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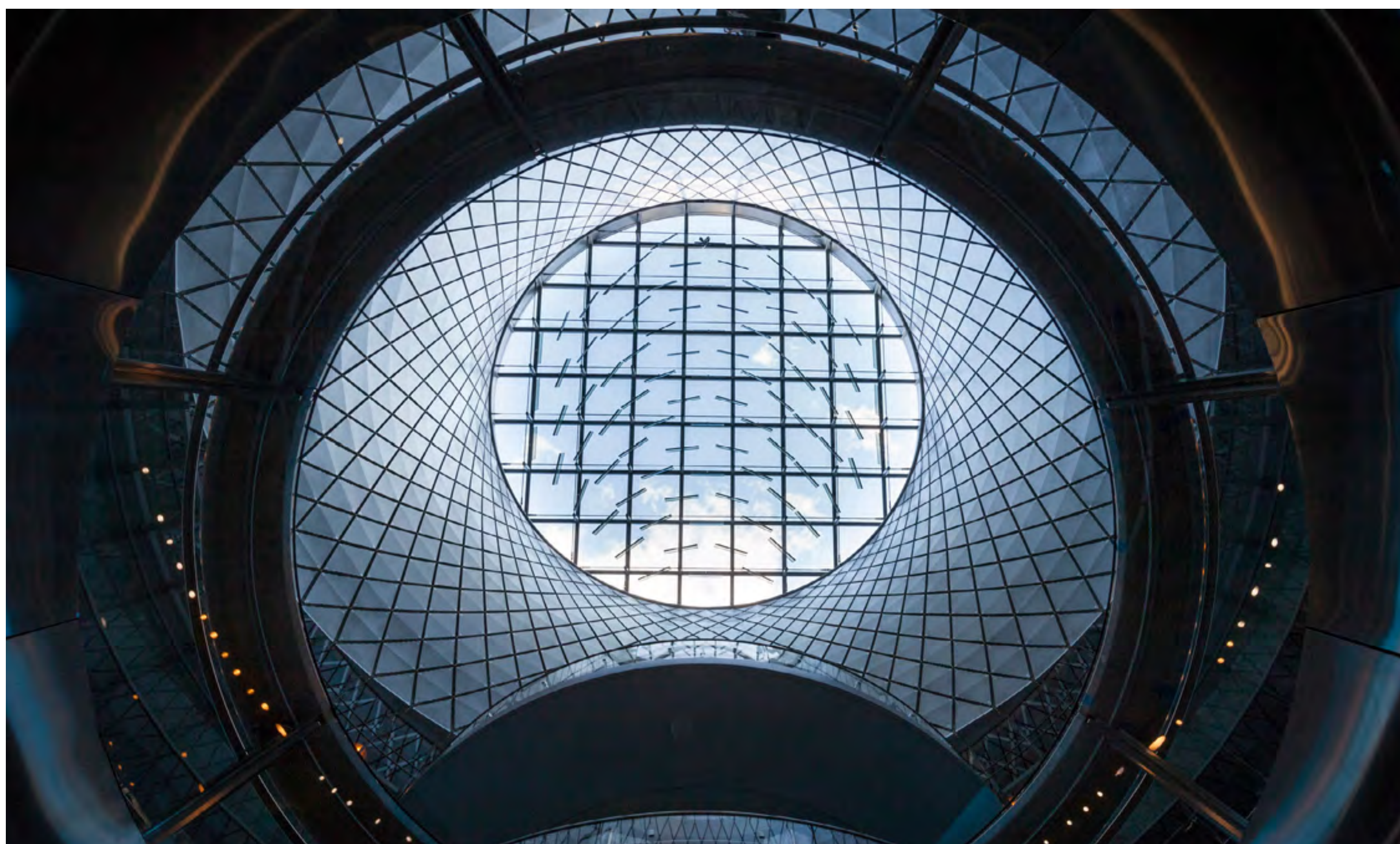

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# FASB Proposes Targeted Changes to Guidance on Liabilities and Equity

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## Introduction

On December 7, 2016, the FASB issued a proposed ASU[1] that would make limited changes to its guidance on classifying certain financial instruments as either liabilities or equity. The FASB's objective is to improve (1) the accounting for instruments with "down-round" provisions and (2) the readability of ASC 480-10[2] by replacing the indefinite deferral of certain pending content with scope exceptions. Comments are due by February 6, 2017.

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

[1] FASB Proposed Accounting Standards Update, *Distinguishing Liabilities From Equity (Topic 480): I. Accounting for Certain Financial Instruments With Down Round Features 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 or "Codification") references, see Deloitte's "Titles of Topics and Subtopics in the *FASB Accounting Standards Codification*."

**Find Out More**

For additional insights into the existing guidance on down-round provisions, see sections 4.3.7.2 and 4.3.7.3 of Deloitte's recently issued *A Roadmap to Accounting for Contracts on an Entity's Own Equity*.

## Overview of Proposed Changes

### 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 the entity issues equity shares at a lower price (or equity-linked financial instruments with 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 companies and development-stage companies.

Under current U.S. GAAP, a contract (or embedded equity conversion feature) that contains a down-round provision does not qualify as equity because such 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.

**Editor's Note**

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 under existing guidance, contracts and features that include down-round provisions do not currently qualify 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) are accounted for at fair value with changes in fair value recognized in earnings. Similarly, embedded equity conversion features that contain down-round provisions must be separated and accounted for as derivative instruments at fair value provided that they meet the bifurcation criteria in ASC 815-15.

**Editor's Note**

When a financial instrument with a down-round provision is accounted for as a derivative instrument pursuant to ASC 815-10, it is marked to its fair value each reporting period with changes in fair value reflected through earnings. This can create accounting outcomes that may seem counterintuitive, because the existence of down-round protection is only one of the factors that drive the instrument's fair value, and the provision would only be triggered if the stock price declines below the strike price. For example, consider a warrant to acquire shares of an entity's common stock that is accounted for as a derivative liability solely because of the existence of a down-round provision. If the price of the entity's common stock increases, the likelihood, as well as the amount, of any potential transfer of value to the holder through a down-round adjustment decreases. 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.

### *Proposed Change*

The proposed ASU applies to issuers of financial instruments (e.g., a warrant or a convertible instrument) with down-round features. Specifically excluded from the scope are (1) freestanding financial instruments and embedded conversion options that are accounted for at fair value with changes in fair value recognized in earnings (e.g., freestanding and bifurcated embedded derivative instruments within the scope of ASC 815 and debt for which the issuer has elected the fair value option in ASC 825-10) and (2) convertible debt instruments that are separated into liability and equity components (e.g., convertible debt with beneficial conversion features or cash conversion features pursuant to ASC 470-20).

**Editor's Note**

The proposed ASU's scope exception for beneficial conversion features (BCFs) includes contingent BCFs. In practice, we expect many down-round features in convertible debt instruments to meet this scope exception. Further, the proposed ASU would amend the scope provisions of ASC 815-10 by excluding down-round features from the analysis of whether an instrument is indexed to the entity's own stock. Accordingly, 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 might, under the proposed ASU, fall instead within the scope of the guidance on contingent BCFs in ASC 470-20.

Under the proposed approach, a down-round provision would not preclude an entity from concluding that the instrument or feature that includes the provision is indexed to the entity's own stock. For example, when an entity evaluates 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, the existence of the down-round feature would not affect the analysis. 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 for 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, however, 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).

The classification of instruments as liabilities or equity would not, under the proposal, be dictated by the down-round feature. Instead, 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 the fair values the instrument would have with and without the feature would be compared. The proposed 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 current strike price of the instrument issued (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.

The accounting for the down-round adjustment differs depending on whether the instrument containing the down-round adjustment is classified as equity or as a liability.

## Equity-Classified Instruments

If a down-round feature is triggered for an instrument classified as equity (e.g., an equity-classified warrant or option on the issuer's equity shares), the entity would recognize the transfer of value as a reduction of retained earnings and an increase of additional paid-in capital (i.e., as a deemed dividend). The feature would not be subsequently remeasured.

**Example 1**

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. Such amount would be treated as a reduction in retained earnings, with an offsetting increase to the carrying value of the warrants in additional paid-in capital.

## Liability-Classified Instruments

If the instrument containing a down-round feature is classified as a liability (e.g., certain convertible debt), entities would recognize the transfer of value resulting from the trigger of that feature through a charge to earnings and a corresponding adjustment to the carrying value of the liability-classified instrument.

**Example 2**

Entity B issued a debt instrument on January 1, 2015, that contains an embedded conversion feature. The embedded conversion feature does not meet the conditions for bifurcation as an embedded derivative under ASC 815-15 and does not result in the separation of an equity component under ASC 470-20. The embedded conversion feature allows the debt holder to convert the outstanding debt to shares of B's equity at a price of $5.00 per share, subject to adjustment if B issues shares of common stock below $5.00 per share, at which time the debt holder's conversion price would be adjusted to that lower issue price subject to a floor of $3.50 (the commitment-date stock price). On January 1, 2017, B issues new shares of common stock at a price of $4.00 per share, which triggered an adjustment to the conversion price from $5.00 per share to $4.00 per share. On January 1, 2017, B would determine the fair value of the effect of that down-round adjustment, recording (1) a reduction to earnings and (2) an adjustment to the carrying value of the debt.

The adjustment to the carrying value of a debt instrument results in an increase in the carrying amount of the instrument that entities would amortize by using the effective interest method described in ASC 835. The feature would not be subsequently remeasured. If the instrument is subsequently extinguished, any remaining unamortized amount is recognized as part of the extinguishment gain or loss. If the instrument is converted to equity, the remaining unamortized amount is reclassified to equity.

### Disclosures

Entities would be 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 being triggered
c. The financial statement line item in which that effect is recorded.

### Effective Date and Transition

The FASB will determine an effective date for the final guidance after the end of the proposal's comment period. The cumulative effect of the change would be recognized as an adjustment to the opening balance of retained earnings in the period of adoption.

## Removal of the Indefinite Deferral Under ASC 480

The transition guidance in ASC 480-10 indefinitely defers the application of some of its 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 suggests that they should be classified as liabilities.

**Editor's Note**

ASC 480-10 requires issuers to classify mandatorily redeemable financial instruments as liabilities. Because of the indefinite deferral noted above, these requirements are labeled "pending content" in the Codification, but the transition guidance in ASC 480-10-65 provides no effective date for them.

The proposed ASU would replace 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 this proposal 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

At its February 3, 2016, meeting, the FASB decided to develop a discussion paper for public comment on its future technical agenda. At the same meeting, the Board 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 but to continue working on the issues addressed in the proposed ASU. Individual Board members suggested at the meeting that shortcomings in the existing guidance on liabilities and equity are so pervasive that a targeted-improvement approach would be inadequate to resolve them. They also observed that few practitioners have a good understanding of the numerous rules and exceptions in the current guidance and that improperly distinguishing liabilities from equity therefore continues to be one of the most common reasons for accounting restatements.

On August 4, 2016, the FASB issued an invitation to comment*, Agenda Consultation,* which seeks public input on whether it should recommence a comprehensive project on distinguishing liabilities from equity. If the Board were to decide to launch such a project, we anticipate that it could eventually result in a fundamental overhaul of existing literature (e.g., for freestanding contracts on the issuer's equity shares and debt with embedded equity conversion features).

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