Certain Hybrid Financial Instruments*. Statement 155 establishes standards designed to simplify accounting for certain hybrid financial instruments by permitting fair value remeasurement for any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation. Statement 155 amends paragraph 16 of Statement 133 to permit this election, while footnote 6bb of Statement 133 clarifies that the guidance applies to hybrid financial instruments that are classified as assets and liabilities and does not apply to hybrid financial instruments classified in permanent or temporary equity, which are instruments described in paragraph 8 of FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*. Therefore, the guidance in this SEC staff announcement continues to be applicable for hybrid financial instruments classified in permanent or temporary stockholders' equity.

#### **FSP EITF00-19-2**

33. In December 2006, the FASB issued FASB Staff Position EITF 00-19-2, "Accounting for Registration Payment Arrangements." FSP EITF00-19-2 addresses the issuer's accounting for registration payment arrangements and specifies that the contingent obligation to make future payments or otherwise transfer consideration under a registration payment arrangement (as defined in the FSP), whether issued as a separate

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<sup>13</sup>Registrants should also consider the guidance in FASB Staff Position FAS 123(R)-4, "Classification of Options and Similar Instruments Issued as Employee Compensation That Allow for Cash Settlement upon the Occurrence of a Contingent Event," when evaluating the classification of options or similar instruments whose terms may permit redemption of the option or underlying share.

agreement or included as a provision of a financial instrument or other agreement, should be separately recognized and measured in accordance with FASB Statement No. 5, *Accounting for Contingencies*. Additionally, paragraph 8 of FSP EITF00-19-2 states that a financial instrument subject to a registration payment arrangement should be recognized and measured in accordance with other applicable GAAP without regard to the contingent obligation to transfer consideration pursuant to the registration payment arrangement. At the March 15, 2007 meeting, the SEC Observer announced the SEC staff's position relating to the interaction of the financial statement classification and measurement guidance in this SEC staff announcement and the guidance for registration payment arrangements in FSP EITF00-19-2. Consistent with the guidance in FSP EITF00-19-2, the SEC staff believes that the guidance in this SEC staff announcement should be applied to a financial instrument subject to a registration payment arrangement without regard to the contingent obligation to transfer consideration pursuant to the registration payment arrangement (that is, the registration payment arrangement is considered to be a separate unit of account that does not impact the classification and measurement of the related financial instrument under this SEC staff announcement). However, for purposes of applying this SEC staff announcement to a financial instrument with any other related arrangement that is outside the scope of FSP EITF00-19-2, the SEC staff believes that a conclusion that the related arrangement is a separate unit of account should not be based on an analogy to the guidance in FSP EITF00-19-2.

34. The SEC staff announcement in paragraph 33 should be applied following the effective date of FSP EITF00-19-2. If upon adoption of FSP EITF00-19-2, a registrant determines that a financial instrument subject to a registration payment arrangement

should be reclassified from temporary equity to permanent equity, the registrant should reclassify the related financial instrument following the guidance in paragraph 19 of FSP EITF00-19-2. Any difference between the carrying amount of the instrument recorded as temporary equity prior to adoption of FSP EITF00-19-2 and the carrying amount reclassified to permanent equity upon adoption of FSP EITF00-19-2 should be included in the cumulative effect adjustment to the opening balance of retained earnings, or other appropriate components of equity or net assets in the statement of financial position. In the period of reclassification, that difference (if any) should not be deducted from or added to income available to common stockholders in the calculation of earnings per share.

35. If a registrant has adopted FSP EITF00-19-2 and issued its financial statements prior to March 15, 2007 (the date of this SEC staff announcement), using a reasonable methodology that is inconsistent with the SEC staff announcement described in paragraph 34, those prior period financial statements should not be restated. However, the earnings per share amounts reported in those prior-period financial statements presented for comparative purposes in the registrant's next interim or annual financial statements should be retrospectively adjusted (if necessary) to conform to the guidance in paragraph 34.

### **Statement 133**

36. At the March 15, 2007 meeting, the SEC Observer announced the SEC staff's position relating to the determination of whether the characteristics of a host contract related to a hybrid financial instrument issued in the form of a share are more akin to a debt instrument or more akin to an equity instrument. This SEC staff announcement also discusses the interaction of the financial statement classification guidance in this SEC staff announcement and the guidance in paragraphs 12(a) and 60 of Statement 133. The

SEC staff's position regarding these matters is discussed in Topic No. D-109, "Determining the Nature of a Host Contract Related to a Hybrid Financial Instrument Issued in the Form of a Share under FASB Statement No. 133."

**Statement 159**

37. In February 2007, the FASB issued FASB Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*. Statement 159 permits entities to choose to measure many financial instruments and certain other items at fair value. Paragraph 8(f) of Statement 159 prohibits an issuer from electing the fair value option for financial instruments that are, in whole or in part, classified as a component of shareholder's equity (including "temporary equity").

38. The SEC staff has previously not objected to liability classification on the balance sheet for certain financial instruments (or host contracts) that meet the conditions for temporary equity classification under ASR 268 and this SEC staff announcement. In these circumstances, registrants recorded dividends and changes in carrying amount currently in earnings, rather than recording such items as direct adjustments to retained earnings. At the June 14, 2007 meeting, the SEC Observer announced the SEC staff's position regarding these classification practices and the related impact on the guidance in paragraph 8(f) of Statement 159. The SEC staff will no longer accept liability classification for financial instruments (or host contracts) that meet the conditions for temporary equity classification under ASR 268 and this SEC staff announcement. Consistent with SEC Regulation S-X, Articles 5-02, 7-03, and 9-03, these financial instruments should be classified on the balance sheet between captions for liabilities and shareholder's equity. As a consequence, the fair value option may not be applied to any

financial instrument (or host contract) that meets the conditions for temporary equity classification under ASR 268 and this SEC staff announcement. The measurement guidance in this SEC staff announcement applies to these financial instruments.

39. The SEC staff announcement in paragraph 38 should be applied prospectively to all affected financial instruments (or host contracts) that are entered into, modified, or otherwise subject to a remeasurement (new basis) event in the registrant's first fiscal quarter beginning after September 15, 2007. Subsequent to initial adoption of the guidance in paragraph 38, a registrant should not initially apply hedge accounting or initially elect the fair value option for an affected financial instrument (or host contract) that continues to be classified on the balance sheet as a liability. That is, while an existing financial instrument (or host contract) that otherwise meets the conditions for classification as temporary equity may continue to be classified as a liability when the guidance in paragraph 38 is adopted prospectively, that financial instrument (or host contract) would not be eligible for initial application of the fair value option under Statement 159 or initial adoption of hedge accounting in fiscal quarters beginning after September 15, 2007. As an alternative to prospective application, a registrant may retrospectively apply the guidance in paragraph 38 to all prior financial reporting periods in accordance with paragraphs 7-10 of Statement 154. Regardless of the method of transition, the disclosures in paragraph 24 of Statement 154 should be provided. Earlier adoption is permitted.

**Statement 160 (an amendment of ARB 51)**

40. In December 2007, Statement 160 was issued. Statement 160 amends ARB 51 to establish accounting and reporting standards for the noncontrolling interest in a subsidiary

and for the deconsolidation of a subsidiary. As indicated in paragraph 27(c) of ARB 51 (as amended by Statement 160), ASR 268 provides guidance on the classification of a financial instrument issued by a subsidiary. Application of ASR 268 and this SEC staff announcement to a redeemable noncontrolling interest is consistent with the SEC staff's longstanding position.

41. Statement 160 does not provide guidance for instruments within the scope of ASR 268 (see paragraph B35 of Statement 160). At the March 12, 2008 meeting, the SEC Observer announced that clarifications were made to this SEC staff announcement to address its interaction with Statement 160. While those amendments are not expected to result in significant changes in existing accounting practices, paragraph 21A of this SEC staff announcement provides transition guidance for the amendments made to paragraphs 17B and 19A.<sup>14</sup> Additionally, the SEC staff is aware that some registrants have not previously applied the measurement guidance in paragraphs 13–17 of this SEC staff announcement when a noncontrolling interest issued in the form of a common security is redeemable at fair value. Those registrants should initially apply that measurement guidance no later than the effective date of Statement 160. Transition should be applied consistent with the transition guidance in paragraph 5(a) of Statement 160 (that is, retrospectively for all periods presented).<sup>15</sup> In periods preceding such initial adoption, those registrants should disclose the redemption amount of those securities on the face of the balance sheet, and provide disclosures of the pertinent terms and conditions of those securities in the footnotes.

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<sup>14</sup>That transition guidance is intended to include the impact that footnote 9 of this SEC staff announcement may have on the determination of whether a noncontrolling interest is redeemable at fair value.

<sup>15</sup>Consistent with paragraph 19A(b) of this SEC staff announcement, the initial application will not impact previously reported earnings per share amounts.

42. In May 2008, the FASB issued FASB Staff Position APB 14-1, *Accounting for Convertible Debt Instruments That May Be Settled in Cash upon Conversion (Including Partial Cash Settlement)*. FSP APB14-1 addresses the issuer's accounting for convertible debt instruments that, by their stated terms, may be settled in cash or other assets upon conversion, including partial cash settlement, unless the embedded conversion option is required to be separately accounted for as a derivative under Statement 133. An issuer of a convertible debt instrument within the scope of FSP APB14-1 is required to separate the convertible debt instrument into a liability-classified component and an equity-classified component. At the September 10, 2008 meeting, the SEC Observer announced the SEC staff's position relating to the interaction of the financial statement classification and measurement guidance in this SEC staff announcement with the guidance in FSP APB14-1.

43. The SEC staff believes that ASR 268 and this SEC staff announcement apply to convertible debt instruments within the scope of FSP APB14-1 and to other situations in which a component of a convertible debt instrument is classified in stockholders' equity.<sup>16</sup> As noted in ASR 268, the objective of temporary equity classification is to highlight cash obligations that are attached to an equity security in order to distinguish it from permanent

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<sup>16</sup>For example, a component of a convertible debt instrument may be separately classified in stockholders' equity pursuant to the guidance in Issues No. 98-5, "Accounting for Convertible Securities with Beneficial Conversion Features or Contingently Adjustable Conversion Ratios," No. 06-6, "Debtor's Accounting for a Modification or Exchange of Convertible Debt Instruments," or No. 06-7, "Issuer's Accounting for a Previously Bifurcated Conversion Option in a Convertible Debt Instrument When the Conversion Option No Longer Meets the Bifurcation Criteria in FASB Statement No. 133."

capital. To meet that objective the SEC staff believes that ASR 268 should be applied to convertible debt instruments with equity-classified components as follows:<sup>17</sup>

- a. The equity-classified component of the convertible debt instrument should be considered redeemable if at the balance sheet date the issuer can be required to settle the convertible debt instrument for cash or other assets (that is, the instrument is currently redeemable or convertible for cash or other assets). Solely for purposes of this paragraph, an assessment of whether the convertible debt instrument will become redeemable or convertible for cash or other assets at a future date should not be made. For example, a convertible debt instrument that is not redeemable at the balance sheet date but could become redeemable by the holder of the instrument in the future based on the passage of time or upon the occurrence of a contingent event is not considered currently redeemable at the balance sheet date.
- b. If the equity-classified component is considered redeemable, the portion of the equity-classified component that is presented in temporary equity (if any) is measured as the excess of (1) the amount of cash or other assets that would be required to be paid to the holder upon redemption or conversion over (2) the current carrying amount of the liability-classified component of the convertible debt instrument. For example, if the convertible debt instrument is currently redeemable at the option of the holder for \$1,000 in cash, and the liability-classified component of the instrument is carried at \$950 on the balance sheet, \$50 of the equity-classified component should be presented as temporary equity.
- c. There should be no incremental earnings per share accounting from the application of this SEC staff announcement. Statement 128 and its related interpretative guidance address the earnings per share accounting.<sup>18</sup>

44. The SEC staff's views in paragraph 43 should be applied to convertible debt instruments within the scope of FSP APB14-1 following the effective date, and using the transition provisions, described in paragraphs 34–36 and 38–39 of FSP APB14-1. Regarding the situations described in footnote 16, the SEC staff's views in paragraph 43 should also be applied retrospectively using the effective date described in paragraph 34 of FSP APB14-1. For the situations described in footnote 16, the retrospective application

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<sup>17</sup>The guidance provided in this paragraph for convertible debt instruments that contain an equity-classified component should not be applied by analogy to other equity instruments that are subject to ASR 268 and this SEC staff announcement.

<sup>18</sup>Topic D-42 also does not apply to convertible debt instruments that contain an embedded conversion option indexed to the issuer's common stock because the application of Topic D-42 is limited to preferred stock instruments.

of the SEC staff's views in paragraph 43 should have no impact on previously reported net income or earnings per share.