

**FASB STATEMENT NO. 150,
ACCOUNTING FOR CERTAIN FINANCIAL
INSTRUMENTS WITH CHARACTERISTICS OF
BOTH LIABILITIES AND EQUITY**



October 2003

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To Our Friends:

In May 2003, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 150 ("FAS 150" or the "Standard"), *Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity*. Under FAS 150, instruments that fall within the Standard's scope must be classified as liabilities by the issuer.

FAS 150 represents phase 1 of the FASB's broader project on distinguishing between instruments that are classified as liabilities and those that are classified as equity. Phase 2 is expected to address accounting for compound instruments such as convertible debt and puttable stock, as well as further refine the concept of "ownership relationship" and the definition of a liability.

The Standard focuses on mandatorily redeemable shares, forward contracts to purchase an entity's own stock, and freestanding written options that enable the investor to put shares of stock to the issuer. Prior to FAS 150, mandatorily redeemable shares were typically presented in the balance sheet between liabilities and equity, commonly referred to as the "mezzanine" section and many forward purchase contracts and written put options were presented as equity, if they could be net-share-settled by the issuer. However, such financial instruments embodied obligations of the issuer and appeared to have little in common with an ownership relationship. Additionally, because of the severe drop in share prices during the past couple of years, there have been a few high-profile cases in which companies have had to settle these instruments at a significant "economic" loss.

In view of the concerns raised over the accounting for these financial instruments, the FASB decided to issue FAS 150 as a limited-scope standard, without waiting for a resolution of the more complex issues involving compound instruments. One of the underlying principles of FAS 150 is that although an entity can settle a contract by issuing equity shares, the contract is not necessarily an equity instrument, because the form of settlement might create more of a debtor/creditor relationship than an ownership relationship between the two parties to the contract.

Although limited in scope, FAS 150 could have a significant impact on many entities. The Standard will (1) result in more instruments being classified as liabilities, (2) partially eliminate the "mezzanine" section of the balance sheet, and (3) require that, for a limited number of non-public (i.e., private) companies, the balance sheet present only assets and liabilities (no equity). Classifying more instruments as liabilities could trigger, for some entities, debt-to-equity covenant violations under loan agreements and, therefore, might make it necessary for those entities to renegotiate existing covenants with lenders.

The Standard is effective immediately for all new instruments issued or modified after May 31, 2003 (except for mandatorily redeemable instruments of non-public entities). For all instruments that existed prior to May 31, 2003, the Standard is effective at the beginning of the first interim period beginning after June 15, 2003 (except for mandatorily redeemable instruments of non-public entities). For calendar-year public entities, therefore, the Standard will be effective for the third quarter beginning on July 1, 2003. For mandatorily redeemable instruments of non-public entities, FAS 150 is effective for fiscal periods beginning after December 15, 2003.

We have prepared this publication to help you understand and implement the new rules. It includes our initial observations on the new requirements and clarifies some important aspects of the Standard. As additional implementation questions emerge, we will consider issuing further guidance.

We look forward to helping you implement the new rules and promise you the full benefit of our knowledge and resources. For assistance, contact your PricewaterhouseCoopers partner or the managing partner of the PricewaterhouseCoopers office nearest you.

Sincerely,

A handwritten signature in black ink, reading "Raymond J. Bromark". The signature is written in a cursive, flowing style.

Raymond J. Bromark
Americas Leader of Professional, Technical, Risk and Quality

**STATEMENT OF FINANCIAL ACCOUNTING STANDARDS No. 150,
ACCOUNTING FOR CERTAIN FINANCIAL INSTRUMENTS WITH
CHARACTERISTICS OF BOTH LIABILITIES AND EQUITY**

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Introduction

.1 In May 2003, the Financial Accounting Standards Board (FASB or the “Board”) issued Statement of Financial Accounting Standards No. 150 (“FAS 150” or the “Standard”), *Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity*. The Standard specifies that instruments within its scope embody obligations of the issuer and that, therefore, the issuer must classify them as liabilities. This publication highlights the significant provisions of FAS 150.

.2 FAS 150 represents phase 1 of the FASB’s broader project on (1) distinguishing between instruments that should be classified as liabilities and those that should be classified as equity and (2) accounting for instruments that have characteristics of both types of instruments (the “liabilities and equity project”). The Standard covers a limited number of instruments that are to be classified as liabilities. It is expected that phase 2 of the project, which is about to begin, will address (1) separating compound financial instruments (including convertible debt and conditionally redeemable stock) that have characteristics of liabilities and equity into their liability and equity components, (2) the definition of an ownership relationship, and (3) the definition of a liability in FASB Concepts Statement No. 6 (“CON 6”), *Elements of Financial Statements*.

Background

.3 The Board initiated its liabilities and equity project in response to concerns regarding the current balance sheet classification of certain financial instruments. Supporters of the project have noted that some financial instruments possessing characteristics of liabilities have been either classified entirely as equity or recorded in the section that lies between the liabilities section and the equity section of the statement of financial position (this in-between section is commonly referred to as the “mezzanine” section). Also, certain financial instruments that have characteristics of both liabilities and equity were being presented entirely as liabilities or entirely as equity. Such presentations have raised questions about the representational faithfulness of the reporting for those instruments.

.4 Another reason for undertaking this project is to have U.S. accounting standards for financial instruments that bear characteristics of both equity and liabilities achieve greater convergence with international accounting standards (IAS) in this area. IAS 32, *Financial Instruments: Disclosure and Presentation*, already requires that a mandatorily redeemable instrument be classified as a liability. Although the conclusions that the FASB reached in FAS 150 do not go as far as IAS 32 in defining mandatorily redeemable instruments, the FASB has clearly moved its accounting guidance in this area closer to international guidance. Phase 2 of the liabilities and equity project will provide an opportunity for even further convergence.

PwC Observation: *The FASB’s desire to converge its guidance with IAS is one of the reasons that the Board split the liabilities and equity project into two phases. By having phase 1 focus on a smaller population of instruments, the Board has been able to achieve some convergence with IAS more quickly. Another reason for this limited-scope standard is the Board’s belief that it is advisable to provide timely and necessary guidance for certain “troublesome” instruments, since the practice problems arising from such instruments are, in the Board’s view, both clear and resolvable and therefore can be addressed independently of a discussion about the more difficult issues and concepts (i.e., separation issues) that the broader project on liabilities and equity encompasses. It took the Board almost a year to finalize the “easier” issues, concluding on the more challenging issues we believe will take much longer.*

Scope

.5 FAS 150 requires that issuers classify as liabilities the following three types of *freestanding* financial instruments (the concept of what is a “freestanding” financial instrument is discussed in paragraphs .17 and .18 of this publication):

1. Mandatorily redeemable financial instruments
2. Obligations to repurchase the issuer’s equity shares by transferring assets
3. Certain obligations to issue a variable number of shares

PwC Observation: *Relatively narrow in scope, the Standard specifies only that certain instruments must be classified as liabilities. It does not include any additional guidance on the concept of what constitutes either a “liability” or “equity.” As indicated above, phase 2 of the liabilities and equity project is expected to address the definition of (1) an ownership relationship and (2) a liability, which is likely to result in an amendment of CON 6. Until phase 2 is completed, entities should continue to follow existing guidance about how to determine the balance sheet classification of instruments that do not specifically fall within the scope of FAS 150. Thus companies are advised not to throw away their copies of Accounting Series Release No. 268 (ASR 268), Presentation in Financial Statements of “Redeemable Preferred Stock,” and Emerging Issues Task Force Issue No. 00-19 (“EITF 00-19”), Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company’s Own Stock; preparers will still need to refer to this guidance for instruments that are not covered by FAS 150.*

Mandatorily Redeemable Financial Instruments

.6 Although mandatorily redeemable instruments may be equity in legal form, the Board concluded that they should be classified as liabilities to the extent that they represent the issuer’s unavoidable obligation to transfer assets to the holder. For purposes of applying FAS 150, the Board defined a mandatorily redeemable financial instrument as any of various financial instruments that are issued in the form of shares and embody an unconditional obligation whereby the issuer must redeem the instrument by transferring its assets on a specified or determinable date (or dates) or upon an event that is certain to occur. Some common examples of mandatorily redeemable instruments that fall within the scope of FAS 150 are

- Preferred stock that must be redeemed on a specified date
- Common stock that must be redeemed upon the death or termination of the holder

PwC Observation: *It is important to note that the FASB’s definition of mandatorily redeemable securities in FAS 150 is narrower than the definition that the Securities and Exchange Commission (SEC) set forth in ASR 268. As further discussed below, puttable or contingently redeemable securities do not fall under the FASB’s current definition, but they continue to qualify as redeemable securities for purposes of classification under ASR 268. In phase 2 of the liabilities and equity project, the Board will consider expanding its definition.*

.7 Of course, if one contemplates the dissolution of the entity itself, one might conclude that all equity securities are liabilities. This was clearly not the Board’s intent; accordingly, the definition of “mandatorily redeemable” specifically excludes instruments that are redeemable only upon the

liquidation or termination of the reporting entity. For example, if the reporting entity (such as a trust or partnership) has a finite life (say, of 25 or 50 years) and is to be liquidated at the end of its term, its equity securities are not considered mandatorily redeemable simply because they are redeemed when the entity is liquidated. On the other hand, a partner's equity interest that must be redeemed upon the death or termination of the partner is considered "mandatorily redeemable" under FAS 150, because the redemption is based on an event that is certain to occur, although the partnership itself is not being liquidated.

PwC Observation: *The "liquidation/termination" exemption described above applies only to the financial statements of the reporting entity, not to financial statements in which such a reporting entity is being consolidated. For example, assume that a limited partnership has a finite life of 25 years and its equity is to be redeemed upon the termination of the limited partnership. Also assume that the general partner of this limited partnership consolidates the limited partnership. In the limited partnership's financial statements, the general and limited partners' capital accounts are not presented as liabilities, because they are redeemable only upon the termination of the reporting entity. In the general partner's consolidated financial statements, however, the limited partners' interest in the limited partnership would have to be presented as a liability if the interest were to meet the "mandatory redemption" requirements of FAS 150, because in this case the reporting entity is the general partner, not the limited partnership.*

This conclusion will have implications for the application of purchase accounting as well, since all such redeemable non-controlling interests that are acquired in a business combination will be treated as acquired/assumed liabilities. Thus 100 percent of the assets of the above-mentioned entity would be deemed as having been acquired and should be stepped up to fair value from the previous carrying amount. Although this is a change in past practice, recording all acquired assets at fair value is consistent with the Board's conclusions to date in its project entitled Business Combinations – Purchase Method Procedures.

.8 Contingently redeemable securities fall outside the scope of FAS 150. For example, preferred stock that can be redeemed only if there is (1) a change in control, (2) a successful initial public offering, or (3) a specified increase in the S&P 500 index does not qualify as a mandatorily redeemable financial instrument under FAS 150; nor does puttable stock, which can be redeemed only at the holder's option. Likewise, a date-certain redeemable security that can be converted into common stock is not considered mandatorily redeemable, since it will be redeemed only if it is not converted, as long as the conversion option is considered substantial (see paragraph 10 which discusses reassessment of the contingency).

.9 Although the Board excluded contingently redeemable securities from the scope of FAS 150, it made a point of requiring that conditions for redemption be substantive. The Board noted that instruments will be classified as mandatorily redeemable (as liabilities) even if the instruments include an "adequate liquidity" clause or a term-extension option, because that type of provision may affect the timing of the unconditional requirement for redemption but not remove that requirement. Also, when an entity adds a conversion option to an otherwise unconditionally redeemable security, the security will still be classified as a liability if the terms of the option are so far "out of the money" at the instrument's inception that it is considered non-substantive. The impact of non-substantive features is further discussed in paragraphs .19 and .20 of this publication. See attachments A and B for how the scope provisions of FAS 150 apply to different types of financial instruments.

PwC Observation: *ASR 268 provides guidance on mandatorily redeemable securities and requires that they be classified in the "mezzanine" section as temporary equity. One of the*

objectives of the Board's project on liabilities and equity is to eventually eliminate the "mezzanine" section of the balance sheet and to classify instruments as either liabilities or equity. Although that will not happen until the SEC is satisfied with the outcome of phase 2, FAS 150 does impact ASR 268 in two key ways:

1. Instruments that fall within the scope of FAS 150 (even if those instruments were classified as "mezzanine equity" under ASR 268) will now be classified as liabilities.
2. For some entities, the rules for the subsequent measurement of instruments that are considered mandatorily redeemable under FAS 150 could be different from the rules under ASR 268 and Emerging Issues Task Force Topic D-98 ("EITF Topic D-98"), Classification and Measurement of Redeemable Securities. This is discussed in paragraphs .25 through .28.

At the meeting that the Emerging Issues Task Force (EITF) held in May 2003, the SEC Observer announced that the SEC would modify EITF Topic D-98 in response to the issuance of FAS 150. We expect that, in due course, the SEC will also take similar, appropriate actions to update ASR 268. Meanwhile, when the guidance in Topic D-98 or ASR 268 conflicts with the guidance in FAS 150, SEC registrants should apply the guidance in FAS 150. The guidance in ASR 268 and Topic D-98 will continue to apply to instruments that fall outside the scope of FAS 150 (e.g., contingently redeemable securities).

One of the areas where the SEC's guidance and FAS 150 differ regards redeemable securities that are funded by insurance. The SEC staff's training manual includes a provision that allows registrants to report as permanent equity instruments that are mandatorily redeemable upon the death of the holder (as defined in ASR 268) if the registrant has purchased life insurance to cover the cost of the redemption. Footnote 14 to paragraph A6 of FAS 150 clarifies that an insurance contract that would cover the cost of the redemption does not affect classifying the shares as liabilities. The Board believes that such shares are liabilities regardless of the issuer's ability to fund their redemption through insurance proceeds.

.10 As we've already mentioned, a contingently redeemable financial instrument (e.g., a share that is redeemable when there is a change in control or that is puttable at the option of the holder) would initially fall outside the scope of FAS 150 because its redemption would not be unconditional. In accordance with the Standard's requirements, however, the issuer would assess in each reporting period whether any change in circumstances has since caused the instrument to qualify as mandatorily redeemable and thus make it necessary to reclassify the instrument as a liability. A contingently redeemable financial instrument should be reclassified as a liability when the contingent event has occurred or when it becomes certain that the event will occur, thus making the instrument unconditionally redeemable. (See paragraph .27 of this publication).

PwC Observation: Under most circumstances, the time between the occurrence of the contingent event and the redemption date is relatively short, thus any reclassification of instruments as liabilities should not significantly impact the financial statements. For example, a company may have only 20 or 30 days to redeem an instrument once a put notice has been delivered. Therefore, it is likely that any interest costs that are deemed to accrue during this period (which is when the instrument should be treated as a liability) will be minor. However, to the extent that (1) this period includes the end of a reporting period or (2) the time between the event and the redemption is relatively long, the impact that the balance sheet classification and related interest-cost accruals will have on the financial statements may be more significant.

Obligations to Repurchase the Issuer's Equity Shares by Transferring Assets

.11 Contracts that require an entity to repurchase its own shares or that are indexed to such an obligation represent obligations that fall under the Board's concept of liabilities. These instruments embody obligations that require (or may require) the transfer of assets in a settlement. Under no conditions may the issuer avoid such obligations. As indicated earlier, these instruments fall within the scope of FAS 150 and must be classified as liabilities (or, in some circumstances, classified as assets). Examples of such obligations are written put options or forward purchase contracts for the issuer's stock that require a physical or net cash settlement. In a physical settlement, the issuer will receive its equity shares and pay cash or other assets. In a net cash settlement, the issuer will pay or receive cash (or an equivalent value in other assets) equal to the net loss or gain on the contract when the option is exercised or the forward purchase contract matures. Please refer to attachments A and B for examples of instruments that are included in and excluded from the scope of FAS 150.

PwC Observation: *Prior to FAS 150, EITF 00-19 provided guidance on the classification and accounting for instruments that are indexed to, and can potentially be settled in, a company's own stock (e.g., written put options and forward purchase contracts). Although FAS 150 nullifies/supersedes EITF 00-19's guidance on instruments that fall within the scope of FAS 150, EITF 00-19 continues to apply to instruments that fall outside the scope of FAS 150. Therefore, it is possible that instruments that do not qualify as liabilities under FAS 150 (i.e., instruments that fall outside the scope of FAS 150) may still be classified as liabilities, because they fail to meet EITF 00-19's requirements for equity classification. See attachment C for additional details about the interaction between FAS 150 and EITF 00-19.*

Certain Obligations to Issue a Variable Number of Shares

.12 The Board believes that obligations that an entity must or could settle by issuing its own equity shares should be classified as liabilities to the extent that such obligations are not consistent with an ownership relationship. Addressing whether such an instrument reflects an ownership relationship, the Board concluded that an issuer must classify a financial instrument as a liability if (1) the issuer must or could settle the instrument by issuing a variable number of its equity shares *and* (2) the obligation's *monetary value* (see below) is based solely or predominantly on any of the following factors at the instrument's inception:

1. A fixed monetary amount that is known at the instrument's inception (e.g., an entity receives \$100,000 in exchange for its promise that it will issue its own equity shares in an amount sufficient to equal a value of \$110,000 on a future date)
2. Variations in something other than the fair value of the issuer's equity shares (e.g., the price of gold or the S&P 500 index)
3. Variations in the fair value of the issuer's equity shares, but moves in the opposite direction (e.g., a written put option that could be net-share-settled)

.13 Please refer to attachments A and B for examples of instruments that are included in and excluded from the scope of FAS 150.

.14 Before FAS 150, financial instruments embodying obligations that required (or permitted, at the issuer's discretion) a settlement via the issuance of the issuer's equity shares were classified as

equity (under the EITF 00-19 model) because they did not require a transfer of assets and, therefore, did not meet CON 6's definition of a liability. However, the Board has concluded that not all such obligations establish the type of relationship that exists between an entity and its owners. For example, an instrument that is affected by factor 1 in paragraph 12 above establishes more of a debtor-creditor type of relationship than an ownership relationship because such an instrument requires the issuer to convey to the holder a fixed amount of value that does not vary with the value of the issuer's equity shares. Similarly, a share-settled put option on the issuer's equity shares (i.e., an instrument such as the type that is affected by factor 3 in paragraph .12) establishes the opposite (inverse) of an ownership relationship, because such a put option requires that the issuer convey to the holder value that *increases* as the value of other owners' interests *decreases*. Therefore, even though the instruments that are affected by factors 1 and 3 are net-share-settled, they should be classified as liabilities because they do not establish an ownership relationship. Similarly, the instruments affected by factor 2 in paragraph .12 have more characteristics of a liability than characteristics of equity because the holder's return is unrelated to changes in the fair value of the issuer's equity shares.

PwC Observation: *Generally, compound instruments, including dual-indexed share-settled instruments, are beyond the scope of FAS 150 because the value of those instruments is tied not only to the issuer's equity shares, but also to something else. Given that limitation, the Board decided to restrict the application of FAS 150 to instruments embodying obligations that have a monetary value based solely on one of the three factors in paragraph 12 of the Standard. To preclude any potential for an entity to circumvent the Standard by embedding in an instrument a small amount of variability based on the issuer's equity share price, the Board extended the scope of FAS 150 to include instruments that are predominantly based on one of the three factors. Judgement is required when one is distinguishing between an instrument that is (1) indexed to the issuer's stock and something else and (2) predominantly based on one of the three factors in paragraph 12 of FAS 150. Also, regardless of whether or not a dual-indexed share-settled instrument falls within the scope of FAS 150 as a result of this provision, the requirements of the FASB's Statement of Financial Accounting Standards No. 133 ("FAS 133"), Accounting for Derivative Instruments and Hedging Activities, may apply — specifically the requirements for the bifurcation of financial instruments containing embedded derivative features that are not clearly and closely related.*

.15 The concept of "ownership relationship" is expected to be refined in phase 2 of the Board's liabilities and equity project. For the moment, the Board regards exposure to changes in the fair value of the issuer's equity shares as a characteristic of an ownership relationship. In this regard, the Board developed the notion of *monetary value* to help entities determine whether the risks or benefits of changes in the fair value of the issuer's equity shares to which a holder of a financial instrument embodying an obligation is exposed are similar to the risks and benefits to which a holder of outstanding equity shares is exposed. FAS 150 defines monetary value as "what the fair value of the cash, shares, or other instruments that a financial instrument obligates the issuer to convey to the holder would be at the settlement date under specified market conditions." Since the concept of monetary value is new, paragraph 4 of the Standard provides examples of the concept's application.

Issuer's Equity Shares

.16 Some of FAS 150's provisions apply to instruments that are indexed to, and can be potentially settled in, the issuer's equity shares. Paragraph 5 of FAS 150 defines the issuer's equity shares as the equity shares of any entity whose financial statements are included in the issuer's consolidated financial statements. Thus, an instrument that is settled in or indexed to a

consolidated subsidiary's common stock could fall within the scope of FAS 150 if the provisions of the instrument otherwise meet the scope of the Standard.

Freestanding Financial Instruments

.17 FAS 150 applies to an issuer's classification and measurement of freestanding financial instruments. The Standard defines a "freestanding financial instrument" as a financial instrument that (1) is entered into separately and apart from any of the entity's other financial instruments or equity transactions or (2) is entered into in conjunction with some other transaction and can be legally detached and exercised on a separate basis. Examples of freestanding financial instruments are a written put option and a forward purchase contract, each of which is structured in a single contract that is not attached to the related share of stock. The term "freestanding" also applies to a single financial instrument that comprises more than one option or forward contract. For example, FAS 150 applies to a "collar" consisting of a written put option and a purchased call option, regardless of whether the entire contract results in a net written option or a net purchased option under FAS 133. In a proposed FASB Staff Position ("FSP") issued in August 2003, the FASB staff has provided several examples of how FAS 150's scope provisions would apply to certain freestanding instruments composed of more than one option or forward contract. The examples include cash-settled or share-settled put warrants, variable share forward sales contracts, and contingently puttable warrants.

.18 FAS 150 specifies that, generally, two or more freestanding financial instruments (e.g., a written put option, a purchased call option, and a share of common stock) should *not* be considered in combination, unless the instruments must be combined pursuant to FAS 133 (e.g., under Derivatives Implementation Group Issue K-1, *Determining Whether Separate Transactions Should Be Viewed as a Unit*). Rather, they should be evaluated separately on a contract-by-contract basis for the purpose of applying the Standard's scope provisions. In many situations, therefore, the accounting will be dictated by whether different instruments are structured in a single contract or entered into as separate contracts. Consider the following examples:

Transaction Form	Within FAS 150's Scope	Outside FAS 150's Scope
<i>Separate Contract</i>		
1. Written put option	X	
2. Purchased call option		X
3. Outstanding share of common stock		X
<i>Combined/Single Contract</i>		
4. Collar – e.g., a written put @ \$10/share and a purchased call @ \$18/share	X	
5. Net purchased put – e.g., a purchased put @ \$12/share and a written put @ \$10/share		X
6. Net written put – e.g., a written put @ \$12/share and a purchased put option @ \$10/share	X	
7. Written put option and an outstanding share of common stock (that is, puttable stock)		X

PwC Observation: *It is interesting to note that a freestanding written put option (item 1) falls within the scope of FAS 150 but a purchased call option (item 2) is outside the scope of FAS 150. If, however, the same written put option and purchased call option are parts of a*

combined/single contract (item 4), the entire collar falls within the scope of FAS 150. Another interesting set of examples relates to combined written and purchased put options. A written put option could be outside the scope of FAS 150 if the obligation were completely eliminated by a purchased put option in a combined/single contract, as is the case in the net purchased put option in item 5 above. If, however, the written option is only partially offset by the purchased option and thus creates a net written option, the entire contract falls within the scope of FAS 150.

As can be seen from the above examples, the determination of whether a contract is freestanding in relation to another financial instrument is key to the application of FAS 150. Initial feedback on the implementation of the Standard has raised a question about whether the Board's definition of a freestanding financial instrument is sufficiently clear, given the critical nature of this determination. We understand that the FASB staff is aware of the issue but has concluded no additional guidance is warranted at this time.

Disregard Non-Substantive or Minimal Features

.19 As noted above, FAS 150 applies to only certain freestanding financial instruments. The accounting for most compound financial instruments that have characteristics of both a liability and equity is expected to be addressed in phase 2 of the Board's liabilities and equity project. Mindful that some entities might attempt to circumvent the Standard's objectives by embedding a minimal or non-substantive feature in a freestanding financial instrument to produce, at least nominally, a compound instrument, the Board has included in FAS 150 some anti-abuse provisions. The Standard specifies that any such feature(s) should be disregarded when entities apply FAS 150. The following example from paragraph A29 of the Standard illustrates this point:

An entity issues one share of preferred stock (with a par amount of \$100), paying a small dividend, and embeds in it an option, allowing the holder to put the preferred share, along with 100,000 shares of the issuer's common stock (currently trading at \$50), for a fixed price of \$45 per share in cash. The preferred stock host is judged at inception to be minimal and would be disregarded under paragraph 8 (of FAS 150) in applying the classification provisions of this Statement. Therefore, under either paragraph 11 or paragraph 12(c) of this Statement (depending on the form of settlement), that instrument would be analyzed as a written put option in its entirety, classified as a liability, and measured at fair value.

.20 Another example of a nonsubstantive feature is described in footnote 15 to paragraph A9 of FAS 150. This example indicates that if the conversion price in a convertible preferred stock is extremely high in relation to the current share price, the conversion option should be considered nonsubstantive and, therefore, disregarded, as required by paragraph 8 of FAS 150. The footnote further indicates that the evaluation of whether a feature is minimal or nonsubstantive is made only at the inception of a financial instrument and that no further assessment is required. Therefore an otherwise mandatorily redeemable security that can also be converted to common stock and has a conversion option that is deemed substantive at the inception of the instrument will not subsequently become a liability as a result of a substantial decline in common stock prices.

PwC Observation: *An entity will need to exercise judgment in considering all of the terms of an instrument and other relevant facts and circumstances to distinguish substantive, non-minimal features from non-substantive or minimal features. Further, although a feature may be non-substantive and therefore can be ignored when one is applying FAS 150, that feature should not necessarily be ignored for other accounting purposes. For example, the earnings-per-share (EPS) effect is likely to be minor (at least initially) in situations in which the conversion option is*

deemed non-substantive.

As noted above, determining whether a feature is minimal or nonsubstantive for purposes of adopting FAS 150 should be made as of the instrument's inception, not on the date of transition to FAS 150.

Hybrid Financial Instruments

.21 A hybrid financial instrument is a compound financial instrument consisting of a host contract and one or more embedded derivative features (e.g., puttable stock). FAS 133 specifies when entities must bifurcate a hybrid instrument and account for embedded derivatives on a separate, mark-to-market basis. An assessment of the necessity to bifurcate sometimes depends on whether the embedded feature would, on a stand-alone basis, be classified as a liability or as equity by the issuer. In determining whether the embedded feature is a liability or equity, issuers of a hybrid instrument must disregard the provisions of FAS 150 and make their determination based on other applicable guidance.

.22 The Board decided to exempt the application of FAS 150 from this process because of concerns over (1) the complexity of the interaction between FAS 150 and FAS 133, (2) the potential for a significant increase in the number of embedded derivatives that might have to be separated from their host contracts (such an increase is undesirable until the Board resolves certain measurement issues), (3) the possibility that phase 2 of the liabilities and equity project could result in further accounting changes, and (4) the potential for conflict with the SEC's guidance on accounting for redeemable securities.

Scope Limitations

.23 FAS 150 does not affect the recognition of financial instruments that are issued as contingent consideration in a business combination that is accounted for under Statement of Financial Accounting Standards No. 141 ("FAS 141"), *Business Combinations*. FAS 150 also does not alter FAS 141's measurement guidance on contingent consideration. When recognized, however, a financial instrument that falls within the scope of FAS 150 and is issued as consideration (whether contingent or noncontingent) in a business combination must be classified pursuant to the requirements of FAS 150.

.24 FAS 150 does not apply to obligations under stock-based compensation arrangements when those obligations are accounted for under the guidance of (1) the Accounting Principles Board (APB) in APB Opinion No. 25 ("APB 25"), *Accounting for Stock Issued to Employees*; (2) the FASB in Statement of Financial Accounting Standards No. 123 ("FAS 123"), *Accounting for Stock-Based Compensation*; (3) the American Institute of Certified Public Accountants in Statement of Position 93-6 ("SOP 93-6"), *Employers' Accounting for Employee Stock Ownership Plans*; or (4) related pronouncements. However, FAS 150 does apply to a freestanding financial instrument that was issued under a stock-based compensation arrangement but that is no longer subject to APB 25, FAS 123, SOP 93-6, or related guidance. For example, FAS 150 applies to mandatorily redeemable shares that are issued once an employee exercises an employee stock option.

PwC Observation: *One of the implementation issues that has arisen since the Board issued FAS 150 involves the application of the Standard's scope limitation to shares of stock under an employee stock ownership plan (ESOP). Some ESOP shares, especially those of a non-public company, have certain redemption features to comply with regulatory/legal/tax requirements. Because these redemption features could result in the ESOP shares being classified as a liability*

under FAS 150, a question arises about when, if ever, these shares are “no longer subject to” SOP 93-6 and related guidance. In October 2003, the FASB staff posted a FASB Staff position (“FSP”) stating that ESOP shares or freestanding agreements to repurchase those shares are not within the scope of FAS 150 because those shares are accounted for under SOP 93-6 or its related guidance through the point of redemption. Companies with ESOPs should look for the final issuance of the FSP by November 2003.

Similarly, mandatorily redeemable stock that is issued as part of stock compensation arrangements need not be evaluated under FAS 150 until the shares are no longer subject to the variable accounting provisions of FAS 123 or APB 25. This includes (1) shares that are subject to APB 25 and Interpretation 44 for six months subsequent to vesting or exercise and (2) shares with repurchase features requiring variable accounting after exercise or vesting.

Initial Measurement

.25 Forward purchase contracts that must be physically settled via a repurchase of a fixed number of the issuer’s equity shares in exchange for cash should initially be measured at the fair value that the shares had at the contract’s inception, adjusted for any consideration or unstated rights or privileges. At the inception of a physically settled forward purchase contract, the issuer should reduce equity and recognize a liability for the fair value of the shares. The fair value of any unstated rights and privileges should be accounted for under current generally accepted accounting principles (GAAP), based on the nature and terms of those rights and privileges.

.26 If the terms of the forward purchase contract indicate a fixed-rate borrowing (for example, when the redemption date and price are fixed), an entity would compute the initial measurement amount by discounting the settlement amount at the rate that is implicit in the contract, after taking into account any consideration or unstated rights or privileges. On the other hand, if the terms of the forward purchase contract indicate a floating-rate borrowing (for example, the redemption price is variable), an entity would compute the initial measurement amount by determining the amount of cash that would be paid under the conditions specified in the contract if the shares were repurchased immediately, adjusted for any consideration or unstated rights or privileges. Paragraph A12 of FAS 150 includes an example of how a physically settled forward purchase contract should be measured initially and accounted for in subsequent periods. Paragraph A13 illustrates the accounting that an entity should apply when there has been any consideration or unstated rights and privileges in connection with a physically settled forward purchase contract.

PwC Observation: *In discussing an entity’s obligation to repurchase the issuer’s equity shares by transferring assets, FAS 150 distinguishes between obligations that are **unconditional** and those that are **conditional**. A forward purchase contract that an entity must physically settle by delivering cash in exchange for shares embodies an **unconditional** obligation to transfer cash to pay the full repurchase price. The Board likens such a contract to an already-executed treasury-stock purchase that was financed through borrowed funds. In the Board’s opinion, this type of forward contract effectively converts into mandatorily redeemable instruments the shares that the counterparty must deliver. Therefore, shares that are subject to purchase under an unconditional forward contract but that are currently outstanding must be accounted for as though they had already been retired for purposes of EPS computations (see paragraph .31 of this publication for a further discussion of EPS).*

*On the other hand, forward purchase contracts that must or can be net-settled are **conditional** obligations, because if prices move in the issuer’s favor, the issuer will receive assets and won’t have to transfer anything. For purposes of initial and subsequent measurement, these net-settled*

contracts are accounted for in the same manner that derivative instruments are accounted for (i.e., measured initially and subsequently at fair value).

.27 All other financial instruments that fall within the scope of FAS 150, including mandatorily redeemable instruments, should be initially measured at fair value. Financial instruments that do not initially meet FAS 150's definition of mandatorily redeemable instruments but subsequently become unconditionally redeemable (i.e., the instrument was conditionally redeemable and the condition is later met) should be reclassified as a liability and also measured at fair value. However, the entity should not record any gain or loss as a result of the reclassification.

PwC Observation: *At first glance, the Board's conclusion that mandatorily redeemable instruments should be initially reported at fair value seems consistent with how those instruments have been treated in the past and with the accounting for debt instruments. With respect to one circumstance, however, the Board appears to have departed from past practice — specifically, a circumstance in which mandatorily redeemable instruments are issued in conjunction with other securities (such as detachable warrants) for which there is no similar explicit requirement that the instruments be initially recognized at fair value. Before FAS 150, mandatorily redeemable securities that were issued with detachable warrants had been accounted for by way of analogy to APB Opinion 14 ("APB 14"), Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants. APB 14 calls for the initial measurement of each instrument that is issued through an allocation of the net proceeds, based on the relative fair values of the issued instruments, which does not necessarily result in the recognition of the instruments on an individual basis and at fair value. However, given FAS 150's explicit requirement that entities record mandatorily redeemable preferred stock at fair value, it appears that any detachable warrants that are issued with such stock will now have to be recorded at the residual amount. This will be a change in practice for issuers.*

Inevitably, a company will receive information after the balance sheet date but before issuance of the financial statements that indicates a conditionally redeemable instrument has become unconditionally redeemable. The issue will be whether or not the instrument should be reclassified as of the balance sheet date. We believe that this matter should be treated the same as any other subsequent event and that the guidance in AU560, Subsequent Events, should be applied. If the received information indicates that the instrument was unconditionally redeemable on the balance sheet date, the financial statements should be adjusted to reflect that the instrument has been reclassified as a liability. If, however, the received information indicates that the event satisfying the condition, and thus causing the instrument to become unconditionally redeemable, occurred after the balance sheet date, the balance sheet should not be adjusted, but appropriate disclosures should be considered.

Subsequent Measurement

.28 With respect to mandatorily redeemable instruments and forward contracts that fall under FAS 150 and must be settled physically via a repurchase of a fixed number of the issuer's equity shares in exchange for cash, subsequent measurement should be done in one of two ways:

1. If both (a) the amount that is to be paid and (b) the settlement date are fixed, the instrument should be subsequently measured at the present value of the amount that is to be paid on the settlement date, with interest cost accruing based on the rate that was implicit at the inception of the instrument. The stated dividend rate on mandatorily redeemable instruments should generally be accrued even if the dividend is not declared.

PwC Observation: *The above accounting is consistent with the current guidance in SEC Staff Accounting Bulletin Topic 3-C, Redeemable Preferred Stock, which requires accretion or adjustment to the mandatory redemption amount over the period that begins on the issuance date and ends on the redemption date.*

2. If either the amount that is to be paid or the settlement date varies as a result of specified conditions, the subsequent measurement of the instrument should be based on the amount of cash (undiscounted) that would have been paid under the conditions specified in the contract if a settlement had occurred on the reporting date. The change in amount as compared to the amount from the previous reporting date should be recognized as interest cost.

PwC Observation: *The above accounting – now required under FAS 150 – may represent a departure from current practice for some entities that follow SEC guidance on this subject. Currently, for securities with a variable redemption amount, SEC registrants can either follow the above-described method under FAS 150 (which is sometimes also referred to as using the “formula redemption price” or the “spot” mark-to-market price), **or** they can follow an alternative approach, as described in EITF Topic D-98. Under the alternative approach, a registrant accretes to the estimated redemption value over the period that begins on the issuance date and ends on the earliest redemption date of the security by using an appropriate methodology, usually the interest method. Under this alternative, changes in the redemption value are considered changes in accounting estimates and thus must be accounted for (and disclosed) in accordance with APB Opinion 20, Accounting Changes. This alternative is no longer permitted for securities that fall within the scope of FAS 150.*

As discussed in paragraph .7 of this publication, companies that consolidate finite-lived entities, such as partnerships, may now have to classify minority interests as a liability under FAS 150. Because the amount to be paid to the minority interest holders is a variable amount equal to their share of the residual net assets of the partnership upon its liquidation, the liability will be subsequently measured at its estimated settlement value at each reporting date as described in 2 above. Therefore, changes in the fair value of the partnership’s assets, less the cost to dispose of the assets and extinguish all liabilities will be reflected in earnings as interest costs. However, in many circumstances, generally accepted accounting principles will not permit a corresponding recognition in earnings for the change in fair value of the underlying assets or liabilities of the consolidated partnership. Thus, the effect of the mixed measurement bases is to distort the financial statements of the company by generating unfavorable results of operations when the partnership assets are increasing in value and favorable results of operations when the partnership assets are declining in value. Many investors and analysts will be surprised by these anomalous results, and companies will want to ensure that there are adequate disclosures in the financial statements related to this issue.

.29 Instruments that are within the scope of FAS 133 should be subsequently measured and accounted for in accordance with the provisions of FAS 133. That is, the instruments should be reported in the balance sheet at fair value.

.30 All remaining financial instruments that fall within the scope of FAS 150 (e.g., written put options on private-company shares) should be subsequently measured at fair value, with changes

in fair value recognized in earnings, unless either FAS 150 or other accounting guidance specifies another measurement attribute.

PwC Observation: *Before FAS 150, many instruments were classified as equity, and subsequent changes in their fair value were ignored for accounting purposes. FAS 150 continues the trend of requiring greater use of fair value as the measurement attribute for financial instruments. It is expected that subsequent measurement at fair value and recognition of changes in fair value in current earnings will increase the volatility of reported earnings. Consequently, certain instruments (such as written put options and forward purchase contracts that many companies have used in their stock buy-back programs) may become less popular in the post-FAS 150 period.*

Presentation

.31 Financial instruments that fall within the scope of FAS 150 should be presented as liabilities in the statement of financial position, not as items in the “mezzanine” section (i.e., such instruments should not be presented between the liabilities section and the equity section in the statement of financial position).

.32 When *all* of an entity’s “equity” instruments are considered mandatorily redeemable and must be classified as liabilities (e.g., as is the case with some private companies whose equity shares are all subject to redemption upon the holder’s death or termination) so that an entity no longer has any equity, the issuer should describe the instruments as “shares subject to mandatory redemption” in the statement of financial position to distinguish them from other liabilities. Further, payments to holders of such instruments (e.g., dividends on the “equity” shares) and related accruals should be presented separately from payments to other creditors in the statements of cash flows and income.

Earnings per Share

.33 The Board believes that if a contract is considered a liability and not equity, the shares should be considered retired and not outstanding. Thus for mandatorily redeemable instruments and physically settled forward contracts, the shares that are to be redeemed or repurchased should not be considered outstanding shares for purposes of calculating basic and diluted earnings per share (EPS). Any amounts (including contractual, accumulated dividends and participation rights in undistributed earnings) that (1) are attributable to shares that are to be redeemed or repurchased and (2) have not been recognized as interest costs in accordance with FAS 150 should be deducted in the computation for income available to common shareholders (the numerator of the EPS calculation), and in a manner consistent with the “two-class” method set forth in paragraph 61 of Statement of Financial Accounting Standards No. 128, *Earnings per Share*. FAS 150 does not change the EPS guidance for other instruments that fall within its scope.

Disclosures

.34 The disclosures required by FAS 150 are incremental; that is, they are in addition to the disclosures required by other generally accepted accounting principles, such as Statement of Financial Accounting Standards No. 129, *Disclosure of Information about Capital Structure*. Issuers are required to disclose the following information for all outstanding financial instruments that fall within the scope of FAS 150:

1. The nature and terms of the financial instrument (including the redemption features), and the rights and obligations embodied in those instruments
2. Any settlement alternatives that may be in the contract, and the entity that controls the settlement alternatives
3. For all outstanding financial instruments that fall within the scope of FAS 150 and for each settlement alternative:
 - a. The amount that would be paid, or the number of shares that would be issued, and the instrument's fair value (as determined under the conditions specified in the contract), if the settlement occurred on the reporting date
 - b. How changes in the fair value of the issuer's equity shares would affect the settlement amounts (for example, "the issuer is obligated to issue x additional shares or pay y additional dollars in cash for each \$1 decrease in the fair value of one share")
 - c. The maximum amount of cash that the issuer could be required to pay to redeem the instrument under a physical settlement, if applicable
 - d. The maximum number of shares that an entity could be required to issue, if applicable
 - e. The fact that a contract does not limit the amount that the issuer could be required to pay or the number of shares that the issuer could be required to issue, if applicable
 - f. The forward price or option strike price of a forward contract or option that is indexed to the issuer's equity shares, the number of that issuer's shares to which the contract is indexed, and the contract's settlement date(s), as applicable

Effective Date and Transition

.35 For all financial instruments entered into or modified after May 31, 2003, FAS 150 is effective immediately. For all other instruments, the Standard goes into effect at the beginning of the first interim period beginning after June 15, 2003, except for mandatorily redeemable financial instruments of a non-public entity. For contracts that were created or modified before May 31, 2003 and still exist at the beginning of the first interim period beginning after June 15, 2003, entities should record the transition to FAS 150 by reporting the cumulative effect of a change in an accounting principle. FAS 150 prohibits entities from restating financial statements for earlier years presented.

PwC Observation: *For calendar-year-end companies, FAS 150 will go into effect at the beginning of their third quarters. Statement of Financial Accounting Standards No. 3 ("FAS 3"), Reporting Accounting Changes in Interim Financial Statements, states that if an entity makes a cumulative-effect type of accounting change during a period other than the first interim period, that entity should restate the financial information for the pre-change interim periods. The cumulative effect that the change has on retained earnings at the beginning of that fiscal year shall be included in the restated net income of the first interim period of the fiscal year in which the change is made.*

Based on informal discussions, however, the FASB staff has concluded that the provisions of FAS 3 should not be applied to the adoption of FAS 150. Apparently, FAS 150's prohibition

regarding the restatement of prior years also applies to the restatement of prior interim periods. Thus in spite of FAS 3's provisions, entities adopting FAS 150 during a period other than their first interim period should not restate their financial statements for the prior interim periods.

.36 For mandatorily redeemable instruments and physically settled forward purchase contracts, "dividends" and other amounts that were paid or accrued before the instruments were reclassified as liabilities should not be reclassified as interest expense upon transition. Reclassifying as liabilities pre-existing, noncontrolling interests that (1) were recognized in business combinations under the purchase method and (2) are mandatorily redeemable should not result in changes in amounts that were previously recognized under the purchase method.

PwC Observation: *With respect to transition, a question has arisen about the accounting treatment for issuance costs related to instruments that were previously classified as either equity or mezzanine equity and that will now be classified as a liability upon the adoption of FAS 150. Should such costs (1) be set up on the balance sheet as deferred costs (net of an appropriate amount of accumulated amortization, in a manner similar to the treatment of issuance costs for any other debt instrument), (2) be left buried in equity upon transition, or (3) be embedded in the recorded value of the instrument upon transition? FAS 150 does not explicitly provide for the recognition of issuance costs; therefore, one might logically conclude that the Board did not intend for them to be recognized at the time of transition, either as assets or embedded features in the fair value of the instrument. However, it is also clear that going forward all such costs that are incurred in connection with new issuances of mandatorily redeemable securities will be treated the same way that the issuance costs for any other debt instrument are treated. Thus one might argue that such costs should be recognized at the time of transition to ensure comparability in future periods.*

We understand that the FASB staff and SEC staff are aware that there are divergent views on this issue and are considering providing implementation guidance. Before finalizing their transition adjustment, therefore, preparers should determine whether the FASB or SEC have clarified this issue.

.37 Paragraph A30 of FAS 150 provides several examples of cumulative-effect entries that may be made for various instruments upon an entity's transition to the Standard's provisions. It is important to note that a transition adjustment is not always based on an instrument's fair value at the time of transition, but rather, may be based on *some other measurement attribute* that is required by the Statement. Hence, in paragraph A30's first example of a cumulative-effect entry, the transition adjustment for a mandatorily redeemable stock is based on the stock's accreted value, as determined according to the rate that was implicit at the contract's inception, not according to the instrument's fair value at the time of transition.

PwC Observation: *Compared with current GAAP, FAS 150 will result in more instruments being classified as liabilities. The Standard will also partially eliminate the "mezzanine" section of the balance sheet. For some entities, therefore, adopting FAS 150 could trigger violations of certain debt covenants (e.g., debt-to-equity ratios) in loan agreements. Companies should therefore evaluate the impact that FAS 150 has on their compliance with such covenants and, if necessary, renegotiate their covenants with the lenders or obtain appropriate waivers. If a company believes that there is a current or expected future violation of a debt covenant, relevant guidance (such as Statement of Financial Accounting Standards No. 78, Classification of Obligations That Are Callable by the Creditor, and EITF Issue No. 86-30, Classification of*

Obligations When a Violation Is Waived by the Creditor) *should be reviewed to determine the appropriate balance sheet classification for the debt instrument.*

Entities that are subject to regulatory "minimum capital" requirements (e.g., banks) should also assess the impact that FAS 150 has on their "equity" capital.

Impact on Non-Public (i.e., Private) Entities

.38 Under FAS 150, some non-public entities may have to present all of their "equity" instruments as liabilities because the liquidity features that are often present in the instruments result in their being considered mandatorily redeemable. The Board decided to delay FAS 150's effective date for non-public entities with respect to the classification of mandatorily redeemable instruments so that those entities will have adequate time to educate the users of their financial statements and, if such entities consider it desirable or necessary, time to restructure the instruments. Thus regarding mandatorily redeemable instruments of a non-public entity, FAS 150 applies to existing or new contracts for fiscal years beginning after December 15, 2003.

PwC Observation: *With respect to the transition for mandatorily redeemable instruments of non-public entities, FAS 150's wording is a bit unclear. It calls for a cumulative-effect entry at the beginning of the period of adoption (i.e., January 1, 2004 for calendar-year companies) for instruments that were created before the effective date (May 31, 2003). The Standard does not, however, address how entities should apply the transition guidance to instruments that were created between the effective date and the beginning of the period of adoption. We believe that the FASB meant for entities to include those new instruments in the cumulative-effect entry as well.*

The Board recently posted a proposed FASB staff position ("FSP") extending the effective date of FAS 150 for mandatorily redeemable instruments of certain nonpublic companies to fiscal periods beginning after December 15, 2004. The proposed effective date extension is limited to only those entities that meet the Standard's definition of "nonpublic entity" and are not SEC registrants. Therefore, those nonpublic entities that have public debt or a sufficient number of private shareholders to require them to file their statements with the SEC will be required to abide by the original effective date in the Standard. We expect that the Board will issue the final FSP in November 2003.

.39 Paragraph A6 of FAS 150 gives an example of the financial-statement presentation for an entity that has no "equity" instruments outstanding because all of its shares are mandatorily redeemable financial instruments and classified as liabilities. The example indicates that when an entity has no equity, (1) there is only a single-line presentation on the face of the balance sheet for the section under the header "Shares Subject to Mandatory Redemption" and (2) all of the details about the equity's components (such as contributed capital, retained earnings, and the elements of other comprehensive income) are disclosed in the notes to the financial statements.

PwC Observation: *The Board's example implies that because all of an entity's "equity" instruments must be classified as liabilities, the entity does not have the ability to present on the face of the balance sheet any of the elements of other comprehensive income (OCI). However, we do not believe that it was the Board's intent to preclude an entity from (1) classifying marketable securities as available for sale pursuant to Statement of Financial Accounting Standards No. 115, Accounting for Certain Investments in Debt and Equity Securities, (2) applying cash flow hedge accounting pursuant to FAS 133, (3) translating a subsidiary's foreign-currency-denominated financial statements pursuant to Statement of Financial Accounting Standards No. 52, Foreign Currency Translation, or (4) recognizing a minimum pension liability pursuant to Statement of Financial Accounting Standards No. 87, Employers' Accounting for Pensions. It appears that such accounting continues to apply, but the entry that would have previously been made for an OCI account will now be made for OCI in memo form, and the actual entry will be recorded directly to the accounts of the redeemable securities themselves.*

In addition to the accounting for elements of OCI, other implementation issues may arise for entities that are deemed to have no "equity" instruments as a result of applying FAS 150. For instance, consider a case in which all of an entity's shares are mandatorily redeemable at a price other than net book value (e.g., fair value). Should the entity report its retained earnings/accumulated deficit on its balance sheet? The Board's example implies that an entity should not present such equity accounts on the face of its financial statements (i.e., the entity should only disclose those accounts). However, it appears that such equity accounts are necessary if the entity is to account for the difference between its net book value and redemption value (in most cases, the latter is higher). The FASB staff is aware of this implementation issue and has recently posted a FASB Staff Position on this matter. Entities that have no "equity" instruments after applying FAS 150 and whose shares are redeemable at a price other than net book value should look for the final issuance of the FSP by November 2003.

.40 FAS 150 requires that instruments falling outside the scope of FAS 133 (e.g., written put options on private-company shares) be measured at fair value.

PwC Observation: *The Standard increases the number of instruments that will be recorded at fair value by requiring that even non-derivative instruments that fall within its scope be recorded at fair value. In the absence of market price data, it may be difficult for private companies to estimate the fair value of such instruments. In some cases, companies may have to consult a valuation specialist to estimate the fair value of such instruments.*

**Examples of Instruments/Contracts
That Are Included in the Scope of FAS 150
(And Therefore Must Be Classified as Liabilities)**

No.	Brief Description of the Instrument/Contract	Reason for Inclusion	Classification Pre-FAS 150	FAS 150 Par. #
	<i>Single Instruments</i>			
1	Preferred stock that must be redeemed after 50 years – the redemption price could be paid in cash, other assets, notes or other mandatorily redeemable instruments	Date-certain redemption	Temporary equity per ASR 268	9, A2
2	Common stock that must be redeemed upon the death or termination of the holder	Event-certain redemption	Temporary equity per ASR 268	9, A2, A6
3	An equity security or capital interest that is issued by a consolidated trust or subsidiary and must be redeemed upon the subsidiary's liquidation or has terms of indenture calling for its liquidation on a specific date	Date-certain redemption	Minority interest or liability in certain instances	9, A4, A5
4	A written put option on the issuer's equity shares that requires a physical or net cash settlement	Requires or could require a transfer of assets by the issuer	May be equity or an asset/liability, depending on whether criteria under EITF 00-19, including criteria for settlement alternatives, are met – see attachment C	11, A10
5	A written put option on the issuer's equity shares that requires or permits a net share settlement	The contract's monetary value is based on variations in the fair value of the issuer's equity shares, which changes in the opposite direction	Same as item 4	12(c), A22
6	A forward purchase contract on the issuer's equity shares that requires a physical or net cash settlement	Same as item 4	Same as item 4	11, A11
7	A forward purchase contract on the issuer's equity shares that requires or permits a net share settlement	Same as item 5	Same as item 4	12(c), A22

No.	Brief Description of the Instrument/Contract	Reason for Inclusion	Classification Pre-FAS 150	FAS 150 Par. #
8	A contract in which an entity receives \$100,000 in exchange for a promise to issue a sufficient number of its own equity shares that will be worth \$110,000 on a future date	The monetary value of the obligation is fixed, even though the number of shares that are to be issued is variable	Depends on the economic substance – see EITF Issue No. 98-12, <i>Application of Issue No. 00-19 to Forward Equity Sales Transactions</i> , and footnote 1 to EITF 00-19	12(a), A18
9	A guarantee contract that requires the guarantor to issue a variable number of its equity shares, the fair value of which will equal a date-specific deficiency between the guaranteed value of an investment (e.g., equity shares of another entity) and the investment’s fair value on the specified date (also known as a “market-value guarantee”)	The monetary value of the obligation is based on something other than the fair value of the issuer’s equity shares (i.e., based on the fair value of another entity’s equity shares)	May be a liability or equity depending on the analysis under EITF 00-19	12(b), A20
10	The same contract as in item 9 above, except that the obligation is based on the deficiency between the investment’s guaranteed value and the investment’s fair value on the specified date plus .005 times the change in the fair value of the guarantor’s equity shares	The contract is predominantly (if not solely) based on something other than the fair value of the issuer’s equity shares	Same as item 9	12(b), A21
	Compound Instruments			
11	A collar – e.g., a single contract comprising <ul style="list-style-type: none"> • A written put option that allows the holder to sell the issuer’s stock at \$100 per share, and • A purchased call option that allows the issuer to buy its own stock at \$120 per share (See attachment B for another collar that is outside the scope of FAS 150)	The combination includes a written put option and, as such, is subject to the same conclusion as that in item 4 or 5 above; depending on the fair values of the components, the compound instrument could initially be	May be equity or an asset/liability, depending on whether criteria under EITF 00-19, including criteria for settlement alternatives, are met	11-13, A15, A16

No.	Brief Description of the Instrument/Contract	Reason for Inclusion	Classification Pre-FAS 150	FAS 150 Par. #
		classified as either an asset or a liability		
12	<p>A “written put spread,” which is a single contract comprising</p> <ul style="list-style-type: none"> • A purchased put option that allows the issuer to sell its own stock at \$100 per share, and • A written put option that allows the holder to sell the issuer’s stock at \$120 per share <p>(See attachment B for a “purchased put spread” that is not within the scope of FAS 150)</p>	The monetary value of the obligation is solely or predominantly based on variations in the fair value of the issuer’s equity shares, but changes in the opposite direction	Same as item 11	Same as item 11

**Examples of Instruments/Contracts That Are Excluded from the Scope of FAS 150
(And Therefore Classified According to Existing, pre-FAS 150 GAAP)**

No.	Brief Description of the Instrument/Contract	Reason for Exclusion	Paragraph in FAS 150
<i>Single Instruments</i>			
1	Contingently redeemable preferred stock (e.g., preferred stock that will be redeemed only if there is (a) a change in control, (b) a successful completion of an initial public offering, or (c) an increase in the S&P 500 by a specified percentage by a specified date, etc.)	Redemption is not certain to occur, because of the contingency	A7
2	Increasing-rate preferred stock ¹	Decision deferred until phase 2	B24
3	An equity security or capital interest that is issued by an entity and must be redeemed upon its liquidation, or has terms of indenture calling for the entity's liquidation on a specific date	Redemption will occur only upon liquidation of the reporting entity	9
4	A purchased put or a written call option on the issuer's equity shares	Exercise (execution) of the contract does not require the issuer to transfer assets – the issuer will issue shares and receive assets	By way of analogy to paragraph 11 (i.e., does not require a transfer of assets)
5	A purchased call option on the issuer's equity shares	Exercise of the option is within the control of the issuer – if the option is not exercised, the transfer of assets might not occur	A26
6	A forward sale contract by the issuer on the issuer's equity shares	Same as item 4	Same as item 4
7	A FAS 133 derivative that requires delivery of a variable number of the issuer's equity shares that have a monetary value equaling changes in the price of a fixed number of the issuer's shares multiplied by the euro/US-dollar exchange rate	This instrument is "dual-indexed" – indexed to both the issuer's share price and the foreign currency exchange rate; it is <i>not</i> based solely or predominantly on something other than the issuer's equity shares	A21

1. Like other mandatorily redeemable preferred stock, however, increasing-rate preferred stock that is mandatorily redeemable on (or not later than) a specified date is classified as a liability under FAS 150.

No.	Brief Description of the Instrument/Contract	Reason for Exclusion	Paragraph in FAS 150
	<i>Compound Instruments</i>		
8	<p>A collar — for example, a single contract comprising</p> <ul style="list-style-type: none"> • A written call option (or a forward sale contract) that allows the holder to buy the issuer’s stock at \$120 per share, and • A purchased put option (or a forward sale contract) that allows the issuer to sell its own stock at \$100 per share <p>(See attachment A for another collar that is within the scope of FAS 150)</p>	A combination of two instruments that are both outside the scope of FAS 150 – see items 4 and 6 above	Same as item 4
9	<p>A “purchased call spread,” which is a single contract comprising</p> <ul style="list-style-type: none"> • A purchased call option that allows the issuer to buy its own stock at \$100 per share, and • A written call option that allows the holder to buy the issuer’s stock at \$120 per share 	A combination of two instruments that are both outside the scope of FAS 150 – see items 4 and 5 above	Same as items 4 and 5
10	<p>A “written call spread,” which is a single contract comprising</p> <ul style="list-style-type: none"> • A purchased call option that allows the issuer to buy its own stock at \$120 per share • A written call option that allows the holder to buy the issuer’s stock at \$100 per share 	A combination of two instruments that are both outside the scope of FAS 150; see items 4 and 5 above	Same as items 4 and 5
11	<p>A “purchased put spread,” which is a single contract comprising</p> <ul style="list-style-type: none"> • A purchased put option that allows the issuer to sell its own stock at \$120 per share, and • A written put option that allows the holder to sell the issuer’s stock at \$100 per share <p>(See attachment A for a “written put spread” that is within the scope of FAS 150)</p>	Viewed as a single instrument under FAS 150, this instrument does not represent an obligation of the issuer under any stock-price scenario; the purchased put option neutralizes the issuer’s obligation under the written put option	13

No.	Brief Description of the Instrument/Contract	Reason for Exclusion	Paragraph in FAS 150
<i>Hybrid Instruments</i>			
12	Date-certain redeemable preferred stock that is convertible into a fixed number of the issuer's common stock at any time at the holder's option	Conversion is within the holder's control; therefore, redemption is not certain to occur, as long as the conversion option is substantive at inception	10
13	Convertible debt	FAS 150 does not apply to embedded features in hybrid instruments; decision deferred until phase 2	6
14	Puttable stock	FAS 150 does not apply to embedded features in hybrid instruments; decision deferred until phase 2	6, B25
15	Callable common stock	The repurchase (call) of the equity shares is at the option of the issuer and, therefore, is not certain to occur	Same as item 4

Comparison of EITF 00-19 and FAS 150 for Selected Freestanding Financial Instruments Indexed to, and Potentially Settled in, the Issuer's Own Stock That Are Included in the Scope of FAS 150

		Settlement Dictated by Contract (No Choice)			Company Choice of Settlement			Counterparty Choice of Settlement		
		<i>Physical</i>	<i>Net Share</i>	<i>Net Cash</i>	<i>Net Share or Physical</i>	<i>Net Share or Net Cash</i>	<i>Net Cash or Physical</i>	<i>Net Share or Physical</i>	<i>Net Share or Net Cash</i>	<i>Net Cash or Physical</i>
Written Put Options	<i>EITF 00-19</i>	Temporary Equity	Equity	Liability	Equity	Equity	Temporary Equity	Temporary Equity	Liability	Liability
	<i>FAS 150</i>	Liability	Liability	Liability	Liability	Liability	Liability	Liability	Liability	Liability
Forward Purchase Contracts	<i>EITF 00-19</i>	Temporary Equity	Equity	Asset/ Liability	Equity	Equity	Temporary Equity	Temporary Equity	Asset/ Liability	Asset/ Liability
	<i>FAS 150²</i>	Asset/ Liability	Asset/ Liability	Asset/ Liability	Asset/ Liability	Asset/ Liability	Asset/ Liability	Asset/ Liability	Asset/ Liability	Asset/ Liability

Note: A classification as equity or temporary equity under EITF 00-19 is based on the assumption that the instrument has met all of EITF 00-19's applicable criteria.

2. Under FAS 150, forward purchase contracts that require gross physical settlement for cash are not derivatives under FAS 133 but are initially measured at the fair value of the shares at the contract's inception and subsequently recognized in a manner similar to how mandatorily redeemable financial instruments are recognized. All other forward purchase contracts are initially and subsequently measured at fair value.

