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To the Point

FASB – final guidance

FASB simplifies the accounting for financial instruments with 'down round' features

The guidance affects all entities that issue equity-linked financial instruments (freestanding or embedded) with down round features.

What you need to know

- The FASB issued final guidance that eliminates today's requirement to consider "down round" features when determining whether certain equity-linked financial instruments or embedded features are indexed to an entity's own stock.
- Entities that present EPS under ASC 260 will recognize the effect of a down round feature in a freestanding equity-classified financial instrument only when it is triggered. The effect of triggering such a feature will be recognized as a dividend and a reduction to income available to common shareholders in basic EPS.
- Entities will have to make new disclosures for financial instruments with down round features and other terms that change conversion or exercise prices.
- The guidance is effective for PBEs in annual periods beginning after 15 December 2018, and interim periods therein, and for all other entities in annual periods beginning after 15 December 2019, and interim periods within annual periods beginning after 15 December 2020. Early adoption is permitted.

Overview

The Financial Accounting Standards Board (FASB or Board) issued an Accounting Standards Update (ASU)[1] that simplifies the accounting for certain equity-linked financial instruments and embedded features with down round features that reduce the exercise price when the pricing of a future round of financing is lower.

Building a better working world

Current US GAAP often requires issuing entities to account for these instruments or embedded features at fair value with subsequent changes in fair value recorded through earnings. This creates measurement complexity and a reporting burden. The new guidance will reduce these costs and complexities.

The ASU also replaces today's indefinite deferral of the guidance in Accounting Standards Codification (ASC) 480-10[2] for certain mandatorily redeemable financial instruments of certain nonpublic entities and certain mandatorily redeemable noncontrolling interests with a scope exception. This change does not have an accounting effect.

Background

A down round feature is a provision in an equity-linked financial instrument (e.g., a freestanding warrant) or an embedded feature (e.g., a conversion option in a convertible instrument) that reduces the exercise price if the entity sells stock for a lower price or issues an equity-linked instrument with a lower exercise price. Down round features are most prevalent in warrants and convertible instruments (e.g., convertible debt, convertible preferred stock) and are designed to protect the holder from declines in the issuer's share price.

Down round features typically adjust the exercise price of the existing instrument or embedded feature to the new issuance or exercise price. They also can reduce the exercise price based on a formula or set a floor below which the exercise price cannot fall.

ASC 815-40[3] requires that a freestanding equity-linked financial instrument be indexed to the issuer's own stock to be classified as equity. An equity-linked embedded feature that meets the definition of a derivative may avoid bifurcation and derivative accounting if it is indexed to the issuer's own stock.

Today, a freestanding financial instrument or embedded feature isn't considered indexed to the issuer's own stock if it has a down round provision. Consequently, the freestanding financial instrument is classified as a liability (or asset), and if it meets the definition of a derivative, it must be measured at fair value with changes in fair value recorded through earnings. Similarly, an embedded feature is bifurcated and separately accounted for as a derivative if it meets all other criteria for bifurcation under ASC 815. The bifurcated embedded feature also must be measured at fair value through earnings.

Measuring these instruments and features at fair value is complex and costly. Further, many stakeholders say this accounting does not reflect the true economics of a down round feature because changes in the fair value of the instrument or embedded feature are recognized in earnings for both increases and decreases in the entity's share price, even though an increase in share price does not trigger a down round feature.

Key considerations

Definition and scope

The ASU defines a down round feature broadly as any provision in an equity-linked financial instrument or embedded feature that reduces the exercise price when the issuing entity subsequently sells stock or issues another equity-linked instrument with a lower issuance or exercise price. The ASU explains that "a down round feature may reduce the strike price of a financial instrument to the current issuance price, or the reduction may be limited by a floor or on the basis of a formula that results in a price that is at a discount to the original exercise price but above the new issuance price of the shares, or may reduce the strike price to below the current issuance price." The definition excludes standard antidilution provisions.

The new guidance on liability or equity classification of financial instruments or embedded features affects all entities that issue equity-linked financial instruments with down round features. The new recognition and measurement guidance applies only to freestanding equity-classified financial instruments with down round features issued by entities that present earnings per share (EPS) under ASC 260.[4]

Classification of instruments with down round features

Under the guidance, entities will no longer consider a down round feature when determining whether a freestanding financial instrument (e.g., a warrant) or an embedded feature (e.g., a conversion option) that contains a down round feature is considered indexed to the entity's own stock under ASC 815-40. As discussed, being indexed to an entity's own stock is required for a freestanding financial instrument to be classified in shareholders' equity and may exempt an embedded feature from bifurcation and derivative accounting.

As a result, a freestanding financial instrument that was previously classified as a liability due to a down round feature may now be classified in equity, and an embedded feature that was bifurcated and accounted for as a derivative due to a down round provision may now qualify for a scope exception from that treatment.

A down round feature, by itself, will not preclude an instrument or embedded feature from being considered indexed to the entity's own stock.

How we see it

The guidance significantly changes today's accounting. More financial instruments such as warrants will likely be classified in shareholders' equity, and fewer embedded features such as conversion options will likely have to be bifurcated and accounted for as derivatives. This will reduce the complexity of measuring them at fair value continuously.

Recognition and measurement of down round features

The ASU requires an entity to recognize the value of the effect of a down round feature in an equity-classified freestanding financial instrument when it is triggered (i.e., when the exercise price is adjusted downward). This value is measured as the difference between (1) the financial instrument's fair value (without the down round feature) using the pre-trigger exercise price and (2) the financial instrument's fair value (without the down round feature) using the reduced exercise price. Both fair value measurements must comply with the guidance in ASC 820.[5] The value of the effect of the down round feature will be treated as a dividend and a reduction to income available to common shareholders in the basic EPS calculation.

This recognition and measurement guidance applies only to freestanding equity-classified financial instruments with down round features issued by entities that present EPS in accordance with ASC 260. It doesn't apply to convertible instruments and freestanding financial instruments (e.g., warrants) that are classified as liabilities. Convertible instruments with embedded conversion features that have down round provisions will continue to be assessed for contingent beneficial conversion features under ASC 470-20.[6]

How we see it

Excluding these instruments from the scope of the new recognition and measurement model for down round features supports the Board's overall objective of reducing complexity and cost in this area of accounting.

The value recognized as a dividend is not subsequently remeasured. However, since down round features may be triggered multiple times, the value transferred to the holder is measured and recognized in the same way each time.

Illustration 1 — Warrants with a down round feature

On 1 January 20X7, Entity A issues warrants that permit the holder to buy 100 common shares for $10 per share. The warrants have a five-year term and can be exercised at any time. The terms specify that if Entity A issues common stock with a lower issuance price per share, or convertible securities or warrants with a lower exercise price per share, the exercise price of the holder's warrants will be reduced to the new issuance price or the exercise price of the new convertible securities or warrants (i.e., the warrants contain a down round feature). Entity A reports EPS in accordance with ASC 260 and classifies the warrants in shareholders' equity in accordance with ASC 815-40.

On 1 July 20X7, Entity A issues convertible debt with a conversion price of $8 per share. Because the conversion price is lower than the warrants' exercise price, the down round feature is triggered, and the exercise price is adjusted to $8 per share. Because the warrants are classified in shareholders' equity and contain a down round feature that is triggered, on 1 July 20X7, Entity A compares the fair value of the warrants (without the down round feature) with an exercise price of $10 and the fair value of the warrants (without the down round feature) with an exercise price of $8 and determines that the value transferred to the warrant holders is $40. Entity A makes the following entry:

Dr. Retained earnings	$ 40	
Cr. Additional paid-in capital (warrant)		$ 40

The $40 reduces income available to common shareholders in the basic EPS computation. For diluted EPS, Entity A applies the treasury stock method for the warrants and adds back the $40 dividend to income available to common shareholders. However, it doesn't apply the treasury stock method if the effect is antidilutive.

Disclosures, transition and effective date

The ASU requires new disclosures for instruments in the scope of ASC 505-10[7] and requires entities to disclose terms that change exercise or strike prices of financial instruments, including those related to down round features (but excluding changes due to standard antidilution provisions), as well as the actual changes to exercise or strike prices that occur during the reporting period. Further, when a down round feature is triggered, entities are required to disclose that fact and the value of the effect of the down round feature.

The guidance must be applied using a full or modified retrospective approach. It is effective for public business entities (PBEs) for annual periods beginning after 15 December 2018, and interim periods therein. For all other entities, it is effective for annual periods beginning after 15 December 2019, and interim periods within annual periods beginning after 15 December 2020. Early adoption is permitted for financial statements of fiscal years or interim periods that have not yet been issued or that have not yet been made available for issuance.

Endnotes:

1 ASU 2017-11, *Earnings Per Share (Topic 260); Distinguishing Liabilities from Equity (Topic 480); Derivatives and Hedging (Topic 815): 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 ASC 480-10, *Distinguishing Liabilities from Equity — Overall.*

3 ASC 815-40, *Derivatives and Hedging — Contracts in Entity's Own Equity.*

4 ASC 260, *Earnings Per Share.*

5 ASC 820, *Fair Value Measurement.*

6 ASC 470-20, *Debt — Debt with Conversion and Other Options.*

7 ASC 505-10, *Equity — Overall.*