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FASB Makes Targeted Changes to Guidance on Accounting for Certain Financial Instruments With Down-Round Features

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Introduction

On July 13, 2017, the FASB issued ASU 2017-11,[1] which makes limited changes to the Board's guidance on classifying certain financial instruments as either liabilities or equity. The ASU's objective is to improve (1) the accounting for instruments with "down-round" provisions and (2) the readability of the guidance in ASC 480[2] on distinguishing liabilities from equity by replacing the indefinite deferral of certain pending content with scope exceptions.

Connecting the Dots

The ASU's guidance differs in some respects from that in the proposed ASU released in December 2016. In particular, the proposed requirement to recognize the value transferred upon the trigger of a down-round feature now applies only to equity-classified instruments for entities that disclose earnings per share (EPS).

[1] FASB Accounting Standards Update (ASU) No. 2017-11, *(Part I) Accounting for Certain Financial Instruments With Down Round Features, (Part II) Replacement of the Indefinite Deferral for Mandatorily Redeemable Financial Instruments of Certain Nonpublic Entities and Certain Mandatorily Redeemable Noncontrolling Interests With a Scope Exception*.

[2] For titles of *FASB Accounting Standards Codification* (ASC) references, see Deloitte's "Titles of Topics and Subtopics in the *FASB Accounting Standards Codification*."

This *Heads Up* provides an overview of the ASU's changes to GAAP and a brief update of the FASB's plan for more wholesale improvements to its guidance on liabilities and equity.

Down-Round Provisions

Background

A down-round provision is a term in an equity-linked financial instrument (e.g., a freestanding warrant contract or an equity conversion feature embedded within a host debt or equity contract) that triggers a downward adjustment to the instrument's strike price (or conversion price) if equity shares are issued at a lower price (or equity-linked financial instruments are issued at a lower strike price) than the instrument's then-current strike price. The purpose of the feature is to protect the instrument's counterparty from future issuances of equity shares at a more favorable price. For example, a warrant may specify that the strike price is the lower of $5 per share or the common stock offering price in any future initial public offering of the shares. Similarly, a debt instrument may include an embedded conversion feature whose conversion price is the lower of $5 per share or the future public offering price. Such provisions are frequently included in warrants, convertible shares, and convertible debt issued by private entities and development-stage companies.

Before an issuer adopts ASU 2017-11, a contract (or embedded equity conversion feature) that contains a down-round provision does not qualify as equity because such an arrangement precludes a conclusion that the contract is indexed to the entity's own stock under ASC 815-40-15 (as illustrated in ASC 815-40-55-33 and 55-34). For a contract to be considered indexed to an entity's own equity under ASC 815-40-15, the only variables that could affect the settlement amount must be inputs into the pricing of a fixed-for-fixed option or forward on the entity's equity shares (i.e., a contract whose settlement amount equals the difference between the fair value of a fixed number of the entity's equity shares and a fixed monetary amount or a fixed amount of a debt instrument). Neither the issuance of new equity securities at the current market price nor the issuance of an equity-linked financial instrument with a lower strike price than a previously issued instrument, however, is an input into the pricing of a fixed-for-fixed option or forward on equity shares.

Connecting the Dots

Economically, a down-round provision is different from an antidilution feature. Antidilution adjustments protect the holder against the impact of dilutive events (e.g., stock splits) but do not put the holder in an economically better position than it was before the event, or relative to existing holders of the underlying equity shares. Under ASC 815-40, an antidilution adjustment would not necessarily preclude a conclusion that the contract is indexed to the entity's own equity. Down-round adjustments are different because they (1) enable the holder to obtain equity shares at an economically more favorable price than before the event and (2) benefit the holder relative to existing holders of the underlying equity shares.

Since down-round protection is not an input into the pricing of a fixed-for-fixed option or forward on equity shares, contracts and features that include down-round provisions have not qualified for the scope exception from derivative accounting in ASC 815-10 for contracts that are indexed to, and classified in, stockholders' equity. Therefore, freestanding contracts on an entity's own equity that contain a down-round feature and meet the definition of a derivative (including net settlement) have been accounted for at fair value, with changes in fair value recognized in earnings. Similarly, embedded equity conversion features that contain down-round provisions have been separated and accounted for as derivative instruments at fair value as long as they met the bifurcation criteria in ASC 815-15.

Connecting the Dots

When a financial instrument is accounted for as a derivative instrument under ASC 815-10, it is marked to its fair value each reporting period, with changes in fair value reflected through earnings. This accounting can result in outcomes that may seem counterintuitive for instruments with down-round features, because the existence of down-round protection is only one of the factors that affect the instrument's fair value, and the provision would be triggered only if the stock price declines below the strike price. If the price of the entity's common stock increases, there will be a decrease in the likelihood and amount of any potential transfer of value to the holder as a result of a down-round adjustment in a warrant that is accounted for as a derivative liability solely because of the existence of that down-round provision. However, the fair value of the warrant liability exclusive of the down-round feature increases, which results in a negative earnings impact (even though the value of the down-round protection the issuer is providing to the holder has declined). Conversely, if the issuer's stock price decreases, the value the issuer is providing to the holder in the form of down-round protection increases even though the fair value of the warrant exclusive of the down-round provision has declined, which has a positive earnings impact.

Key Provisions of the ASU

The ASU applies to issuers of financial instruments with down-round features. It amends (1) the classification of such instruments as liabilities or equity by revising the guidance in ASC 815 on the evaluation of whether instruments or embedded features with down-round provisions must be accounted for as derivative instruments and (2) the guidance on recognition and measurement of the value transferred upon the trigger of a down-round feature for equity-classified instruments by revising ASC 260.

Derivative Analysis — Amendments to ASC 815

The ASU amends ASC 815 to exclude consideration of a down-round feature in the evaluation of whether an instrument is indexed to an entity's own stock under ASC 815-40-15-7C.[3] That is, a down-round provision would not preclude an entity from concluding that an instrument or feature that includes a down-round feature is indexed to the entity's own stock. This guidance applies to both freestanding financial instruments and embedded conversion options (e.g., in convertible instruments with beneficial conversion features (BCFs) or cash conversion features (CCFs)). For example, an entity's evaluation of whether it is required to classify a freestanding warrant that gives the counterparty the right to acquire the entity's common stock as a liability or equity under ASC 815-40 would not be affected by the existence of the down-round feature. If the warrant otherwise meets the condition for equity classification, therefore, it would be classified as equity. Similarly, in the analysis of whether an embedded conversion feature in a debt host contract must be bifurcated as an embedded derivative under ASC 815-15, the existence of a down-round provision would not prevent the contract from qualifying for the scope exception in ASC 815-10-15-74 that applies to contracts indexed to an entity's own stock and classified in stockholders' equity. While instruments that contain down-round features would no longer be expressly precluded from equity classification, such instruments may still not qualify for equity classification for other reasons (e.g., if the issuer could be forced to net cash settle the contract). In summary, the classification of instruments as liabilities or equity is not dictated by the down-round feature under the ASU.

[3] ASC 815-40-15-7C states, "An instrument (or embedded feature) shall be considered indexed to an entity's own stock if its settlement amount will equal the difference between the following:
a. The fair value of a fixed number of the entity's equity shares
b. A fixed monetary amount or a fixed amount of a debt instrument issued by the entity."

Connecting the Dots

The ASU affects the evaluation of whether convertible instruments contain CCFs or contingent BCFs that must be accounted for separately under ASC 470-20. For example, a contingent BCF that was previously separated and accounted for as an embedded derivative instrument in accordance with ASC 815 solely because of the down-round feature would instead, under the ASU, fall within the scope of the guidance on contingent BCFs unless the convertible instrument contains a CCF.

Recognition and Measurement for Equity-Classified Instruments — Amendments to ASC 260

As noted above, the ASU amends the guidance on the recognition and measurement of freestanding equity-classified instruments (e.g., warrants) by adding requirements to ASC 260 for entities that disclose EPS. The amendments do not apply to convertible instruments.

Connecting the Dots

As noted in paragraph BC41 of the ASU, convertible instruments are subject to specialized accounting models in ASC 470-20. Because the Board decided not to amend those models, convertible instruments with down-round features that no longer are required to be bifurcated as derivative instruments under ASC 815 will be within the scope of ASC 470-20 once the ASU is adopted. The ASU does not change the EPS guidance for these instruments (e.g., the if-converted method of calculating diluted EPS).

For entities that have equity-classified instruments and disclose EPS, the down-round feature would affect the accounting only if it was triggered (i.e., the entity issued shares at a price below the strike price). Once the feature was triggered, entities would determine the value that was transferred to the holder when the price adjustment occurred. They would determine this value in accordance with the fair value measurement guidance in ASC 820 by using a "with and without method," under which they would compare the fair values the instrument would have with and without the feature. The ASU states that entities would measure the fair value as the difference between:

a. The fair value of the financial instrument (without the down round feature) with a strike price corresponding to the currently stated strike price of the issued instrument (that is, before the strike price reduction)

b. The fair value of the financial instrument (without the down round feature) with a strike price corresponding to the reduced strike price upon the down round feature being triggered.

After determining the value that was transferred to the holder, the entity would recognize the value transferred as a reduction of retained earnings and an increase of additional paid-in capital (i.e., as a deemed dividend). Further, the transfer of value would be reflected as a deduction to income available to common stockholders in the basic EPS calculation. The feature would not be subsequently remeasured.

Connecting the Dots

The amendments to ASC 815 apply to all entities with financial instruments that have down-round features; however, the ASU's requirement to recognize the value transferred upon the trigger of a down-round feature in a freestanding equity-classified instrument only affects companies that disclose EPS. Accordingly, private companies that do not disclose EPS will reevaluate the classification of financial instruments with down-round features under ASC 815 and the applicability of the CCF and BCF guidance in ASC 470-20 to convertible instruments, but the ASU will not require them to recognize the impact of a down-round feature that is triggered for a freestanding equity-classified instrument. If a private company discloses EPS, however, it will be subject to the ASU's recognition model for equity-classified instruments.

Example

On January 1, 2017, Entity A grants warrants to Investor X to acquire A's common shares. The warrants have an exercise price of $3.00 per share, subject to adjustment if A issues new shares of its common stock. If A issues new shares of its common stock for less than $3.00 per share, the exercise price is adjusted to that issue price. Entity A evaluated the warrants pursuant to ASC 815-40 and concluded that they should be classified in equity since they are considered indexed to the entity's own stock if the down-round provision is disregarded. On July 1, 2017, A issues new shares of its common stock to Investor Y at a price of $2.50 per share. Accordingly, the exercise price of the warrants is adjusted to $2.50.

On July 1, 2017, A would determine the value transferred to X when it lowered the exercise price of the warrants from $3.00 to $2.50 and would treat that amount as a reduction in retained earnings, with an offsetting increase to the carrying value of the warrants in additional paid-in capital. The amount would also be reflected as a reduction to the income available to common stockholders in the basic EPS calculation.

Connecting the Dots

As a result of recognizing the impact of the trigger, an entity may be required to adjust the diluted EPS calculation. Under the treasury stock method, options and warrants are assumed to be exercised as of the beginning of the period. As a result, under the treasury stock method, the assumption is that the options or warrants are exercised before the trigger of the down-round feature. Therefore the impact would be added back to income available for common stockholders to calculate diluted EPS if the option or warrant is dilutive. The ASU's Example 16 in ASC 260-10-55-95 through 55-97 illustrates this guidance. As noted in ASC 260-10-45-25, warrants or options have a dilutive effect under the treasury stock method if the options or warrants are in the money (i.e., "the average market price of the common stock during the period exceeds the exercise price of the options or warrants").

Disclosures

The ASU specifies that upon the trigger of a down-round feature, entities are required to disclose:

a. The fact that [a down-round] feature has been triggered

b. The value of the effect of the down round feature that has been triggered.

In addition, the ASU amends ASC 505-10-50-3, which requires entities to disclose all pertinent rights and privileges of the equity securities outstanding. Under the amended guidance, entities must disclose terms that may change conversion or exercise prices (excluding standard antidilution provisions).

Connecting the Dots

The new requirement to disclose terms that may change conversion or exercise prices is not limited to down-round features. Accordingly, there may be features other than down-round features (e.g., conversion-price adjustments or make-whole provisions) that are subject to this disclosure requirement (e.g., contingent BCFs, as noted in paragraph BC43 of the ASU).

Effective Date and Transition

For public business entities, the ASU is effective for annual reporting periods beginning after December 15, 2018, including interim periods within those annual reporting periods.

For all other entities, the ASU is effective for annual reporting periods beginning after December 15, 2019, and interim periods within annual reporting periods beginning after December 15, 2020.

Early adoption is permitted in any interim or annual period for which financial statements have not yet been issued or have not been made available for issuance.

Under the ASU's transition requirements, entities may elect to do either of the following:

- Recognize the cumulative effect of the change as an adjustment to the opening balance of retained earnings in the period of adoption.
- Apply the amendments retrospectively for each prior reporting period presented in accordance with the guidance on accounting changes in ASC 250-10-45-5 through 45-10.

Connecting the Dots

It may be particularly challenging to determine the appropriate transition accounting for a convertible instrument that, before adoption of the ASU, had a conversion feature that was bifurcated as a derivative instrument but that must be separated into liability and equity components in accordance with the guidance on CCFs or BCFs in ASC 470-20 after adoption of the ASU (e.g., a contingent BCF that was triggered before the ASU's effective date). Some companies may not previously have tracked the information necessary for application of the accounting guidance in ASC 470-20 on CCFs, noncontingent BCFs, or contingent BCFs, as applicable.

In the period of adoption, entities must provide disclosures in accordance with ASC 250-10-50.[4]

Removal of the Indefinite Deferral Under ASC 480

Before ASU 2017-11, the transition guidance in ASC 480-10 indefinitely deferred the application of some of that subtopic's requirements for certain instruments and entities (i.e., certain mandatorily redeemable financial instruments of nonpublic entities that are not SEC registrants and certain mandatorily redeemable noncontrolling interests). Accordingly, such instruments may qualify as equity under U.S. GAAP even though ASC 480-10-25 suggested (before ASU 2017-11) that they should be classified as liabilities.

[4] These disclosures include:
"1. The nature of the change in accounting principle
2. The method of applying the change
3. The cumulative effect of the change on retained earnings in the statement of financial position as of the beginning of the earliest period presented in which [the ASU] is effective."

Connecting the Dots

Because of the indefinite deferral noted above, these requirements were labeled "pending content" in the Codification, but the transition guidance in ASC 480-10-65 provided no effective date for them.

The ASU replaces the indefinite deferral in ASC 480-10 with scope exceptions that have the same applicability. The Board's objective is to improve the navigability of the Codification without changing its application. Since the ASU is not intended to change how GAAP is applied to items within its scope, no transition guidance is provided.

FASB's Research Project on Liabilities and Equity

In 2016, the FASB decided to remove from its technical agenda its project on simplifying the equity classification conditions for contracts on an entity's own equity under ASC 815-40-25, with the exception of the targeted changes in ASU 2017-11. The Board acknowledged the complexity of the current guidance and also observed that few practitioners have a good understanding of the numerous rules and exceptions in it and that improperly distinguishing liabilities from equity therefore continues to be one of the most common reasons for accounting restatements. The Board is currently engaged in a preagenda research project in which it is evaluating its guidance on distinguishing liabilities from equity to determine whether to undertake a comprehensive project.

On August 4, 2016, the FASB issued an invitation to comment (ITC)[5] to gather public input on whether the Board should recommence a comprehensive project on distinguishing liabilities from equity. On June 14, 2017, the FASB staff gave the Board an update of its outreach related to the ITC, which was intended to help the FASB understand (1) how financial statement users evaluate relevant disclosures to determine an entity's capital structure and (2) the complexities associated with the guidance on liabilities and equity. No decisions were made, and the Board asked the FASB staff to perform further research to present at a future Board meeting. The addition of a liabilities and equity project to the FASB's agenda could result in a fundamental overhaul of existing literature (e.g., on freestanding contracts on the issuer's equity shares and debt with embedded equity conversion features).

[5] FASB Invitation to Comment, *Agenda Consultation*. The comment period ended October 17, 2016.

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