OWNERSHIP-SETTLEMENT APPROACH—OBJECTIVE AND SUMMARY OF ACCOUNTING PRINCIPLES

Scope: The requirements of this summary apply to all instruments issued or held by business enterprises[1] that are either (1) financial instruments or (2) nonfinancial instruments that are settled with or that have payoffs based on financial instruments issued by the reporting entity or by a reporting entity within a consolidated group.

Overall Objective: To establish a framework for classifying and measuring instruments with characteristics of equity, liabilities, and assets.

The principles presented in this summary are bolded. Principles include application criteria that are presented in regular text.

<u>Principle 1—Linking Instruments</u>

1. An entity should link (account for as a single instrument) two or more instruments that are part of the same arrangement if accounting for the instruments individually differs from accounting for them as if they were a single instrument with the same or similar outcome (or possible outcomes). A linked group of instruments should be classified, measured, and displayed as if it were a single instrument, which includes possible separation into an equity component and a nonequity component under Principle 4.

a. Instruments are part of the same arrangement if at least one of the following conditions is met:

(1) Interdependency exists between the instruments. For example, interdependency exists if (a) exercise of one depends on exercise of the other or causes the expiration of the other, (b) an instrument is specifically tied to a second instrument, or (c) there is contractual evidence of interacting payoff structures affecting an outcome. In these cases, the timing or the counterparty does not matter.

(2) The instruments have interacting payoff structures and are entered into at or near the same time with the same or a related counterparty or an agent acting on behalf of a counterparty.

[1]*Business enterprises* include all reporting entities and reporting entities within a consolidated group except not-for-profit organizations.

<u>Principle 2—Classification: Substantive Features</u>

2. An entity should classify a single instrument, a linked group of instruments (as described in Principle 1), or a component of an instrument (as described in Principle 4) in the same manner as another instrument with the same or similar outcome (or set of possible outcomes with the same or similar probabilities of occurrence). To do so, an entity should consider substantive settlement features (stated or unstated) and ignore any settlement features that are not substantive.

a. A stated or unstated settlement feature is substantive if the feature has (1) more than a remote likelihood of affecting an instrument's outcome (is reasonably possible) and (2) more than a minimal effect as compared to other features within an instrument. All other settlement features are not substantive. For example, an unstated cash settlement feature would be identified and thus included in an instrument's substantive terms for classification purposes if a reporting entity determines that it may be unable to deliver shares to settle the instrument. In that case, two substantive settlement alternatives are identified—shares and cash.

b. Substantive settlement features should be identified in determining whether instruments should be linked by applying an iterative process. That process entails comparing the accounting results under the unlinked and linked methods by identifying substantive features for each method. Additionally, the likelihood of a settlement feature's occurrence is assessed by considering all facts and circumstances over the lifetime of the instrument.

<u>Principle 3—Classification: Equity Instruments</u>

3. An equity instrument represents an ownership interest of a reporting entity and is determined by the type of return the instrument conveys to the counterparty and the settlement outcome. An equity instrument may be a single instrument or a component of an instrument (identified based on differing outcomes and payoffs at settlement). There are three types of equity instruments: (a) a perpetual instrument issued by the reporting entity, (b) a direct ownership instrument issued by the reporting entity, and (c) an indirect ownership instrument issued or held by the reporting entity that is based on and will be settled with the same direct ownership instrument or instruments.

a. A perpetual instrument issued by the reporting entity embodies no settlement obligation and entitles the holder to a portion of the issuer's net assets in liquidation. For example, some forms of common stocks, preferred stocks, and callable stocks are perpetual instruments. A perpetual instrument is equity even if the instrument is not a direct ownership instrument.

b. A direct ownership instrument may or may not be perpetual and is an instrument issued by the reporting entity that has both of the following two characteristics:

(1) The instrument represents a proportional claim to a share[2] of the net assets of the reporting entity that is neither limited nor guaranteed (that is, there is no ceiling or floor other than zero net assets) either before or at liquidation. An instrument that is redeemable at fair value meets this characteristic (either mandatorily redeemable or puttable by the holder). An instrument that is redeemable at book value or a formula based on book value also meets this characteristic if (a) there is no active market for the instrument or (b) the instrument can be exchanged only with the reporting entity.

(2) The claim represented by the instrument has no priority over any other claims if the issuer were to liquidate on the date the classification decision is being made.

c. An indirect ownership instrument issued or held by the reporting entity has all three of the following characteristics and is classified as equity only if it is settled with the indexed instrument:

(1) The instrument is not perpetual.

(2) The instrument lacks one or both of the characteristics of a direct ownership instrument, but has a counterparty payoff at settlement that is based on and varies in the same direction as the fair value of a direct ownership instrument.

(3) The instrument does not include contingent exercise provisions based on (a) an observable market other than the market for the reporting entity's direct ownership instruments or (b) an observable index other than an index calculated or measured solely by reference to the reporting entity's own operations (for example, revenue of the reporting entity).

d. A direct or indirect ownership instrument of a consolidated subsidiary retains the same equity classification in the consolidated financial statements unless the instrument's depiction has changed at the consolidated entity level (see subsequent reassessment in Principle 12).

[2] A proportional claim to a share of the net assets is based on the level of ownership in the reporting entity and varies based on the magnitude of the net assets and the instrument's defined share of the net assets. That portion may be partly or wholly determined by capital contributions (in the form of cash, services, or any other consideration) or number of shares owned as well as other factors.

Principle 4—Classification: Separation of Components

4. An instrument is separated into equity and nonequity components if it (a) embodies an obligation and (b) has both equity and nonequity outcomes with differing counterparty payoffs at the outcome date. No instrument should be separated into more than two components. A separated component of an instrument should be classified and displayed as if it were a single instrument and measured under the requirements described in Principles 6–10.

a. Equity outcomes are identified based on the three types of equity instruments. Instruments comprising more than one equity component would not be separated.

b. The fair value option[3] for an instrument in its entirety would not be available in lieu of separation. However, the fair value option could be applied to the nonequity component in applying the measurement provisions of this summary.

c. An instrument that has an interim settlement consisting of an instrument that would be separated (for example, a warrant on shares puttable at a fixed price) would not be separated until the interim settlement occurs. Prior to any interim settlement, the instrument would be classified as a liability or an asset in its entirety.

Principle 5—Classification: Other Instruments

5. All other instruments that are not equity instruments or are not separated into equity and nonequity components are classified as liabilities or assets in their entirety.

a. An issuer or holder of an indirect ownership instrument that may not be settled with the indexed instrument is a liability or an asset unless it meets the separation criteria (for example, if there are two substantive settlement alternatives with differing counterparty payoffs at settlement). An example is an instrument with two substantive settlement alternatives (cash or shares) having the same (or substantially the same) payoffs. That instrument is classified as a liability or an asset regardless of either party or a condition controlling the form of settlement.

[3]Under the FASB Exposure Draft, *The Fair Value Option for Financial Assets and* Financial *Liabilities,* entities would have the option of electing to fair value instruments in their entirety.

Principle 6—Initial Measurement: Single Instruments

6. An instrument[4] that is equity or nonequity in its entirety should be initially measured at its transaction price, which, for an asset or liability is generally its fair value. The transaction price does not include issuance costs or any unstated rights or privileges whether they are included in the price quoted by the seller (to the buyer) or billed and paid separately.

Principle 7—Initial Measurement: Separated Components

7. The initial measurement of the two components of a separated instrument should always sum up to the transaction price of the entire instrument as described in Principle 6. In dividing that total transaction price between the two components, an entity should first determine the fair value of a hypothetical nonequity instrument with terms that would produce the same or a similar outcome as the separated nonequity component. The separated nonequity component is initially measured at that amount (which is the component's hypothetical transaction price). The equity component is measured by deducting the amount assigned to the nonequity component from the transaction price of the instrument as a whole.

a. In determining the fair value of a hypothetical nonequity instrument, an entity should consider the following factors:

(1) That the expected amount and timing of the nonequity outcome must be determined. Factors such as the share price, put, call, and conversion features would be considered in determining a component's expected settlement date.

(2) That a fixed settlement amount (a floor) results in describing a fixed amount that is 100 percent likely to be paid. For example, the floor in convertible debt or shares puttable at a fixed price would always be paid even if the equity outcome occurs.

(3) That, if the amount or timing of a settlement obligation varies or is uncertain, the fair value of the nonequity component would be determined by considering the probability-weighted (expected) settlement date (or dates) and amount (or amounts) due. For example, since the amount due at the expected settlement date for a share with a make-whole provision is contingent upon the share price, the reporting entity must determine the probability-weighted amount of the contingent liability.

(4) That if the nonequity component would be subsequently accreted (as in the floor component of convertible debt), the probability-weighted (expected) settlement date is determined first and then used to calculate the amount due at that date and the implicit interest rate for the settlement period.

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[4]Instruments accounted for under FASB Statement No. 123 (revised 2004), *Share-Based Payment*, are not subject to these initial measurement requirements.

Principle 8—Separate Reporting Within Equity

8. Equity instruments or components that may be settled with cash or other assets should be reported under a separate heading within equity from equity instruments that are perpetual or settled with other equity instruments. Measurement requirements are described in Principle 9.

Principle 9—Subsequent Measurement: Equity Instruments

9. An equity instrument or component that may be settled with cash or other assets is remeasured at each reporting period. The subsequent measurement attribute is the current settlement value—the fair value of the consideration that would be paid if the instrument were settled according to its terms at the reporting date. Other equity instruments are not remeasured unless required by another accounting standard.

a. Current settlement value is defined as the current result of the redemption formula applied in the way it would be applied on the redemption date. Current settlement value is the amount resulting from the redemption formula as if the reporting entity had known of the redemption in advance of the reporting date. In that case, a reporting entity assumes that it had time to arrange its affairs in the same way the entity expects to arrange them when it actually redeems the instrument.

Principle 10—Subsequent Measurement: Nonequity Instruments

10. Nonequity instruments or components with varying payoffs at settlement should be remeasured at fair value at each reporting period. Other nonequity instruments or components should also be remeasured at fair value at each reporting period unless a different attribute is specified by another accounting standard.

a. An instrument or a component with a fixed settlement amount is subsequently measured by applying APB Opinion No. 21, *Interest on Receivables and Payables.* However, the nonequity component of convertible debt is accreted to the amount due at its initially determined expected settlement date based on the implicit interest rate. A reporting entity may elect to fair value such a nonequity instrument or component under the Board's pending fair value option project.

b. Reallocation of nonequity and equity components is required only under the following circumstances: (1) the forecasted expected settlement date lapses and the nonequity component remains outstanding or (2) early settlement or a modification to contractual terms occurs (see extinguishment accounting under Principle 13). Expected settlement dates are not reassessed under any other circumstances.

c. All other instruments, for example, derivatives and nonequity components with varying or uncertain settlement amounts, are subsequently measured at fair value (unless required by other GAAP).

<u>Principle 11—Reassessment of Classification</u>

11. An instrument should be reassessed at each reporting date to determine if the previous classification is still appropriate. No gain or loss is recognized as a result of the reclassification unless there is an extinguishment (or contractual modification—see Principle 13).

a. Upon consolidation and at each reporting date, the reporting entity should reassess the substantive features (stated and unstated) of an instrument or linked group of instruments for classification purposes.

b. Reassessment may result in reclassification and, in some cases, remeasurement of an instrument. Instruments reclassified to assets, liabilities, or separately reported equity that may be settled with cash or other assets, should be measured at the attributes at which they would have been measured if they were previously classified that way as of the date of the event that caused the reclassification. No gains or losses are recognized upon a reclassification unless it results in a debt extinguishment or a modification (see extinguishment accounting section under Principle 13). There is no limit on the number of times an instrument may be reclassified.

<u>Principle 12—Classification in Consolidated Financial Statements</u>

12. The classification of an instrument of a consolidated subsidiary or variable interest entity should be reconsidered in the consolidated financial statements and could be different from its classification in the subsidiary's separate financial statements.

Principle 13—Extinguishment Accounting

13. An entity should apply extinguishment accounting consistently. Extinguishment accounting includes settlement (a) per contractual terms, (b) at an amount outside the contractual terms, (c) by conversion into equity instruments, or (d) by modification of an instrument. If an instrument has been separated into liability and equity components and the liability component is subsequently extinguished or modified, that event is accounted for as if both components of the original instrument had been replaced by issuing a new instrument with the new terms. The new instrument is assessed for separation considering the modified terms according to Principle 4. If the entire extinguishment amount differs from the carrying amount of the liability at the date of extinguishment, a gain or loss will result for any remaining amount after reallocation to the liability and equity components.

a. The extinguishment amount is equal to either the amount paid or the fair value of the new instrument.

b. Extinguishment accounting for separated instruments is applied as follows:

   (1) Allocate the entire extinguishment amount to liability and equity components.

   (2) Determine the fair value of the liability component at the extinguishment-modification date by using the:

      (a) Settlement period remaining from the original expected period, or, if zero, the new expected settlement period

      (b) Amount due at the end of the remaining or new expected settlement period

      (c) Discount rate for that period.

   (3) Apply the remaining portion of the entire extinguishment amount to equity.

   (4) If the entire extinguishment amount differs from the current liability carrying amount, the extinguishment gain or loss will be the remaining amount after reallocating to the liability and equity components.

(Note that the detailed reallocation steps b(1)–(4) need not be applied if an instrument is settled either (a) at its expected settlement date and at its contractual amount [in that case, the liability carrying amount is simply extinguished and there is no gain or loss to record], or (b) outside its contractual terms at the date the extinguishment accounting is applied [in that case, the gain or loss would be equal to the difference between the payment and the current liability carrying amount].)

EXAMPLES

The following examples illustrate how the principles in this summary are applied by stepping through each of the principles.

1. Zero Coupon Convertible Debt Containing Various Put and Call Features

Face Amount	$1,000		Convertible into shares anytime
Proceeds (yield = 2%)	$742		Callable at and anytime after year 5 for 2% accreted yield amount
Issue Date	11/1/2000		Puttable at year 3 for $788, 5 for $820, and 10 for $905 (2% accreted amounts)
Maturity Date	11/1/2015		
Conversion Ratio (in shares)	8.33		Puttable anytime upon a change in control at the 2% accreted amount
Share Price 11/1/2000	$71.25		Initially expected settlement date is year 5

Linkage: If the instrument was not entered into with another instrument as part of the same arrangement, then it would not be linked. Assume that this is the case (see following additional note on linkage).

Additional Note on Linkage: If this instrument were entered into with another instrument at the same time, the instruments would be analyzed to determine if they should be linked. For example, assume contemporaneous issuance of a purchased call option with a strike price equal to the conversion price that can only be exercised if the debt is converted and expires if the debt is paid with cash. Those instruments would be linked to describe straight debt because there is interdependency between the instruments and the accounting differs (in this case, the counterparties and the timing does not matter because the instruments are linked by their contractual interdependency).

Substantive Features (Classification): In identifying stated and unstated substantive features for classification purposes, assume it is determined that the change in control put has a remote likelihood of occurring before the expected settlement date at year five. Therefore, that feature is disregarded in depicting the instrument (that is, it does not affect the expected settlement date). Additionally, assume that the reporting entity determines that it has the ability to deliver the shares over the expected life of the instrument, if converted. Therefore, the unstated cash settlement feature would be considered remote of occurring and is disregarded and would not affect the classification.

Classification: The instrument is separated into liability and equity components. It has both equity (an indirect ownership instrument settled with the same direct ownership instruments) and liability (a fixed amount [floor]) outcomes involving settlement with differing counterparty payoffs.

1. Zero Coupon Convertible Debt Containing Various Put and Call Features (continued)

Initial Measurement: At inception, the nonequity component is measured at its fair value. The amount due at the expected settlement date ($820) is discounted using the probability-weighted expected settlement date (year 5) and straight debt rate for that settlement period (6.1 percent). The remaining portion of the proceeds would be allocated to equity. The result is to allocate a liability of $607 ($802 due in 5 years discounted at 6.1 percent) and equity of $135 ($742-$607). (Note that the expected settlement date was determined by considering the interaction of the put, call, and conversion options at year 5.)

Subsequent Measurement: The debt component is accreted to the amount of principal to be paid at the expected settlement date ($820) by applying the straight debt rate (6.1 percent) to compute interest expense. The equity component remains unchanged.

Reassessment and Extinguishment Accounting: Features of this instrument are reassessed at each reporting date to determine if they are still substantive or nonsubstantive. For example, if the reporting entity determines that it no longer will have the ability to deliver shares, the entire instrument is reclassified as a liability because the unstated cash settlement feature is now considered to be a substantive feature, and the previously considered equity component ceases to meet the criteria for equity classification. The liability is measured at its fair value (because the settlement amount varies). No gain or loss would be recorded upon that reclassification.

The five-year expected settlement date is not reassessed unless the expected date lapses and the debt remains outstanding or the contractual terms of the instrument are modified. In those cases, extinguishment accounting is applied as follows.

Extinguishment accounting is applied consistently whether this instrument is converted, repaid, or modified. The spreadsheet found on the next page illustrates various scenarios of possible extinguishments for this example. (Note that, for illustrative purposes, the spreadsheet applies the detailed reallocation steps described under Principle 13 for all extinguishment scenarios. As described under Principle 13, an entity may simply compare the extinguishment amount to the current liability carrying amount to determine any gains or losses for Scenarios 6 and 8 [noncontractual settlements at the date of extinguishment]. Additionally for Scenarios 1 and 2, no reallocation or determination of gains or losses would be necessary [contractual settlements at the expected date.])

1. Zero Coupon Convertible Debt Containing Various Put and Call Features (continued)—Extinguishment Accounting Scenarios

	Extinguishment Scenarios	Settled Per Contractual Terms					Noncontractual Settlements		
		1	2	3	4	5	6	7	8
		Settled at Expected Date (Liability)	Settled at Expected Date (Conversion)	Settlement Date Lapses at Year 5	Settled Early at Year 3 (Liability Outcome)	Settled Early at Year 3 (Conversion)	Extinguished in Open Market Transaction at Year 3	Instrument Modified at Year 5 (Not Settled)	Induced Conversion at Year 5
A	Liability Carrying Amount	820	820	820	727	727	727	820	820
B	Extinguishment Amount	820	900	820	788	850	650	840	840
C	Remaining Settlement Period	0 yrs	0 yrs	5 yrs	2 yrs	2 yrs	2 yrs	5 yrs	0 yrs
D	Due End of Remaining Period	820	820	905	820	820	746	952	840
E	Discount Rate for Period	N/A	N/A	6.00%	5.00%	5.00%	7.00%	6.20%	N/A
F	Fair Value Liability Component	820	820	673	743	743	650	702	840
G	Equity Allocation (Reduction)	0	(80)	147	(45)	(107)	0	138	0
H	Gain/(Loss)	N/A	0	N/A	(16)	(16)	77	(20)	(20)
	Journal Entries	Liability 820 Cash 820	Liability 820 Equity 820 (900-80)	Liability 147 Equity 147	Liability 727 Loss 16 Equity 45 Cash 788	Liability 727 Loss 16 Equity 743 (850-107)	Liability 727 Gain 77 Cash 650	Liability 118 Loss 20 Equity 138	Liability 820 Loss 20 Equity 840

Line A: The liability carrying amount has been accreted up to that amount based on its initial balance of $607 (with the recording of interest expense).

Line B: The extinguishment amount is the amount of the consideration paid (Scenarios 1, 2, 4, 5, 6, and 8) or the fair value of the instrument at the extinguishment date (Scenarios 3 and 7). For Scenarios 2 and 5, the amount paid is the conversion value based on the 8.33 shares times the current share price (assumed). For Scenario 8, the conversion ratio was increased to 12 shares times the current assumed share price of $70 ($840).

Line C: The remaining settlement period is (1) zero if settled at the expected date (Scenarios 1, 2, and 8), (2) based on a newly determined expected settlement date if the expected settlement date lapses (Scenarios 3 and 7), or (3) the period remaining to the initially determined expected settlement date if settled early (Scenarios 4, 5, and 6).

Line D: The amount due at the end of the remaining period is either given in the original facts or, if a noncontractual settlement, projected based on the modified terms. Scenario 7 is projected based on an increased yield to 3 percent.

Line E: Discount rates for remaining periods are assumed as notated.

Line F: The fair value of the liability component is the discounted amount due at the end of the remaining period (from Line D) using the remaining settlement period (from Line C) and the discount rate for that period (from Line E). For example, Scenario 3 is the present value of $905 discounted for five years at 6% semiannual.

Line G: The equity allocation is the extinguishment amount (from Line B) minus the fair value of the liability component (from Line F). For example, Scenario 2 is $900 minus $820.

Line H: The gain or loss is any remaining amount after allocation to the liability and equity components.

2. Written Call Option with Share and Possible Cash Settlement Features

(An entity writes a call option that gives the counterparty the right to require the entity to sell it a share of stock for $10.)

Premium	$2		Physical settlement
Strike Price	$10		Net-cash settled if there is a change in control
Notional	1 share		

Linkage: Assume the instrument was not entered into with another instrument as part of the same arrangement.

Substantive Features (Classification): In identifying stated and unstated substantive features, assume it is determined that the change in control put has a remote likelihood of occurring. Therefore, that feature is disregarded in depicting the instrument (does not affect the classification). Additionally, assume that the reporting entity determines that it has the ability to deliver the shares over the expected life of the instrument. Therefore, that unstated cash settlement feature is disregarded and would not affect the classification.

Classification: The instrument is equity. It is an indirect ownership instrument to be settled with a direct ownership instrument.

Initial Measurement: The premium ($2) is recorded in equity.

Subsequent Measurement: Equity is not remeasured.

Reassessment and Extinguishment Accounting: Features of this instrument are reassessed at each reporting date to determine if they are still substantive or nonsubstantive. For example, if the reporting entity determines that it no longer has the ability to deliver shares or it appears that a change in control is more than remotely likely to occur, the entire instrument is reclassified as a liability that is measured at its fair value because the settlement amount varies. No gain or loss would be recorded upon that reclassification. No extinguishment accounting issues arise for this example because it is either recorded in equity or, if a liability, the instrument is measured and extinguished at fair value.

3. Share Puttable at Fixed Price, Fair Value, and Warrants on those Shares (see revised facts at end for fair value examples)

(An entity issues a share to a counterparty that has a right to require the entity to redeem the share at a fixed price of $820.)

Proceeds	$742		Puttable at year five
Put Price	$820		Put physically settled with cash

Linkage and Substantive Features (Classification): Assume the instrument was not entered into with another instrument as part of the same arrangement, and all features are substantive (see following additional note on linkage).

Additional Note on Linkage: A separately issued put option and share may be linked to depict puttable stock, for example, if the put is tied to the specific underlying share or instruments are entered into at the same time with the same counterparty.

Classification: The instrument is separated into liability and equity components. It has both equity (a perpetual instrument) and liability (a fixed amount [floor]) outcomes involving settlement with counterparty payoffs. Warrants that are issued on shares puttable at a fixed price would be classified as liabilities until interim settlement with the shares occurs, at which time the share would be separated.

Initial Measurement: At inception, the nonequity component is measured at fair value. The amount due at the settlement date ($820) is discounted using the five-year straight debt rate (6.1 percent). The remaining portion of the proceeds would be allocated to equity. The result is to allocate a liability of $607 and equity of $135. Warrants would be recorded at their transaction prices.

Subsequent Measurement: The debt component is accreted to the amount of principal to be paid at the expected settlement date ($820) by applying the straight debt rate (6.1 percent) to compute interest expense. The equity component remains unchanged. Warrants on shares puttable at a fixed price would be measured at fair value with changes recorded in income.

Reassessment and Extinguishment Accounting: If the put option expires at year five, for example, because the share price is above $820, the liability is reclassified to equity at its carrying amount ($820). Extinguishment accounting for shares puttable at a fixed price is addressed in Example 1 (convertible debt).

Revised Facts: If instead, the share in this example was puttable at fair value, the instrument would be separately reported in equity (if it meets the criteria to be a direct ownership instrument). Subsequently, the share would be remeasured in equity at its current settlement amount with changes recorded in the equity accounts. Warrants on shares puttable at fair value would be equity if the shares are direct ownership instruments (they would not be separately displayed until interim settlement occurs).

In contrast, assume at year five, the reporting entity must pay the holder cash equal to the difference between $820 and the current share price if the current share price is lower than $820. In that case, the instrument is depicted as a share with a make-whole provision (also could be depicted as a net-cash-settled puttable share) and would be separated into liability and equity components. However, the liability payoff is a derivative liability and would be recorded and measured as such. For example, assume that the derivative has an initial fair value of $100. The reporting entity would initially record a liability of $100 and equity of $642, and the liability would subsequently be measured at fair value.

4. Prepaid Written Put Option

(An entity prepays to the counterparty $800. The counterparty has the right to return to the entity one share or $1,000.)

Payment (by the reporting entity)	$800		Puttable at year two
Put Price	$1,000		Results at settlement: if share price is (1) above $1,000—the reporting entity will receive $1,000 or (2) at or below $1,000—the reporting entity will receive one of its shares
Notional	1 share		

Linkage and Substantive Features: Assume the instrument was not entered into with another instrument as part of the same arrangement, and all features are substantive.

Classification: The instrument is an asset. It is not separated because it has two nonequity outcomes (a fixed payoff or a payoff inversely related to the share price) involving settlement alternatives with differing counterparty payoffs.

Initial Measurement: At inception, the payment ($800) is recorded as an asset.

Subsequent Measurement: The instrument is recorded as an asset in its entirety at fair value with changes in value reflected through income.

Reassessment and Extinguishment Accounting: No reassessment or extinguishment accounting issues arise for this example because it is accounted for at fair value.

Additional Notes: This example illustrates an instrument that has two nonequity components that is measured at fair value in its entirety instead of being separated. It is measured at fair value because the payoff at settlement varies. Liability and asset instruments that do not have two nonequity components but have varying settlement amounts would also be measured at fair value. An example is debt that has a payoff indexed to the reporting entity's share price. That instrument has one outcome and one payoff (a single liability component) that varies and, therefore, would be measured at fair value.

Another noteworthy example of a liability that is measured at fair value is a written call option for the counterparty to purchase shares that are immediately redeemable at fair value. At first glance, that instrument appears to be an indirect ownership instrument that would be settled with direct ownership instruments and, therefore, would be classified as equity. However, the reporting entity must examine this instrument based on the possible outcomes to determine the substantive depiction of this instrument for classification purposes. In this case, the instrument is a net-cash-settled option, which is classified as a liability because the counterparty would not be a shareholder with a claim to a share of the net assets without limits.

5. Examples of Separately Displayed Equity

The following example illustrates separate display within the equity section of the balance sheet for equity instruments that may be settled with cash or other assets. Assume 30 percent of the reporting entity's shares are mandatorily redeemable at book value and the remaining 70 percent of the shares are perpetual (common shares).

Balance Sheet	**Period 1**	**Period 2**
Assets		
Cash	150	180
Available-for-Sale Securities	100	110
Property, Plant, & Equipment	300	275
Total Assets	550	565
Liabilities		
Liabilities	200	190
Equity		
Mandatorily Redeemable Shares*	105	113
Cumulative Change in Shares Subject to Mandatory Redemption	(75)	(83)
Common Shares	70	70
APIC	80	80
AOCI	60	70
Retained Earnings	110	125
Total Liabilities and Equity	550	565

Notes to Financial Statements:

*Manadatorily Redeemable Shares Consist of:		
Shares	30	30
APIC	24	24
AOCI	18	21
Retained Earnings	33	38
	105	113

Examples of Separately Displayed Equity (continued)

The following example illustrates separate display within the equity section of the balance sheet for equity instruments that may be settled with cash or other assets. Assume 100 percent of the reporting entity's shares are mandatorily redeemable at book value.

Balance Sheet	**Period 1**	**Period 2**
Assets		
Cash	150	180
Available-for-Sale Securities	100	110
Property, Plant, & Equipment	300	275
Total Assets	550	565
Liabilities		
Liabilities	200	190
Equity		
Mandatorily Redeemable Shares*	350	375
Cumulative Change in Shares Subject to Mandatory Redemption	(250)	(275)
APIC	80	80
AOCI	60	70
Retained Earnings	110	125
Total Liabilities and Equity	550	565

Notes to Financial Statements:

*Manadatorily Redeemable Shares Consist of:		
Shares	100	100
APIC	80	80
AOCI	60	70
Retained Earnings	110	125
	350	375

The increase of $8 is reported in the statement of shareholders' equity as a transfer from common stock to mandatorily redeemable shares.