Financial reporting developments

*A comprehensive guide*

# Issuer's accounting for debt and equity financings

***(after the adoption of ASU 2020-06, Accounting for Convertible Instruments and Contracts in an Entity's Own Equity)***

**September 2024**

# To our clients and other friends

The accounting for the issuance of debt and equity instruments is among the more complex areas of US GAAP. That complexity is caused not only by the sophistication of financial instruments and features, but also the patchwork of accounting guidance that has evolved over time.

This publication is designed to provide you with a road map to help you analyze the accounting for the issuance of debt and equity instruments, including specific transactions. Subsequent accounting considerations are also included. The appendices provide further insight into the accounting literature on specific parts of the analysis.

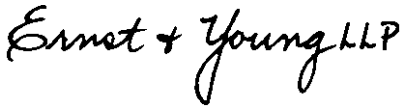
Given the variety of instruments and potential features, an instrument's terms should be fully understood in order to properly apply the accounting guidance. Moreover, accounting for the issuance of debt and equity instruments often requires significant judgment based on the individual facts and circumstances. While this publication includes our views and interpretations on many practice issues, other views may also be acceptable.

This edition of our Financial reporting developments (FRD) publication on an issuer's accounting for debt and equity financings reflects the amendments issued in Accounting Standards Update (ASU) 2020-06[1] by the Financial Accounting Standards Board (FASB or Board). ASU 2020-06 eliminates the beneficial conversion feature and cash conversion models in Accounting Standards Codification (ASC or Codification) 470-20 that require separate accounting for embedded conversion features in convertible instruments.

The guidance also eliminates some of the conditions that must be met for equity classification under ASC 815-40-25. The guidance also requires entities to use the if-converted method to calculate earnings per share (EPS) for all convertible instruments in the diluted EPS calculation and include the effect of potential share settlement (if the effect is more dilutive) for instruments that may be settled in cash or shares, except for liability-classified share-based payment awards.

For public business entities that meet the definition of a Securities and Exchange Commission (SEC) filer, other than smaller reporting companies as defined by the SEC as of 5 August 2020, ASU 2020-06 is currently effective. For all other entities, it is effective for annual periods beginning after 15 December 2023 and interim periods therein. Early adoption is permitted, but an entity must adopt the guidance as of the beginning of a fiscal year.

We hope this publication helps you understand and apply the accounting for the issuance of debt and equity instruments. As always, EY professionals are available to answer any questions you may have.



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[1] ASU 2020-06, *Debt — Debt with Conversion and Other Options (Subtopic 470-20) and Derivatives and Hedging — Contracts in Entity's Own Equity (Subtopic 815-40): Accounting for Convertible Instruments and Contracts in an Entity's Own Equity*.

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Notice to readers:

This publication includes excerpts from and references to the Financial Accounting Standards Board (FASB or Board) Accounting Standards Codification (Codification or ASC). The Codification uses a hierarchy that includes Topics, Subtopics, Sections and Paragraphs. Each Topic includes an Overall Subtopic that generally includes pervasive guidance for the Topic and additional Subtopics, as needed, with incremental or unique guidance. Each Subtopic includes Sections that in turn include numbered Paragraphs. Thus, a Codification reference includes the Topic (XXX), Subtopic (YY), Section (ZZ) and Paragraph (PP).

Throughout this publication references to guidance in the Codification are shown using these reference numbers. References are also made to certain pre-Codification standards (and specific sections or paragraphs of pre-Codification standards) in situations in which the content being discussed is excluded from the Codification.

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# 1 Overview

This publication reflects the amendments issued in ASU 2020-06. The guidance eliminates the beneficial conversion and cash conversion accounting models in ASC 470-20 that required separate accounting for embedded conversion features, which will result in more convertible instruments being reported as single units of account.

The guidance also simplifies the settlement assessment that issuers perform to determine whether a contract in their own equity qualifies for equity classification under ASC 815-40-25. As a result, more freestanding contracts will qualify for equity classification and more embedded features will qualify for the derivative scope exception. ASU 2020-06 also requires entities to use the if-converted method to calculate EPS for all convertible instruments and generally requires them to include the effect of share settlement for instruments that may be settled in cash or shares.

The amendments are currently effective for public business entities that meet the definition of a Securities and Exchange Commission (SEC) filer, other than smaller reporting companies as defined by the SEC as of 5 August 2020. For all other entities, they are effective for annual periods beginning after 15 December 2023 and interim periods therein. Early adoption is permitted, but an entity must adopt the guidance as of the beginning of a fiscal year.

## 1.1 Debt and equity financings

Companies raise capital by issuing debt and equity instruments, which can take many forms. Frequently, companies offer several debt and equity instruments in a single transaction, which may include additional elements, such as warrants or conversion features, to meet investors' demands. Most of those transactions are designed with a focus on tax, EPS and other financing and financial reporting considerations.

The combination of instruments and features increases the complexity of the accounting analysis both at issuance and on an ongoing basis.

## 1.2 Accounting considerations

An issuer's accounting for debt and equity depends on the instruments issued. For an option or forward on the issuer's own shares (generally referred to in this publication as "equity contracts"), the analysis focuses on whether the equity contract should be classified as an asset or liability, which is generally adjusted to fair value through earnings each reporting period, or as equity, which is not subsequently remeasured. In contrast, the analysis for shares or debt requires consideration of whether the instrument contains embedded features (e.g., puts, calls, conversion options) that may require separate accounting. In addition, despite their form, shares may need to be classified as a liability or under SEC rules as temporary (mezzanine) equity. If the securities issued are convertible into common stock, the issuer is required to evaluate whether a portion of the issuance proceeds should be allocated to a separate component in equity.

To evaluate the accounting considerations, issuers may want to consider the following questions:

- Which instruments are being issued?
- Are there any rights or obligations that should be considered a freestanding financial instrument?
- Should the instrument(s) issued be classified as an asset or liability or in equity?
- Should the entire instrument, or part of the instrument, be carried at fair value through earnings?

- Are there embedded features, such as conversion, put or call options, that require separate accounting?
- What are the accounting considerations if the instrument is convertible into the entity's own common stock?
- How does the SEC staff's guidance on redeemable securities affect the instrument's classification?

Notably, only rights and obligations that are contractually binding may require accounting recognition. For example, a forward contract that allows both the issuer and the investor to terminate the arrangement without any penalty or recourse to recover damages would not be a binding contract that requires accounting recognition. Consultation with legal counsel is often necessary to determine whether an arrangement is contractually binding.

This section provides a high-level summary of the key accounting considerations for debt and equity transactions, including general overview of the guidance.

### 1.2.1 Identifying all freestanding financial instruments

When companies issue multiple instruments to the same counterparty in a single transaction (e.g., debt and warrants), it isn't always clear what is a freestanding instrument (e.g., detachable warrant) and what is an embedded feature (e.g., a conversion option). In addition, a freestanding instrument may be evaluated differently than an embedded feature with the same economics (such as a written put option). Moreover, US GAAP may dictate the accounting for the feature, regardless of where it is documented (such as certain registration rights in connection with a convertible instrument issuance).

The first step in evaluating the accounting for debt and equity instruments is to identify all freestanding financial instruments. Freestanding instruments should first be separately analyzed and accounted for, and then evaluated to determine whether embedded features, if any, within those instruments should be bifurcated or accounted for separately.

ASC 480 defines a freestanding financial instrument as a financial instrument that is entered into (1) separately and apart from any of the entity's other financial instruments or equity transactions or (2) in conjunction with some other transaction and is legally detachable and separately exercisable. In contrast, ASC 815 defines embedded derivatives as implicit or explicit terms that affect some or all of the cash flows or the value of other exchanges required by the instrument in a manner similar to a derivative instrument.

The determination of whether an instrument is freestanding or embedded in another instrument involves understanding both the form and substance of the transaction and may involve substantial judgment. For example, a single legal agreement may consist of multiple instruments, such as preferred stock with tranche rights. If a party to a contract is able to separately transfer each instrument within the contract to a third party, that instrument is generally considered legally detachable. However, if an instrument can be separately transferred only with the consent of the counterparty, further analysis should be performed. We generally view an instrument as not legally detachable if the contractual terms require consent of all parties. That is, no party has the unilateral right to separately transfer. However, the legal detachability criteria may be met if the contract specifies that consent cannot be unreasonably withheld.

The specific document in which a term or feature is described is not determinative when evaluating whether that term or feature is considered freestanding or embedded. Moreover, an instrument is not necessarily freestanding just because it is documented in a separate contract. Similarly, rights and obligations documented in a single agreement may be treated as separate freestanding instruments. The accounting should generally follow the contractual terms, not the intent of the parties. In certain cases, legal counsel may need to be engaged to interpret the contractual terms.

Factors to be considered in making this determination include whether:

- The instruments were issued separately or concurrently and in contemplation of each other.
- The rights, obligations or instruments can be separated, including consideration of any transferability provisions or restrictions in the legal documents constituting the transaction.
- The exercise of one instrument results in the termination of the other instrument (e.g., through redemption, simultaneous exercise or expiration).

#### 1.2.1.1 Combining freestanding financial instruments

Issuers may find that, in certain circumstances, the economic substance of multiple freestanding financial instruments may suggest that accounting for them on a combined basis is more appropriate.

ASC 480 prohibits the combination of any freestanding financial instrument within its scope with any other instruments unless required by ASC 815 (in which case they would become a derivative and generally would be accounted for at fair value). The FASB prohibited combining an instrument within the scope of ASC 480 with any other instrument to avoid the inadvertent or planned circumvention of the requirements of ASC 480. For example, combining an instrument that is otherwise a liability within the scope of ASC 480 (e.g., a written put) with another freestanding instrument (e.g., a share) might (1) cause a freestanding instrument to be considered to be embedded in another instrument and therefore not within the scope of ASC 480 (as that guidance applies only to freestanding instruments), (2) change the reported amount of the liability or (3) change the required measurement method.

ASC 815 prohibits separating a single contract meeting the definition of a derivative into separate components to circumvent the derivative guidance. Therefore, ASC 815-10-15-9 states that the following indicators should be considered in the aggregate and, if present, cause separate transactions to be viewed as a unit:

- The transactions were entered into contemporaneously and in contemplation of one another.
- The transactions were executed with the same counterparty (or structured through an intermediary).
- The transactions relate to the same risk.
- There is no apparent economic need or substantive business purpose for structuring the transactions separately that could not also have been accomplished in a single transaction.

**Illustration 1-1: Forward contracts with the same counterparty to purchase and sell shares**

Entity A enters into a forward contract to purchase 1,000,000 shares of Entity B's stock in six months for $5 per share. Simultaneously, Entity A enters into a forward contract to sell 900,000 shares of Entity B's stock in six months for $5 per share. The purchase and sale contracts are both with Entity B. There is no market mechanism to facilitate net settlement of the contracts and both contracts require physical delivery of Entity B's shares in exchange for the forward price. On a gross basis, neither contract is readily convertible to cash because the market cannot rapidly absorb the specified quantities without significantly affecting the share price (e.g., the trading volume for Entity B's shares is currently about 100,000 shares daily). However, on a net basis, Entity A has a forward purchase contract to buy 100,000 of Entity B's shares, a quantity that can be rapidly absorbed by the market and thus is readily convertible to cash.

In this example, if the transactions were entered into with the same counterparty, executed simultaneously, relate to the same risk and there is no clear business purpose for structuring the transactions separately, the two forward contracts should be combined and accounted for as a derivative because the structured transaction circumvents the application of derivative accounting pursuant to ASC 815.

As a result of the FASB's conclusion in ASC 480, the decision to combine two instruments that are issued contemporaneously should be made under the following framework:

- Combine two instruments if required under ASC 815, then evaluate the combined instruments under ASC 480 and ASC 815.
- If both (1) ASC 815 does not require the combination of the two instruments and (2) one of the instruments is within the scope of ASC 480, do not combine the two instruments.
- If both (1) ASC 815 does not require the combination of the two instruments and (2) neither of the instruments is within the scope of ASC 480, evaluate the instruments using the basic concepts around combination.

The basic concepts related to combination were discussed pre-Codification in Emerging Issues Task Force (EITF) 02-2, *When Certain Contracts That Meet the Definition of Financial Instruments Should Be Combined for Accounting Purposes*. That Issue provided considerations in determining whether separate transactions should be combined for accounting purposes and were based on various models for combining instruments, including the guidance in ASC 815-10-25-6. While those concepts were very similar to those in ASC 815-10-25-6, the third criterion was modified somewhat to require not only that the separate transactions or contracts being evaluated share at least one underlying, but also that changes in that underlying (holding the prices of all other underlyings constant) result in at least one substantially offsetting change in fair value for those transactions or contracts.

The EITF did not complete work on the issue, but the SEC staff observer did note that the SEC staff would continue to challenge the accounting for transactions for which it appears that multiple contracts have been used to circumvent US GAAP. As a result, judgment is required given the particular facts and circumstances to determine if freestanding contracts should be combined for accounting purposes.

In practice, having sufficiently different settlement dates may indicate that the instruments relate to different risks and thus provide support for separate accounting for the two instruments.

Determining whether two or more contracts should be combined is a matter of facts and circumstances requiring the use of professional judgment.

### 1.2.2 Distinguishing liabilities from equity (ASC 480)

ASC 480 distinguishes liabilities from equity for certain freestanding financial instruments. The guidance requires liability classification for the following three types of instruments:

- Mandatorily redeemable shares
- Instruments other than an outstanding share that, at inception, embody, or are indexed to, an obligation to buy back the issuer's equity shares that could require the transfer of assets
- Instruments that embody a conditional obligation, or shares that embody an unconditional obligation, to issue a variable number of the issuer's equity shares and at inception, the monetary value of the obligation is based solely or predominantly on:
  - A fixed value known at inception (e.g., an obligation to deliver shares with a fair value at settlement equal to $1,000)
  - Variations in something other than the fair value of the issuer's equity shares (e.g., an obligation to deliver shares with a fair value at settlement equal to the value of one ounce of gold)
  - Variations that move in the opposite direction to changes in fair value of the issuer's shares (e.g., net share settled written put options)

#### 1.2.2.1 Debt

Debt is classified as a liability because of its legal form. However, certain debt instruments may fall within one of the categories in ASC 480. For example, share-settled debt that requires the issuer to settle the instrument by delivering a variable number of shares with a then-current fair value equal to the principal amount of the debt would also be a liability pursuant to ASC 480. Debt instruments are usually carried at amortized cost, unless an election is made pursuant to one of the fair value options provided in ASC 815 and ASC 825.

#### 1.2.2.2 Stock

Companies may issue preferred stock that is mandatorily redeemable for cash or other assets. ASC 480 requires mandatorily redeemable financial instruments to be classified as liabilities. Shares are mandatorily redeemable pursuant to ASC 480 if it is certain that the issuer will redeem those shares by transferring cash or other assets. That certainty would exist if the issuer is required to redeem the shares on a contractual maturity date or upon an event that is certain to occur (e.g., upon the death of the investor). Shares that are optionally redeemable or convertible into another class of shares before a mandatory redemption date are not considered mandatorily redeemable pursuant to ASC 480 because the redemption is not certain.

Shares that require settlement in a variable number of another class of shares upon a mandatory settlement date, with a monetary value of the settlement obligation equal to a fixed or predominantly fixed amount, may also require liability classification pursuant to ASC 480. An example of such instrument is share-settled preferred stock.

#### 1.2.2.3 Equity contracts

Forwards, options or warrants should be carefully evaluated pursuant to ASC 480. Certain contracts that may require the issuer to transfer assets (e.g., cash) in exchange for its own shares are liabilities (or sometimes assets) pursuant to ASC 480. One example is a physically settled written put option that may require the issuer to pay cash in exchange for its shares upon the holder's exercise. A less obvious example is a warrant on conditionally redeemable preferred shares. Upon the exercise of the warrant, the holder is entitled to preferred shares that may require the issuer to transfer assets upon redemption.

Equity contracts can also fall within ASC 480 if they require, or may require, the issuer to transfer a variable number of shares and the monetary value of the shares does not expose the holder to risks and rewards similar to those of an owner. For example, the value of a net share settled written put option to the holder increases as the share price declines, which is inversely related to the issuer's equity shares, and therefore, requires liability classification.

An equity contract that is accounted for pursuant to ASC 480 should still be evaluated pursuant to ASC 815 to determine whether it also meets the definition of a derivative, in which case the related derivatives disclosures should also be made.

Refer to Appendix A for a comprehensive discussion of ASC 480.

### 1.2.3 Derivatives and embedded derivatives (ASC 815)

Freestanding financial instruments that are not within the scope of ASC 480 should be evaluated pursuant to ASC 815. Those instruments may either be derivatives themselves or may contain embedded features that would be derivatives if freestanding. Those instruments or embedded features that are bifurcated and accounted for separately should be accounted for as derivatives and measured at fair value continuously.

To be a derivative pursuant to ASC 815, an instrument must be a financial instrument or other contract (or embedded feature) with all of the following characteristics:

- One or more underlyings. An underlying is a variable whose changes are observable or otherwise objectively verifiable and whose movements cause the cash flows or fair value of the financial instrument or other contract to fluctuate. Examples of an underlying include a share price, an interest rate, a commodity price and the occurrence or nonoccurrence of an event.
- One or more notional amounts or payment provisions or both. While the underlying is the variable, the notional amount is a quantity that determines the size of the change caused by the movement of the underlying. Notional amounts are, for example, the number of underlying shares or the number of barrels of crude oil. A payment provision is an alternative to a notional amount in which the contract specifies a fixed or determinable settlement amount to be made if the underlying behaves in a specified manner. The underlying and the notional amount determine the amount of settlement, and in some cases, whether or not a settlement is required.
- No initial net investment or an initial net investment that is smaller than would be required for other types of contracts expected to have a similar response to changes in market factors. Derivatives do not require the parties to the contract to initially invest in, own or exchange the underlying asset or liability. In fact, there is usually no exchange of cash (or a relatively small amount) at the date that two parties enter into a derivative contract. The initial net investment in a hybrid instrument should not be considered the initial net investment in an embedded derivative.
- Net settlement provisions through (1) implicit or explicit terms, (2) a market mechanism outside the contract or (3) delivery of an asset that, because the delivered asset is readily convertible to cash, puts the recipient in a position not substantially different from net settlement (a gross settlement that is economically equivalent to a net settlement). Net settlement is a one-way transfer of an asset, usually cash or shares, from the counterparty in a loss position to the counterparty in a gain position that settles the obligation. For example, a warrant that permits a cashless exercise is considered a contractual net settlement, regardless of whether the underlying stock is readily convertible to cash. In contrast, a gross settlement involves an exchange, whereby Party A transfers cash to Party B, and Party B transfers an asset to Party A. To be a derivative, the contract must either explicitly permit net settlement or place the receiving party in a position that is essentially equivalent to net settlement.

  The nature of a share underlying a contract or feature can affect the assessment of net settlement. For example, publicly traded shares of a company are generally considered readily convertible to cash unless the market for the shares is not active and the number of shares to be exchanged (given the smallest increment available for conversion) is large relative to the daily trading volume of the underlying shares. However, if the underlying is a share in a private company, the contract or feature may not meet the net settlement criterion.

#### 1.2.3.1 Debt and stock

Debt and stock generally do not meet the definition of a derivative because they typically require a payment in cash (or other assets) equal to the fair value of the debt or stock at inception. However, debt and stock may be hybrid instruments that contain embedded features (e.g., conversion option, puts or calls) that require bifurcation (refer to section 1.2.3.3 below).

#### 1.2.3.2 Equity contracts

Options or forwards issued by private companies may not meet the net settlement criterion when those equity contracts require physical settlement because the underlying shares usually are not freely transferrable and thus not deemed readily convertible to cash. In contrast, a warrant that requires physical settlement in shares of a public company that allows the recipient of those shares to easily sell them in the market without affecting the price would put the holder in a position not substantially different from a holder of a warrant net settled in cash.

An equity contract that is accounted for pursuant to ASC 480 should still be evaluated pursuant to ASC 815 to determine whether it also meets the definition of a derivative, in which case the related derivatives disclosures should also be made.

#### 1.2.3.3 Embedded derivatives and bifurcation

While a financial instrument may not meet the definition of a derivative in its entirety, it may contain contractual terms that function similar to a derivative. Debt and stock often contain embedded features that require additional analysis. Debt and stock containing embedded features are referred to as hybrid instruments, which should be analyzed to determine whether any of the embedded features should be bifurcated (i.e., accounted for separately). The most common embedded derivatives in debt and stock instruments are conversion options, puts, calls and other interest rate features.

ASC 815-15-25-1 requires an embedded derivative to be bifurcated if all three of the following conditions are met:

- The economic characteristics and risks of the embedded derivative are not clearly and closely related to the economic characteristics and risks of the host contract.
- The hybrid instrument is not remeasured at fair value under otherwise applicable US GAAP with changes in fair value reported in earnings as they occur.
- A separate instrument with the same terms as the embedded derivative would be considered a derivative instrument subject to derivative accounting (the initial net investment for the hybrid instrument should not be considered to be the initial net investment for the embedded derivative).

After identifying, evaluating and concluding on which features (e.g., conversion option, puts, calls, other embedded features) require bifurcation, a single derivative comprising all the features requiring bifurcation should be separated from the host instrument. ASC 815 requires that the derivative be initially measured and recorded at fair value and the residual value assigned to the host contract.

Embedded derivatives may be broadly categorized as one of the following:

- Option-based embedded derivatives — A feature where one party (the holder of the option) has a gain and the other party (the writer of the option) has a loss at exercise. This is referred to as an asymmetrical payout profile. The writer of the option receives a premium for assuming the risk of loss and the holder of the option pays a premium for having the option, often in the form of an adjustment to the interest rate or other terms of the instrument. Examples of option-based embedded derivatives are conversion options, redemption features (puts and calls) and interest rate caps and floors. Some options require explicit exercise by the holder (such as conversion options and redemption features) and others require automatic exercise (such as interest rate caps and floors).
- Forward-based embedded derivatives — A feature where either party can have a gain, with the other party having a loss depending on whether the underlying (market prices or rates) is above or below the price or rate stipulated in the contract. This is referred to as a symmetrical payout profile. If the fair value of the underlying equals the stipulated price or rate at settlement, neither party has a gain or loss. A forward-based embedded derivative requires performance on both sides, as opposed to one party having the right to force performance. An example of a forward-based embedded derivative would be a mandatory conversion feature, where the debt must settle in a fixed number of shares at maturity. Embedded forward-based features are generally less frequent than option-based features.

The initial measurement of a bifurcated derivative depends on whether the embedded derivative is option-based or forward-based. Generally, an option-based embedded derivative is bifurcated based on the stated terms documented in the hybrid instrument, while a forward-based embedded derivative is separated from the host contract based on terms that result in the fair value of that forward-based embedded derivative generally being equal to zero at the inception of the hybrid instrument.[2]

Refer to sections 2.4 and 3.3 of our FRD publication, ***Derivatives and hedging***, for further guidance on the definition of a derivative and bifurcation of embedded derivatives.

### 1.2.4 Contracts (or features) in an entity's own equity (ASC 815-40)

If an instrument (or embedded feature) is indexed to, and potentially settled in, the issuer's own stock, ASC 815-40, *Derivatives and Hedging — Contracts in Entity's Own Equity*, should be applied to determine whether:

- The freestanding instrument (or embedded feature) that meets the definition of a derivative qualifies for the exception from derivative accounting pursuant to ASC 815-10-15-74(a).
- The freestanding instrument that does not meet the definition of a derivative (e.g., some private company contracts) should be classified in equity.

Examples include freestanding equity contracts, such as warrants and forward contracts, as well as embedded conversion options in debt or preferred shares and embedded puts or calls in preferred or common shares.

ASC 815-40 states that contracts should be classified as equity instruments (and not as an asset or liability) if they are both:

- Indexed to its own stock (ASC 815-40-15)
- Classified in stockholders' equity in its statement of financial position (ASC 815-40-25)

ASC 815-40-15 outlines a two-step evaluation to determine whether an instrument (or embedded feature) is indexed to the issuer's own stock. The first step is to evaluate any contingent exercise provisions. If an exercise contingency is an observable market or index unrelated to the issuer, the instrument would not be considered indexed to the issuer's own stock.

The second step requires an analysis of provisions that could change the instrument's settlement amount. In general, the instrument (or feature) must settle in an amount based on an exchange of a fixed amount of cash (or principal amount of debt) for a fixed number of shares. Frequently, equity contracts or equity-linked features contain provisions that require adjustment to the terms upon certain events (e.g., tender offer, delisting, merger, acquisition). Those provisions should be carefully analyzed under the second step, as there are a number of exceptions to the general concept.

Freestanding equity contracts that are not indexed to an entity's own stock under ASC 815-40-15 are required to be classified as assets or liabilities and measured at fair value, with subsequent changes in fair value recognized in earnings, regardless of whether they meet the definition of a derivative.

ASC 815-40-25 provides guidance to determine whether an instrument that is indexed to the issuer's own stock should be classified in equity. That determination depends heavily on how the instrument settles and whether an acceptable form of settlement is entirely within the control of the issuing entity. The basic principle underlying the equity classification guidance is that instruments that require net cash

[2] Examples throughout this publication assume that an option-based embedded derivative is bifurcated at a fair value other than zero. Alternative methods for bifurcating option-based features may exist based on the specific facts and circumstances.

settlement (or the issuer can be forced or presumed to net cash settle) are assets or liabilities and those that require settlement in shares (or the issuer can choose a form of settlement that involves either party transferring shares) are equity instruments.

ASC 815-40-25 includes other detailed conditions that must be met for equity classification. Those conditions focus on whether the issuer will have the ability, in all cases, to effect the settlement in shares. Otherwise, net cash settlement is presumed and equity classification is not permitted.

Freestanding equity-classified instruments are initially measured at fair value (or allocated value). Subsequent changes in fair value are not recognized as long as the contract continues to be classified in equity. In contrast, if a freestanding instrument that was indexed to the issuer's own stock fails the requirements for equity classification, it should be classified as an asset or liability and is initially measured at fair value. The equity classification guidance specifies that subsequent changes in fair value are recorded in earnings.

Embedded derivatives that meet the requirements of ASC 815-40 (i.e., are indexed to the entity's own stock and classified in stockholders' equity) should not be bifurcated.

Refer to Appendix B for a comprehensive discussion of the equity classification guidance.

### 1.2.5 Accounting for convertible instruments (ASC 470-20)

Convertible instruments (primarily convertible debt and convertible preferred stock) are generally accounted for as single units of account, unless conversion features are derivatives that must be bifurcated from the host contracts in accordance with ASC 815-15 or, in the case of convertible debt, if the instruments are issued with a substantial premium. In the latter case, ASC 470-20-25-13 requires the substantial premium to be attributable to the conversion feature **and** recorded in additional paid-in capital (APIC). Refer to section 2.2.9 for further discussion of the substantial premium model.

### 1.2.6 Classification and measurement of redeemable securities (ASC 480-10-S99-3A)

Public entities should consider the SEC staff's guidance (included in ASC 480-10-S99, *SEC Materials*) when evaluating the accounting for redeemable shares classified as equity. That guidance addresses the balance sheet presentation (temporary or "mezzanine" equity versus permanent equity) and measurement of equity classified shares that are redeemable for cash or other assets in any of the following ways:

- At a fixed or determinable price on a fixed or determinable date
- At the option of the holder
- Upon the occurrence of an event that is not solely within the control of the issuer

ASC 480-10-S99-3A, *SEC Staff Announcement: Classification and Measurement of Redeemable Securities*, requires classification outside of permanent equity for redeemable instruments for which the redemption triggers are outside of the issuer's control. Therefore, it is important that redemption features within those instruments are carefully analyzed to assess the effect on the instrument's classification. The assessment of whether the redemption of an equity security could occur outside of the issuer's control should be made without regard to the probability of the event or events that may result in the instrument becoming redeemable.

ASC 480-10-S99-3A provides guidance that may require subsequent remeasurement of equity instruments classified outside of permanent equity. The measurement requirements vary depending on whether the instrument is (1) currently redeemable or (2) probable of becoming redeemable in the future. The subsequent remeasurement, if required, may affect the issuer's EPS.

This guidance also applies to the equity component of convertible debt or shares of a subsidiary (noncontrolling interests (NCI)). ASC 480-10-S99-3A provides specific classification and measurement guidance on those instruments.

Freestanding equity contracts that are classified in equity pursuant to ASC 815-40 are not subject to the SEC staff's guidance on redeemable securities because, if the instruments were redeemable on a specified date or upon the occurrence of an event that is not in the issuer's control, they would not meet the conditions in ASC 815-40 to be classified in equity.

Refer to Appendix C for a comprehensive discussion of the SEC staff's guidance on redeemable equity securities.

### 1.2.7 Allocation of proceeds

When multiple instruments are issued in a single transaction, the total proceeds from the transaction should be allocated among the individual freestanding instruments identified. The allocation occurs after identifying (1) all the freestanding instruments and (2) the subsequent measurement basis for those instruments. The subsequent measurement basis helps inform how the proceeds should be allocated. After the proceeds are allocated to the freestanding instruments, those instruments should be further evaluated for embedded features that may need to be bifurcated or separated.

Generally, proceeds may be allocated based on one of the following methods:

- Fair value method — The instrument being analyzed is allocated a portion of the proceeds equal to its fair value, with the remaining proceeds allocated to the other instruments as appropriate.
- Relative fair value method — The instrument being analyzed is allocated a portion of the proceeds based on the proportion of its fair value to the sum of the fair values of all the instruments covered in the allocation.
- Residual value method — The instrument being analyzed is allocated the remaining proceeds after an allocation is made to all other instruments covered in the allocation.

If debt or stock is issued with detachable warrants, the guidance in ASC 470-20-25-2 (applied by analogy to stock) requires that the proceeds be allocated to the two instruments based on their relative fair values. This method is generally appropriate if debt or stock is issued with any other freestanding instrument that is classified in equity (such as a detachable forward contract) or as a liability but not subject to subsequent fair value accounting (such as a detachable forward contract to purchase shares — accounted for under an accretion model in ASC 480).

We understand that the FASB staff and the SEC staff believe that a freestanding instrument issued in a basket transaction should be initially measured at fair value if it is required to be subsequently measured at fair value pursuant to US GAAP, with the residual proceeds from the transaction allocated to any remaining instruments based on their relative fair values.

The following is a general outline of the application of the allocation methods to certain combinations of instruments:

| Instruments issued and subsequent measurement model | Allocation methodology |
|---|---|
| Instrument A – not at fair value<br>Instrument B – not at fair value | Relative fair value basis of both instruments |
| Instrument A – at fair value<br>Instrument B – not at fair value | Fair value to Instrument A and residual value to Instrument B |
| Instrument A – not at fair value<br>Instrument B – not at fair value<br>Instrument C – not at fair value | Relative fair value basis of all instruments |
| Instrument A – at fair value<br>Instrument B – not at fair value<br>Instrument C – not at fair value | Fair value to Instrument A with residual allocated to Instruments B and C on relative fair value basis |
| Instrument A – at fair value<br>Instrument B – at fair value<br>Instrument C – not at fair value | Fair value to both Instruments A and B with residual allocated to Instrument C |

The amount of proceeds allocated to an instrument may affect the initial accounting for the instrument. For example, a redemption feature (put or call) in debt is an embedded derivative that may require bifurcation based in part on the existence of any premiums or discounts on the debt host. Therefore, the allocation of proceeds is usually performed prior to completing the accounting analysis for each instrument.

If the sum of the fair values of the individual instruments being issued and the issuance proceeds are significantly different, there may be little or no proceeds allocated to the instrument(s) that are not subsequently measured at fair value. In that case, the issuer should challenge (1) the valuation of the individual financial instruments and (2) whether there are additional rights or obligations requiring separate accounting.

#### 1.2.7.1 SEC staff's view on allocation of proceeds when the fair value of a liability exceeds net proceeds received

At the 2014 AICPA National Conference on Current SEC and PCAOB Developments,[3] the SEC staff discussed the allocation of proceeds received for the issuance of a hybrid instrument (e.g., convertible debt), when the fair value of financial liabilities required to be measured at fair value (e.g., an embedded derivative) is greater than the net proceeds the issuer received. The SEC staff noted that;

> "… [W]hen reporting entities analyze these types of unique fact patterns, they should first, and most importantly, verify that the fair values of the financial liabilities required to be measured at fair value are appropriate under Topic 820. If appropriate, then the reporting entity should evaluate whether the transaction was conducted on an arm's length basis, including an assessment as to whether the parties involved are related parties under Topic 850. Lastly, if at arm's length between unrelated parties, a reporting entity should evaluate all elements of the transaction to determine if there are any other rights or privileges received that meet the definition of an asset under other applicable guidance.

[3] Hillary H. Salo, 2014 – Refer to the SEC website at **http://www.sec.gov/News/Speech/Detail/Speech/1370543610129**.

> In the fact patterns analyzed by the staff, we concluded that if no other rights or privileges that require separate accounting recognition as an asset could be identified, the financial liabilities that are required to be measured at fair value (for example, embedded derivatives) should be recorded at fair value with the excess of the fair value over the net proceeds received recognized as a loss in earnings. Furthermore, given the unique nature of these transactions, we would expect reporting entities to provide clear and robust disclosure of the nature of the transaction, including reasons why the entity entered into the transaction and the benefits received.
>
> Additionally, some people may wonder whether the staff would reach a similar conclusion if a transaction was not at arm's length or was entered into with a related party. We believe those fact patterns require significant judgment; therefore, we would encourage consultation with OCA in those circumstances."

Although the SEC staff did not address transactions with related parties, we generally believe the accounting for the excess of the fair value of a financial liability over proceeds received will depend on the individual facts and circumstances. In some cases, it may be appropriate to record the excess in retained earnings (e.g., dividends to a particular class of equity holders).

## 1.3 Navigating the transaction documents

A thorough understanding of the transaction and the terms of each instrument is required to determine the appropriate accounting for debt and equity transactions.

The primary legal agreements that specify the terms of debt and equity arrangements may include: a promissory note or indenture (for debt), the articles of incorporation or a certificate of designation (for stock) and an International Swaps and Derivatives Association (ISDA) contract (for equity contracts). There may also be ancillary agreements to the transaction, such as securities purchase agreements, shareholders' agreements, investors' rights agreements, share lending agreements and registration rights agreements. Those agreements specify other contractual terms related to the transaction that may affect the accounting evaluation (e.g., terms that would be considered freestanding financial instruments or embedded in the primary instruments issued).

A transaction may also include a registration statement, prospectus and prospectus supplement (generally public transactions) or an offering memorandum (generally private transactions). Those documents may contain summary information about the instruments being issued and their contractual terms. While those documents may be helpful to understanding the transaction, they do not establish the legal rights and obligations related to the instruments being issued.

The review of the executed agreements should focus on the terms that establish the rights and obligations of the parties to the arrangements, especially those terms related to cash flows or other consideration exchanges, including terms that:

- Establish amounts to be paid or received
- Identify events that trigger additional payments or receipts
- Identify events that cause the timing of a cash flow or consideration exchange to change
- Relate to any value flows, such as conversion options, including the conversion ratio, events that trigger or delay a conversion, and the events that cause a conversion ratio to be adjusted
- Require or may require an action from either the issuer (e.g., registration of securities, maintenance of registration statements, right or obligation to issue more securities in the future) or the investor (e.g., right or obligation to purchase more securities in the future)

### 1.3.1 International Swaps and Derivatives Association contracts

Equity contracts can be documented in different forms. However, many transactions are documented in ISDA contracts.

ISDA, a trade organization of participants in the market for over-the-counter financial instruments, has created standard ISDA documentation for financial instruments. The documentation for a single ISDA equity contract usually consists of:

- Master Agreement — Describes the overall relationship between the issuer and the counterparty and contains terms applicable to any future transactions. A single Master Agreement may support several individual transactions, each documented by a specific ISDA confirmation.
- Equity Derivatives Definitions — Provide a common set of contract terms and terminology to standardize the documentation process. The definitions are periodically updated (e.g., the 2011 definitions) and past versions (e.g., the 2002 definitions) may still be referenced in a current transaction.
- Confirmation — Specifies the terms of an individual transaction, including which elections from within the Master Agreement or Equity Derivatives Definitions are being selected or modified. The terms of the instrument are provided in the ISDA Confirmation, which makes references to the Master Agreement and Equity Derivative Definitions.

When using ISDA contracts, all three together form the contractual terms and should be analyzed under the relevant accounting guidance.

The terms of the ISDA documentation should be carefully considered in light of the indexation and equity classification guidance discussed in section 1.2.4. Any adjustment and settlement provisions and early termination provisions should be carefully reviewed because they may have a significant effect on the classification of the instrument. At the beginning of the analysis, the ISDA confirmation should be reviewed to determine which adjustment and settlement methods described in the Master Agreement and Equity Derivatives Definitions have been elected for the particular equity contract. Those methods should be traced through all of the documents and definitions to identify the triggers for termination or adjustment and how it is settled.

## 1.4 How to use this publication

This publication is intended to serve as a reference tool to assist issuers in accounting for debt and equity transactions at issuance. Selected subsequent accounting considerations are also included. This publication has been divided into sections based on the basic instrument types as follows:

- Section 2 — Debt
- Section 3 — Common shares, preferred shares and other equity-related topics
- Section 4 — Equity contracts
- Section 5 — Selected transactions

Sections 2 through 4 provide guidance for determining an issuer's accounting for the type of instruments covered in the section. Common structures and features are included throughout the sections. Flowcharts are also provided to help in navigating the accounting framework.

Section 5 includes a discussion of some common but more complex debt and equity transactions observed in the market. Examples include unit structures, remarketable put bonds, accelerated share repurchases, equity contracts on noncontrolling interests, warrants for redeemable shares and convertible debt with call spread.

The appendices supplement the sections and provide a detailed discussion of the key accounting considerations discussed in the flowcharts. The guidance in the appendices generally addresses various instrument types.

# 2 Debt

## 2.1 Overview and general descriptions of types of debt

Debt is an amount owed for funds borrowed. While debt can have many different features, the debtor typically agrees to repay the lender the amount borrowed (the principal) plus interest (a return on the borrowed funds). Principal may be paid back over time or at maturity. Interest is generally paid at fixed intervals over a specified period of time, but it may accrue over time on the unpaid principal balance, resulting in a single payment of principal and interest in the future at maturity. A contractual agreement, generally a note (if borrowed from a bank or other intermediary) or an indenture (if borrowed under a security or bond offering to multiple investors), establishes the terms of the obligation.

### 2.1.1 Debt terminology

The following terms are generally used when discussing debt:

- Principal (par amount or face amount) — The amount to be repaid at the maturity date or over time. (Frequently, the principal amount equals the initial gross proceeds before considering debt issuance costs.)
- Coupon — The periodic interest payments the issuer must make to the debt holder. (The payments can be monthly, quarterly, semiannually, annually or any other negotiated frequency.)
- Coupon rate or stated interest rate — The predetermined interest rate used to calculate the coupon payments on the debt. (These rates are often expressed as a fixed percentage of the principal amount or are variable based on a market index (Secured Overnight Financing Rate (SOFR) or a US Treasury rate) plus a fixed spread that is generally based on the creditworthiness of the issuer (and any related collateral) at issuance. In some cases, the spread over the referenced rate may adjust over time.)
- Maturity — A defined date on which the issuer must repay the debt's principal amount
- Issue price — The price at which investors buy the debt when it is first issued
- Premium and discount — Part of the issue price that is in excess of (premium) or less than (discount) the par amount
- Accreted or carrying amount — The issue price increased or decreased by the unamortized premium or discount and unamortized issuance costs

Debt that is not convertible is sometimes referred to as "straight debt" or "term debt." Debt may be convertible into another instrument (typically shares) during its life.

### 2.1.2 Common types of debt instruments

#### 2.1.2.1 Convertible debt

Convertible debt provides the investor with the ability to convert the debt into equity securities (common or preferred) of the issuer (or sometimes a subsidiary of the issuer or the issuer's parent), usually at some predetermined ratio. The debt includes a conversion option (or forward in the case of mandatorily convertible debt), which is an embedded written call option (or forward sale) on the underlying shares by the issuer to the investor. Convertible debt is considered to be a hybrid instrument because it contains an embedded feature (i.e., a conversion feature).

While most convertible debt instruments provide the investor an option to convert, certain convertible debt requires the holder to convert the instrument into the underlying equity security either on or before a specified date or upon the occurrence of certain events (e.g., completion of the issuer's initial public offering (IPO) or receipt of stockholders' approval of the conversion). Those securities generally provide investors with higher yields than optionally convertible instruments to compensate the holders for the fact that conversion may be required when the shares to be received are worth less than the principal amount of the notes.

Similar to typical nonconvertible debt, convertible debt generally includes a principal amount, coupon and maturity date. Convertible instruments contain the following elements related to the embedded conversion option:

- Conversion price — The price at which a convertible debt instrument can be converted into the underlying equity security
- Conversion rate (or conversion ratio) — The number of underlying equity securities to be received by investors at the time of conversion for each fixed dollar value of convertible debt (principal value of each note/conversion price)
- Parity value (or conversion value) — The as-converted value of each note (current underlying equity security trading price multiplied by the number of shares into which the debt is convertible)
- Conversion spread — The amount by which the parity value of the convertible debt exceeds the accreted value (sometimes referred to as conversion premium)

Conversion terms vary by instrument, but they historically have taken several forms (including Instruments A, B and C that were described previously in EITF 03-7, *Accounting for the Settlement of the Equity-Settled Portion of a Convertible Debt Instrument That Permits or Requires the Conversion Spread to Be Settled in Stock (Instrument C of Issue No. 90-19)*, before being superseded):

- Classic convertible debt — Upon conversion, the issuer must satisfy the obligation entirely in shares based on the fixed number of shares into which the debt is convertible.
- Instrument A — Upon conversion, the issuer must satisfy the obligation entirely in cash based on the conversion value.
- Instrument B — Upon conversion, the issuer may choose to satisfy the entire obligation in either stock or cash in an amount equal to the conversion value.
- Instrument C — Upon conversion, the issuer must satisfy the accreted value of the obligation (the amount accrued to the benefit of the holder exclusive of the conversion spread) in cash and may choose to satisfy the conversion spread (the excess conversion value over the accreted value) in either cash or stock.
- Instrument X — As identified by market convention, provides that upon conversion, the issuer may settle the conversion value of the debt in shares, cash or any combination of shares and cash.

The types and terms of convertible debt can vary significantly. The most common variations are discussed in section 2.2.4.

#### 2.1.2.2 Zero-coupon bond

A zero-coupon bond is a debt instrument that is issued at a discount to its par amount at inception and pays no interest during the life of the instrument. When held to maturity, the bond is redeemed at its par amount, with the return to those investors being the difference between the amount paid for the bond at issuance and the amount received at maturity. As there are no periodic coupon payments, the investor is not subject to the reinvestment risk (risk of reinvesting cash receipts at a lower market interest rate) that investors in coupon-paying instruments assume. Refer to section 2.4.3.1.1 for a discussion of the effective interest method.

#### 2.1.2.3 Term-extending debt

Debt instruments may have a stated maturity that may be extended either at the election of the issuer or the investor or upon the occurrence of specific events or conditions. The instrument may specify a stated interest rate for the extended period that was set at inception or require a reset of the interest rate to either a then-market rate or to a formulaic rate. Refer to section 2.2.6.3 for more information on these types of debt instruments.

#### 2.1.2.4 Share-settled debt

Share-settled debt is settled using equity shares of the issuer in lieu of cash. That is, the debt is settled for a variable number of shares with a fair value equal to the principal amount of the debt at the time of settlement. For example, when an issuer's common shares are trading at $20 per share, it would share-settle debt with a principal amount of $1,000 by issuing 50 shares. In some cases, the parties may negotiate terms that result in a discount to the fair value of the share used to determine the number of shares to be delivered. Refer to sections 2.2.4.6 and 5.23 for more information on this type of instrument.

#### 2.1.2.5 Indexed debt

A debt instrument's contractual terms may require that interest and/or principal payments be adjusted based on the price of a commodity, such as gold or an index other than an interest index (e.g., the Standard & Poor's (S&P) 500). These adjustments may cause the contractual payments (i.e., principal and/or interest) to increase or decrease. Refer to section 2.2.6.4 for additional information on these types of debt instruments.

#### 2.1.2.6 Exchangeable debt

Exchangeable debt permits the investor to exchange the debt for the shares of a company unrelated to the issuer. Some indentures, often called "mandatorily exchangeable," require that, at maturity, debt holders accept a determinable number of common shares in an unrelated entity. In many cases, the number of shares is determined by the share price at the exchange date in relation to a price range specified at inception. If the price is at or below the range, the number of shares is fixed. If the price is within the range, the number of shares may vary and the investor receives shares with a fair value equal to the face amount of the debt. If the price is above the range, the investor receives a fixed number of shares, and therefore participates in a portion of the upside of the underlying equity securities.

Those instruments are often used to monetize an underlying investment held by the issuer. Mandatorily exchangeable debt typically has a shorter life than other long-term debt. Refer to section 5.1 for further discussion of exchangeable debt.

#### 2.1.2.7 Inflation-indexed debt

Inflation-indexed debt provides protection to the holder against the risk of inflation through periodic adjustments of the principal amount to reflect changes in a measure of inflation, such as the Consumer Price Index. The coupon payments are determined by applying the fixed coupon rate to the inflation-adjusted principal amount. For example, if the annual coupon rate were 10% and the underlying principal of the debt were $10,000, the annual interest payment would be $1,000. If the inflation index increased by 10%, the principal amount would increase to $11,000. The coupon rate would remain at 10%, resulting in an interest payment of $1,100 ($11,000 x 10%). Refer to section 2.2.6.4 for additional information on these types of debt instruments.

#### 2.1.2.8 Perpetual debt

Perpetual debt, which is often deeply subordinated, has no stated maturity and pays regular interest payments indefinitely. In many ways, perpetual debt is similar to preferred stock in that the coupon payments are similar to dividend payments and the principal is typically payable only upon liquidation of the issuer. Perpetual debt is classified as a liability because it is legally an obligation of the issuer and the holder generally has creditor's rights. Although perpetual debt does not have a maturity date, it may be redeemable (callable) by the issuer after a stated period. Refer to section 2.4.3.1.2 for more information for these types of instruments.

#### 2.1.2.9 Increasing-rate debt

Increasing-rate debt is a type of debt instrument whose maturity date can be extended at the option of the borrower at each maturity date until a final maturity date. The interest rate increases at a specified rate each time the debt is renewed. Refer to section 2.2.6.6 for guidance on accounting for these types of debt instruments.

#### 2.1.2.10 Tax increment financing entity (TIFE) (added August 2023)

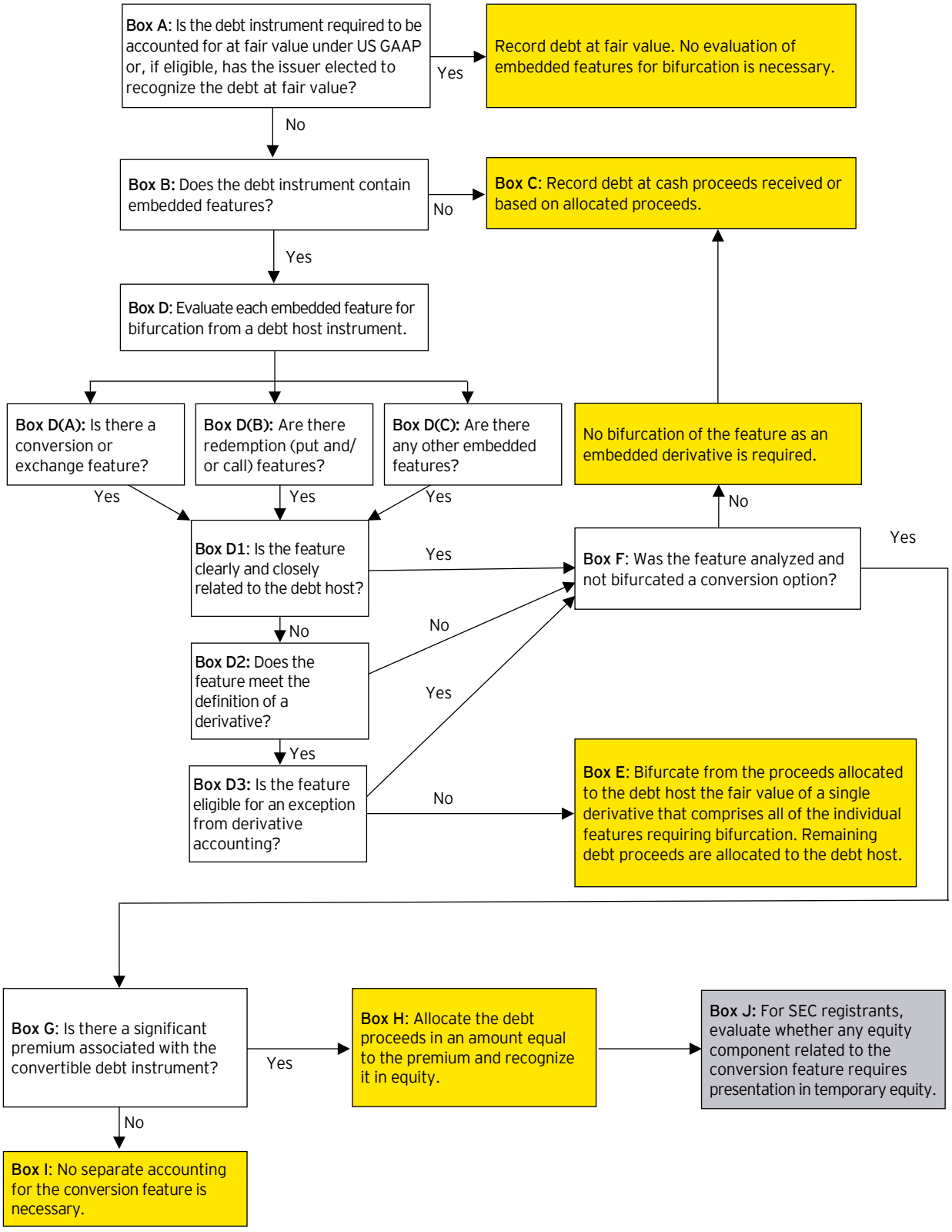
A municipality may levy a special assessment to finance the development of infrastructure assets or improvements (e.g., roads, waterlines, utilities). Alternatively, a real estate developer may form a TIFE to issue bonds to finance the construction of infrastructure (e.g., road, water) on real estate it owns or leases. When a TIFE issues bonds, the debt is repaid through future user fees or taxes assessed on the property.

ASC 970-470, *Real Estate — General — Debt*, addresses whether companies should recognize a liability for TIFE debt. Refer to section 2.2.1 of our FRD publication, ***Real estate project costs***, for additional discussion.

## 2.2 Issuer's initial accounting for debt instruments (including flowchart)

This section describes the steps generally necessary to determine the accounting for debt (including convertible debt) at issuance. In particular, this section provides considerations related to embedded conversion options, redemption features and other common embedded features.

The following flowchart summarizes the analysis at a conceptual level and should be used in conjunction with the interpretive guidance that begins after the flowchart.



### 2.2.1 Box A — Debt instruments accounted for at fair value

ASC 815-15-25-1(b) states that a hybrid instrument that is measured at fair value each period with changes in fair value reported in earnings as they occur should not be evaluated for embedded derivatives.

Debt is usually not subsequently measured at fair value unless an election is made pursuant to the separate fair value options provided in both ASC 815 and ASC 825.[4] The fair value option may not be elected for certain types of debt. For example, ASC 825-10-15-5(f) prohibits an entity from electing the fair value option for financial instruments that are, in whole or in part, classified by the issuer as a component of shareholders' equity (including temporary equity). Based on this restriction, the fair value option may not be elected for convertible debt that is in the scope of the substantial premium model (evaluated in Box G of the flowchart).

Under the fair value option in ASC 815-15-25-4 through 25-6, if the issuer has determined a debt instrument has an embedded derivative that requires bifurcation pursuant to ASC 815-15-25-1, the issuer may elect the fair value option for the hybrid instrument.

Although not entirely clear in the guidance, we generally believe the fair value option under ASC 815-15 may not be elected for a convertible debt instrument with a substantial premium, even if the instrument contains a non-equity-related bifurcatable derivative under ASC 815. That is, a convertible debt instrument that was precluded from being measured at fair value pursuant to the option in ASC 825 should not be eligible for the fair value option pursuant to ASC 815.

### 2.2.2 Box B — Identifying embedded features

ASC 815-10-20 defines an embedded derivative as an implicit or explicit term that affects some or all of the cash flows or the value of other exchanges required by a contract in a manner similar to a derivative instrument. Those embedded features may or may not meet the definition of a derivative pursuant to ASC 815. Instruments that themselves are not derivatives may contain embedded features, and are referred to as hybrid instruments, which comprise a host contract (e.g., a debt host) and one or more embedded features.

ASC 815-15 requires an instrument that is not a derivative itself to be evaluated for embedded features that should be bifurcated and separately accounted for as freestanding derivatives. Bifurcated embedded derivatives are split from the hybrid instrument and recorded in the same manner as a freestanding derivative pursuant to ASC 815 (i.e., recorded at fair value with subsequent changes in fair value recognized in earnings each period).

Debt instruments should be carefully reviewed to identify any terms that could result in a change in either the amount or timing (or both) of any cash or other value flows or settlements. Common embedded features in debt instruments include conversion options, redemption features (e.g., call option or put option), contingent interest, term extension options and make-whole provisions (incremental value delivered at a settlement date before the stated maturity date presumably to compensate the investor for some lost future cash flows or value).

Refer to section 2.2.3.4 for evaluating whether an embedded feature meets the definition of a derivative.

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[4] For financial liabilities measured using the fair value option under ASC 825-10 or ASC 815-15, ASC 825-10-45-5 requires entities to recognize the changes in fair value of liabilities caused by a change in instrument-specific credit risk (own credit risk) in other comprehensive income.

### 2.2.3 Box D and Boxes D1, D2 and D3 — Evaluating embedded features for bifurcation

Embedded features should be evaluated as potential embedded derivatives that should be bifurcated. Box D(A) and Box D(B) represent two broad categories of features commonly found in debt instruments: conversion options and redemption (put/call) features, respectively. Box D(C) includes any other features that could meet the definition of a derivative and require bifurcation.

Box D1, Box D2 and Box D3 apply to any contractual feature requiring analysis as a potential embedded derivative. The questions in those boxes align closely with the criteria in ASC 815-15-25-1, which requires an embedded feature to be bifurcated if all three of the following conditions are met:

(1) The economic characteristics and risks of the embedded derivative are not clearly and closely related to the economic characteristics and risks of the host contract.

(2) The hybrid instrument is not remeasured at fair value under otherwise applicable US GAAP with changes in fair value reported in earnings as they occur.

(3) A separate instrument with the same terms as the embedded derivative would be considered a derivative instrument subject to derivative accounting (the initial net investment for the hybrid instrument should not be considered to be the initial net investment for the embedded derivative).

Under criterion (1), if an embedded feature being analyzed is clearly and closely related to the host, bifurcation is not required. To evaluate this criterion, the host contract should be properly identified.

Criterion (2) is not addressed because the hybrid instrument is not being measured at fair value pursuant to the analysis in Box A.

Criterion (3) considers not only whether the embedded feature meets the definition of a derivative (evaluated as if it were a freestanding instrument with the same terms), but also whether it is eligible for an exception from derivative accounting. If the embedded feature would not be accounted for as a derivative if freestanding, either because it does not meet the definition of a derivative or because it does meet the definition but receives an exception from derivative accounting under ASC 815, bifurcation is not required.

Refer to section 3 of our FRD publication, ***Derivatives and hedging***, for additional information on embedded derivatives.

#### 2.2.3.1 Unit of analysis

Each embedded feature identified in a contract generally is evaluated for bifurcation. There are different approaches used to determine whether an embedded feature requires bifurcation. Under one approach, each embedded feature is evaluated individually. Under another, similar embedded features may be (or in some cases should be) combined. The approach followed for the unit of analysis (i.e., embedded features evaluated individually or in a group) may affect whether some or all of those embedded features should be bifurcated.

For example, consider a typical contingently convertible debt instrument (or "CoCo," which is described in section 2.2.4.4) that may be converted in four different situations (e.g., based on the trading price, parity, a notice of redemption or a specified corporate transaction), with each situation representing the resolution of a contingency in the instrument. The contractual conversion features in a CoCo could be analyzed in two ways. Under one approach, the instrument would have a single conversion option with four separate triggers that permit conversion (e.g., based on the trading price of the common stock, parity, a notice of redemption or a specified corporate transaction). Under another approach, the instrument could be viewed to have four conversion options, each of which is exercisable only upon the occurrence of a certain event (i.e., the trading price of the common stock, parity, a notice of redemption or a specified corporate transaction).

If the instrument were viewed to have one option with multiple exercise triggers, the entire conversion option would be bifurcated if any individual trigger or related settlement met the requirements for bifurcation. Under the second approach (four options, each with its own exercise trigger), only each individual trigger or related settlement requiring separate accounting would be bifurcated. The valuation of that bifurcated derivative would be based on the conversion option (or options, if several required bifurcation) value that included an input for the probability of the trigger (or triggers) occurring. The remaining conversion options would not be bifurcated.

Both approaches may be acceptable depending on facts and circumstances.[5] For a hybrid instrument, such as the contingently convertible debt, judgment will be required to determine when it is appropriate (or necessary) to combine terms into a single embedded feature to be evaluated for bifurcation. Factors to be considered include the commonality of the underlyings, a detailed analysis of the calculation of related settlement amounts, the situations in which settlements may be required and default provisions related to the terms.

Once the appropriate unit of analysis is determined, each unit should be evaluated in accordance with the criteria in ASC 815-15-25-1 described below. If more than one feature requires bifurcation, a single derivative comprising all features requiring bifurcation should be separated. Refer to section 2.2.7 for further discussion.

#### 2.2.3.2 Meaning of 'clearly and closely related'

The clearly and closely related evaluation generally refers to a comparison of the economic characteristics and risks of the embedded feature to those of the host instrument. The concept is not specifically defined in the guidance, but it is illustrated throughout the examples in ASC 815-15-25-23 through 25-51. Generally, the underlying that causes the value of the embedded feature to fluctuate, must be related to the inherent economic nature of the host instrument to be considered clearly and closely related to the host instrument.

If the economic characteristics and risks of the embedded feature are clearly and closely related to the economic characteristics and risks of the host contract, ASC 815 does not require bifurcation of the feature, and there is no separate accounting as a derivative.

This concept is illustrated throughout the discussion and examples in ASC 815-15-25-23 through 25-51.

#### 2.2.3.3 Identifying the host contract in a debt instrument

The nature of the host contract should be determined to assess whether an embedded feature is considered clearly and closely related to the host contract. US GAAP defines an equity host as a residual interest in an entity, and a debt host as any other financial instrument host contract. From the examples in ASC 815-15-25, it can be inferred that interest, credit and inflation can be considered debt-host-like characteristics. A legal form debt instrument would have a debt host.

Some instruments could be legal form equity instruments that are classified as a liability pursuant to the guidance in ASC 480, such as preferred stock that is mandatorily redeemable. The host instrument (the preferred stock) should be evaluated pursuant to ASC 815-15-25 to determine whether the host instrument is more akin to debt or equity. As the instrument would have a stated maturity date or some form of date-certain redemption in order to be classified as a liability pursuant to ASC 480, the host instrument most likely would be deemed a debt-like host. Refer to section 3.2.6 for further discussion of how the host contract of shares should be determined.

The terms of the host debt instrument are based on the stated or implied substantive terms of the hybrid instrument. Those terms may include a fixed rate, variable rate, zero coupon, discount or premium or some combination thereof. The characteristics of the host debt instrument should not be expressed in a

[5] The second approach may not be applied for a freestanding equity contract. ASC 815-15-25-7 indicates that a single freestanding derivative should not be split into multiple derivatives. Therefore, a freestanding warrant that has four exercise contingencies should be viewed as a single equity contract.

manner that would result in identifying an embedded derivative that is not already clearly present in a hybrid instrument. For example, a fixed-rate debt instrument should not be considered a variable-rate debt host with an embedded variable-to-fixed interest rate swap.

We generally believe the debt host of a typical convertible debt instrument is generally a nonconvertible, fixed-rate debt instrument with a stated maturity date that pays interest at the issuer's current borrowing rate for the contractual life of the instrument. Under this approach, when evaluating interest-related features (such as put/call provisions) against the host instrument in convertible debt, the interest rate on the host should be the fixed rate that would have been set on a nonconvertible instrument and should be higher than the convertible instrument's contractual fixed rate.

#### 2.2.3.4 Definition of a derivative instrument

To be a derivative pursuant to ASC 815, an instrument should have all of the following characteristics:

- A derivative's cash flows or fair value must fluctuate and vary based on the changes in one or more underlyings.
- The contract contains one or more notional amounts or payment provisions or both.
- The contract requires no initial net investment or requires an initial net investment that is smaller than would be required for other types of contracts expected to have a similar response to changes in market factors.
- The contract (1) provides for net settlement, (2) can be settled net through a market mechanism outside the contract or (3) provides for delivery of an asset that, because the delivered asset is readily convertible to cash, puts the recipient in a position not substantially different from net settlement (a gross settlement that is economically equivalent to a net settlement).

Refer to section 1.2.3 of this publication and section 2.4 of our FRD publication, ***Derivatives and hedging***, for additional guidance on the definition of a derivative.

### 2.2.4 Box D(A) and Boxes D1, D2 and D3 — Evaluating embedded conversion options

The conversion feature in convertible debt should be evaluated for potential bifurcation under the criteria in ASC 815-15-25-1, which includes the considerations described in section 2.2.3. If the option meets the definition of a derivative, the analysis should also consider whether the conversion feature, if freestanding, would receive an exception from derivative accounting.

While issued less frequently, debt may also be exchanged into equity of another entity (referred to as exchangeable debt). The evaluation of an exchange feature for potential bifurcation should follow the guidance discussed in section 2.2.3 and this section. However, because the debt is not convertible into equity of the issuer, the exchange feature would generally be bifurcated. This section primarily focuses on the evaluation of conversion features. Refer to section 5.1 for further discussion of exchangeable debt.

#### 2.2.4.1 Determining whether a conversion option is clearly and closely related to the debt host instrument

To be considered clearly and closely related to the debt host in convertible debt, the embedded feature's underlying should relate to economic characteristics and risks that affect debt, such as interest rates, credit considerations or inflation.

Most commonly, the economic characteristics and risks of a conversion option embedded in a debt instrument are considered related to those of an equity instrument, because its value is influenced principally by the underlying equity security's fair value (and the volatility in that fair value). Therefore,

the economic characteristics and risks of an embedded conversion option in a debt instrument should not be considered clearly and closely related to the economic characteristics and risks of a debt host contract, as stated in ASC 815-15-25-51.

#### 2.2.4.2 Determining whether a conversion option meets the definition of a derivative

The criteria for the definition of a derivative should generally be applied to conversion features as follows:

- Underlying and notional amount — The underlying is the price (i.e., fair value) of the equity instrument to be issued when the embedded conversion option is exercised, and the notional amount is the number of shares into which the debt instrument is convertible.
- No initial net investment — The implicit premium for the embedded conversion option at inception is considered the initial investment (not the initial investment in the convertible debt instrument), which should generally be less than the fair value of the underlying equity security.
- Net settlement — An embedded conversion option may require physical settlement (i.e., no possibility that the conversion option will settle in cash, such as "classic convertible debt" described in section 2.1.2.1) such that, upon conversion, the issuer is required to deliver the underlying equity shares in settlement of the convertible debt. An embedded conversion option that requires physical settlement would meet the net settlement requirement only if the shares to be delivered upon conversion are "readily convertible to cash" as described in ASC 815.

  For example, a share of a publicly traded company is generally considered readily convertible to cash unless the market for the shares is not active and the number of shares to be exchanged (given the smallest increment available for conversion) is large relative to the daily trading volume of the underlying shares. However, if the underlying share is of a private company, the conversion option would generally not meet the net settlement criteria in a physical settlement unless there is sufficient active trading to result in a conclusion that a common share is readily convertible to cash.

  In some cases, a convertible debt instrument may contractually require net settlement of the embedded conversion option. This net settlement of the conversion feature could be in shares or cash. For example, Instrument C provides that the conversion spread (i.e., the intrinsic value of the conversion option) is to be settled in net cash or net shares upon conversion. Instruments A, B and X also permit net settlement. In these cases, the embedded conversion option would meet the net settlement characteristic of a derivative even if the underlying shares were not readily convertible to cash.

#### 2.2.4.3 Exceptions from derivative accounting

Notwithstanding that an embedded feature, if freestanding, may meet all the characteristics of a derivative, an embedded feature (including conversion options) should not be bifurcated if the feature is eligible for a scope exception from ASC 815. The most common exception for a conversion feature is provided by ASC 815-10-15-74(a), which states that contracts issued or held by that reporting entity that are both (1) indexed to its own stock and (2) classified in stockholders' equity in its statement of financial position are not considered derivative instruments in the scope of ASC 815. That analysis draws on the indexation and classification guidance in ASC 815-40 related to contracts in an entity's own stock.

If the embedded conversion option does not qualify for the scope exception in ASC 815-10-15-74(a), the issuer should determine whether the feature is eligible for other scope exceptions in ASC 815. While it is unlikely the instrument would qualify for any other exceptions, in the event convertible debt instruments are issued in exchange for goods or services, an exception may exist pursuant to ASC 815-10-15-74(b), which excludes contracts issued in a company's own securities as share-based payment arrangements until such contracts are no longer subject to the guidance in ASC 718. Refer to our FRD publication, ***Share-based payment***, for further guidance related to accounting for share-based payment arrangements.

#### 2.2.4.3.1 *Meaning of 'indexed to issuer's own stock'*

To determine whether a conversion feature is indexed to the issuer's own stock, it should be analyzed pursuant to ASC 815-40-15-5 through 15-8, including the related implementation guidance. The examples in ASC 815-40-55-26 through 55-48 should, in particular, be considered. This guidance is referred to throughout this publication as "the indexation guidance."

The indexation guidance requires a two-step evaluation of an instrument or feature. In the first step, any contingent exercise provisions are evaluated, and in the second step, an analysis of features that could change the instrument's settlement amount is conducted.

In the first step, an exercise contingency (as defined in the indexation guidance) does not preclude an instrument (or embedded feature) from being considered indexed to an entity's own stock provided that it is not based on either of the following:

- An observable market, other than the market for the issuer's stock (if applicable)
- An observable index, other than an index calculated or measured solely by reference to the issuer's own operations (e.g., sales revenue of the issuer, earnings before interest, taxes, depreciation and amortization of the issuer, net income of the issuer or total equity of the issuer)

In the second step, an instrument (or embedded feature) is considered indexed to an entity's own stock if its settlement amount equals the difference between (1) the fair value of a fixed number of the entity's equity shares and (2) a fixed monetary amount or a fixed amount of a debt instrument issued by the entity. While the second step appears to be a strict "fixed-for-fixed" concept, an exception is provided so that if the feature's strike price or the number of shares used to calculate the settlement amount is not fixed, the embedded feature could still be considered indexed to an entity's own stock if the only variables that could affect the settlement amount would be inputs to a fair value valuation model for a fixed-for-fixed forward or option on equity shares.

Any feature that adjusts the embedded conversion option should be carefully analyzed. Those features could include antidilution provisions (e.g., adjustments for stock splits or dividends) as well as provisions that adjust the conversion price or rate to protect the investor from a loss of value due to events that were not expected to occur or events in the control of the issuer that could be detrimental to the holder (e.g., as merger, tender offer, nationalization, insolvency or delisting). Refer to section B.3 for a comprehensive discussion of the indexation guidance.

If based on the indexation guidance the conversion option is not considered indexed to the issuer's own stock, it would not qualify for the scope exception in ASC 815-10-15-74(a) and should be bifurcated.

#### 2.2.4.3.2 *Meaning of 'classified in stockholders' equity'*

To determine whether an embedded conversion feature would be classified in stockholders' equity if considered freestanding, ASC 815-40-25-1 through 25-43 should be considered, including the related implementation guidance (primarily codified in ASC 815-40-55-2 through 55-18). This guidance is referred to throughout this publication as "the equity classification guidance."

The equity classification guidance generally indicates that an embedded conversion option on a company's own stock, if freestanding, would be considered to be classified in equity under either of the following types of settlement:

- Required physical settlement or net share settlement
- Issuer has a choice of net cash settlement or settlement in its own shares (physical settlement or net share settlement), regardless of the intent of the issuer

However, an embedded conversion option would not be considered classified in equity if either of the following provisions is present:

- Required net cash settlement (including a requirement to net cash settle if an event occurs that is outside the control of the issuer)
- Holder has choice of net cash settlement or settlement in shares (physical settlement or net share settlement)

ASC 815-40-25-7 through 25-38 include additional conditions that should be met for equity classification, including whether the issuer will have the ability, in all cases, to settle in shares. Those additional conditions need not be met for certain convertible debt instruments (refer to section 2.2.4.8). If any condition (as summarized below) is not met for a debt instrument that is not the specific type of convertible debt discussed in section 2.2.4.8, the embedded conversion option would not be considered classified in stockholders' equity and should be bifurcated:

- No explicit requirement to settle the contract in cash when registered shares are unavailable
- Entity has sufficient authorized and unissued shares
- Contract contains an explicit share limit
- No required cash payments (with the exception of penalty payments) if entity fails to timely file
- No cash-settled top-off or make-whole provisions

Those criteria should be applied on a theoretically possible standard. Issuers should also evaluate the implementation guidance in ASC 815-40-55-2 through 55-6 that discusses circumstances where equity classification is appropriate despite the possibility of a cash settlement if holders of the same class of underlying shares also would receive cash in exchange for their shares.

Refer to section B.4 for a comprehensive discussion of the equity classification guidance.

### 2.2.4.4 Contingently convertible debt

In a traditional convertible debt instrument, the holder may exercise its option to convert the notes into a number of underlying securities at any time. In contrast, CoCo debt generally entitles the holder to convert only after certain contingencies have been satisfied. Contingently convertible debt often also allows conversion at the end of its life.

When exercise contingencies exist and the conversion feature meets the definition of a derivative, the issuer should evaluate each of those contingencies to determine whether they would preclude the conversion option from being considered indexed to its own stock. This evaluation should be made in the first step under the indexation guidance, which requires that the contingent exercise provisions not be based on an observable market (other than the market for the issuer's stock) or an observable index (other than those calculated or measured solely by reference to the issuer's own operations). Refer to section 2.2.4.3 and Appendix B for further discussion of these requirements.

The most common exercise contingencies in a CoCo are:

- Common stock trading price — A holder may convert the note if the last reported price of the stock for a specified period is more than some percentage of the conversion price. For example, a convertible debt instrument with a conversion price of $12 and a contingent conversion trigger of 130% may permit conversion only if the stock trades above $15.60 ($12 x 130%) for 20 out of the 30 days before the end of the quarter.

- Satisfaction of trading price condition or "parity trigger" — A holder may convert during a specified period after any period in which the trading price per $1,000 principal amount of the debt for each day of that period was less than a percentage (e.g., 95%) of the parity value. For example, assume a convertible instrument with a conversion price of $12 and a conversion ratio of 83.33 shares is convertible only when the debt is trading at less than 95% of its parity (as converted) value. In this example, if the trading price of the underlying stock is $15, the debt would be convertible only when it was trading at less than $1,187.50 (or 95% of $1,250, which is the parity value (83.33 shares x $15)).
- Notice of redemption — A holder may convert the note if the notes have been called for redemption by the issuer.
- Specified corporate transactions — A holder may convert the note upon the occurrence of specified corporate transactions. These corporate events may include "fundamental change" triggers similar to those discussed in section 2.2.5.

Many common exercise contingencies pass the first step of the indexation guidance because they are contingent upon the trading price of the issuer's equity shares or are not contingent on any observable market or index unrelated to the entity's own stock or operations.

Parity trigger exercise contingencies are specifically addressed in ASC 815-40-55-45 through 55-46, which states in part:

> The market price trigger and parity provision exercise contingencies are based on observable markets; however, those contingencies relate solely to the market prices of the entity's own stock and its own convertible debt ... Therefore, Step 1 does not preclude the warrants from being considered indexed to the entity's own stock.

Conversion exercise contingencies based on an observable market other than the market for the issuer's stock or an observable index other than those referenced to the issuer's own operations preclude the embedded conversion option from being considered indexed to the entity's own stock. For example, if the embedded conversion option permits the holder to convert only if SOFR increases or decreases by 200 basis points, the conversion feature would fail Step 1 of the evaluation under the indexation guidance, because SOFR is an observable index that is not calculated or measured based on the market for the issuer's own stock or measured solely by reference to the issuer's own operations.

Refer to section 2.2.3.1 for how individual contingencies should be considered in determining the unit of analysis when evaluating embedded conversion features for bifurcation and section B.3 for more information on the evaluation of exercise contingencies under the indexation guidance.

### 2.2.4.5 'Time value make-whole' features

Debt instruments may include some form of a make-whole provision, which provides that in the event of conversion by the investor under certain circumstances (e.g., change of control), the issuer is required to deliver to the holder additional consideration beyond the settlement of the conversion obligation. The additional consideration may be provided in cash or shares, usually at the issuer's option. There are two frequent forms of the make-whole feature: an "interest make-whole" and a "time value make-whole." Refer to section 2.2.6.2 for a discussion on interest make-whole features.

A time value make-whole feature is designed to compensate the investor for lost benefits of the investment (including the time value of the remaining term of the conversion option) upon conversion because of the occurrence of certain fundamental change events (refer to section 2.2.5) that result in early settlement of the instrument.

The number of additional shares to be provided to the investor is generally determined based on (1) the date on which the fundamental change occurs or becomes effective and (2) the price per share of the underlying equity security at that time, as set forth in the indenture.

In some cases, a make-whole provision may be triggered on any conversion, rather than certain contingent conversions. In those situations, the feature should be carefully evaluated to determine if it should be evaluated as part of the basic conversion option. Refer to the discussion of determining the unit of analysis in section 2.2.3.1 for further guidance.

Because time value make-whole provisions are not clearly and closely related to the debt host and would meet the definition of a derivative if considered freestanding, they should be evaluated under the indexation guidance to determine whether they would be afforded the scope exception pursuant to ASC 815-10-15-74(a). This evaluation is generally performed in conjunction with the analysis of the embedded conversion feature.

ASC 815-40-55-46 indicates that if the fair value of the shares into which the debt is convertible plus the make-whole shares would be expected to approximate the fair value of the convertible debt instrument at the settlement date (assuming no change in the pricing inputs — other than stock price and time — since the instrument's inception), the time value make-whole feature would not violate the fixed-for-fixed concept in the indexation guidance because the number of make-whole shares is determined based on a table with axes of stock price and time, which would both be inputs in a fair value measurement of a fixed-for-fixed option on equity shares.

The following is an example of a typical time value make-whole table (except for the "Amount" column, which has been added for reference) that could be included in an indenture. Based upon the stock price and the effective date, the number of additional shares per note can be determined.

| Stock price | Effective date | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | 1 December 20X0 | | 1 December 20X1 | | 1 December 20X2 | | 1 December 20X3 | |
| | Shares | Amount | Shares | Amount | Shares | Amount | Shares | Amount |
| $ 15.00 | 5.00 | $ 75.00 | 5.00 | $ 75.00 | 5.00 | $ 75.00 | 5.00 | $ 75.00 |
| $ 20.00 | 3.80 | 76.00 | 3.58 | 71.60 | 3.15 | 63.00 | 2.00 | 40.00 |
| $ 25.00 | 2.50 | 62.50 | 2.15 | 53.75 | 1.60 | 40.00 | 1.05 | 26.25 |
| $ 30.00 | 1.75 | 52.50 | 1.40 | 42.00 | 0.85 | 25.50 | 0.80 | 24.00 |
| $ 35.00 | 1.25 | 43.75 | 0.95 | 33.25 | 0.35 | 12.25 | 0.25 | 8.75 |
| $ 40.00 | 1.00 | 40.00 | 0.65 | 26.00 | 0.24 | 9.60 | – | – |
| $ 45.00 | 0.75 | 33.75 | 0.50 | 22.50 | 0.15 | 6.75 | – | – |
| $ 50.00 | 0.50 | 25.00 | 0.35 | 17.50 | 0.10 | 5.00 | – | – |

In evaluating whether the time value make-whole satisfies the criteria discussed in Step 2 of the indexation guidance, the terms of the indenture should provide that the stock price used to determine the make-whole payment should be the fair value of a share used as an input to an appropriate valuation model (e.g., Black-Scholes, lattice or other appropriate model that is based on the instrument's terms and valuation theory) for a fixed-for-fixed option or forward.

To satisfy the indexation guidance, the make-whole amounts should represent compensation for the expected loss in the time value component at settlement (assuming no change in pricing inputs, other than stock price and time, since the instrument's inception). Accordingly, the make-whole amount should fluctuate with the "Stock Price" and the "Effective Date" axes in a manner that is reasonably expected to compensate the investor for the value lost upon an early conversion.

For example, the time value of a conversion option typically decreases as the term to maturity shortens and decreases as the share price (fair value of the share) moves further away (higher or lower) from the contractual conversion price. In cases where the make-whole amount results in a fixed or predominantly fixed value for a number of different share prices on the same date, the make-whole provision may not be considered indexed to the entity's own stock. Rather, it may be more akin to an interest make-whole feature. A feature expressed in such a table would likely require bifurcation (as discussed further in section 2.2.6.2).

If the time value make-whole feature and the base conversion option are considered indexed to the entity's own equity, the exception in ASC 815-10-15-74(a) related to the feature being classified in equity if freestanding should also be considered, as discussed in section 2.2.4.3.2.

While ASC 815 does not explicitly address the unit of an embedded feature that should be evaluated, make-whole provisions are generally evaluated as part of the embedded conversion feature based on the make-whole illustration in ASC 815-40-55-46, which implies that the entire conversion option — including the make-whole provision — should be evaluated together. However, the original EITF consensus that was codified was not intended to interpret the unit of analysis for embedded derivatives. Therefore, it is not clear what should be bifurcated if the make-whole feature is not considered indexed to the entity's own stock.

We generally believe there are different approaches that one could consider in determining the unit of analysis for the make-whole provision based in part on the discussion of the unit of analysis for contingent conversion options in section 2.2.3.1. Depending on the facts and circumstances, the make-whole feature may be viewed together with the entire conversion option or with only conversion options that share the same exercise contingencies as the make-whole feature (e.g., conversion upon a fundamental transaction that also triggers the make-whole provision). The unit of analysis as determined then affects which conversion option(s), including the make-whole feature, would be bifurcated.

### 2.2.4.6 Share-settled debt

Convertible debt typically provides the investor with the ability to convert the debt into a fixed number of the issuer's equity securities. As a result, the value the holder receives upon conversion is based on the price of the shares. However, some debt instruments may settle by providing the holder with a variable number of shares with an aggregate fair value equal to the debt's outstanding principal (referred to as share-settled debt). In some cases, a discount to the fair value of the share may be used to determine the number of shares to be delivered. This results in settlement at a premium to the debt's outstanding principal.

Because the value that the holder of share-settled debt receives at settlement does not fluctuate with the fair value of the shares, this variable-share settlement provision is not considered a conversion option. As a result, the debt instrument would not be considered convertible debt unless it also contained a conversion option (as discussed in section 2.1.2.1). Instead, debt with this variable-share settlement provision should first be evaluated pursuant to ASC 480-10-25-14 (refer to section A.6.2.1). If the debt is not subject to that guidance, the variable-share settlement provision should be evaluated as a redemption feature as discussed in section 2.2.5.

Refer to section 5.23 for more information on variable-share settlement provisions.

### 2.2.4.7 Debt that is convertible into shares of a subsidiary or the parent

ASC 815-40-15-5C states that freestanding financial instruments (and embedded features) for which the payoff to the counterparty is based, in whole or in part, on the stock of a consolidated subsidiary are not precluded from being considered indexed to the entity's own stock in the consolidated financial statements of the parent if the subsidiary is a substantive entity. Accordingly, if the subsidiary is considered to be a substantive entity, an embedded option to convert debt (issued by the parent or the subsidiary) into a substantive subsidiary's shares may be considered indexed to the issuer's own stock in the consolidated financial statements if the two steps in the indexation guidance are met, as discussed in section 2.2.4.3.1.

ASC 815-40-15-5C does not explicitly address convertible debt issued by a subsidiary that is convertible into the shares of its parent. We generally believe that for purposes of the parent's consolidated financial statements that instrument could meet the indexation guidance, in part based on concepts formerly in EITF 98-2, *Accounting by a Subsidiary or Joint Venture for an Investment in the Stock of Its Parent Company or Joint Venture Partner*, which wasn't finalized by the EITF and wasn't codified. That tentative consensus

stated that in certain circumstances a subsidiary's investment in the shares of its parent would be treated as treasury stock in the financial statements of the subsidiary or joint venture. If such a share could be considered treasury stock by the subsidiary, then by analogy it could be considered a share of the subsidiary.

The following chart summarizes whether the embedded conversion option in the following instruments may be considered indexed to the reporting entity's stock pursuant to ASC 815-40-15-5C.

| | Embedded conversion feature indexed to reporting entity's stock? |
|---|---|
| **Debt issued by consolidated subsidiary convertible into subsidiary's stock** | Yes, in consolidated financial statements and the subsidiary's standalone financial statements. |
| **Debt issued by parent convertible into a substantive consolidated subsidiary's stock** | Yes, in consolidated financial statements. |
| **Debt issued by subsidiary convertible into parent's stock** | Yes, in consolidated financial statements.<br>No, in subsidiary's standalone financial statements because the holder's conversion right is for stock of an entity (parent) that is not the reporting entity (subsidiary). |

Accounting for debt issued by a subsidiary that is convertible into either the parent's or consolidated subsidiary's stock at the election of the holder should be carefully determined based on the individual facts and circumstances.

### 2.2.4.8 Convertible debt that is convertible into a fixed number of shares or an equivalent amount of cash

As discussed in ASC 815-40-25-39 through 25-42, the additional criteria described in ASC 815-40-25-7 through 25-30, including the related implementation guidance in ASC 815-40-55-2 through 55-6, are not applicable to a convertible debt instrument that permits the holder to convert into a fixed number of shares in its entirety (or an equivalent amount of cash at the discretion of the issuer) and for which the ability to exercise the conversion option is based on the passage of time or a contingent event.

The analysis for determining whether an embedded conversion feature in this type of convertible debt (previously known as "conventional convertible debt") receives an exception from derivative accounting pursuant to ASC 815-10-15-74(a) is simplified in comparison to other convertible debt. While the requirements in the indexation guidance should continue to be met, in evaluating whether the embedded conversion feature would be classified in stockholders' equity if freestanding, the additional criteria described in ASC 815-40-25-7 through 25-30, including the related implementation guidance in ASC 815-40-55-2 through 55-6, are not applicable. Instead, the only consideration under the equity classification guidance is whether the contract requires or permits the issuer to settle in shares under the general equity classification guidance in ASC 815-40-25-1 through 25-4. Refer to section 2.2.4.3.2 for further guidance on those requirements.

In practice, convertible debt instruments infrequently permit holders to convert into a fixed number of shares in its entirety (or an equivalent amount of cash at the discretion of the issuers) because they generally include at least one provision that makes the number of shares to be delivered upon conversion variable, such as:

- Any conversion feature that permits the settlement of the conversion obligation in a variable number of shares (e.g., instruments allowing conversions to be settled in cash for the principal amount and shares for any conversion spread, or in any mix of cash or shares, because the number of shares or equivalent amount of cash to be delivered upon conversion is not fixed (e.g., Instruments C and X))
- The existence of a make-whole provision, which may result in a variable number of shares upon conversion
- The inclusion of anything other than standard antidilution provisions

Standard antidilution provisions as defined in Codification are designed to maintain the value of the conversion option in the event of an equity restructuring. "Equity restructuring" is defined in Codification as a nonreciprocal transaction between an entity and its shareholders that causes the per-share fair value of the shares underlying an option or similar award to change, such as a stock dividend, stock split, spin-off, rights offering or recapitalization through a large, nonrecurring cash dividend.

Standard antidilution adjustments require an adjustment to the conversion option when the following events occur:

- Issuance of the underlying security as a dividend or distribution on the underlying security or a split or combination of the underlying security
- Issuance to holders of the underlying security any rights or warrants entitling them to the underlying security at a discount
- Distributions of capital stock, other assets or property to holders of the underlying security
- Large and nonrecurring cash dividend or distribution

Typical antidilution provisions included in recent convertible debt instruments that are not considered standard antidilution provisions include adjustments for:

- Cash dividends — To be considered an equity restructuring, a cash dividend must be both large and nonrecurring. Therefore, adjustments due to regular cash dividends, or even an initial cash dividend that is not large, are not considered standard, as they are usually neither large nor nonrecurring.
- Payment in respect of a tender offer — Such offers are generally made by the issuer or a subsidiary, but in some cases triggered by a third-party tender offer. These also include exchange offers for the underlying security in which the tender price is higher than the last reported sale of the underlying security. This adjustment is not considered standard as it is a reciprocal transaction with shareholders (exchange of cash for purchase of shares).

#### 2.2.4.9 Conversion options with a strike price denominated in a currency other than the issuer's functional currency

Pursuant to ASC 815-40-15-7I, a conversion option embedded in debt that is denominated in a currency other than the issuer's functional currency is not considered indexed to the issuers' own stock because the issuer is exposed to the changes in the currency's exchange rate, and thus there is not a fixed amount of value (in the issuer's functional currency) being exchanged.

The determination of whether an equity-linked financial instrument is indexed to an entity's own stock is not affected by the currency (or currencies) in which the underlying shares trade.

### 2.2.5 Box D(B) and Boxes D1, D2 and D3 — Evaluating embedded redemption (put and/or call) features

Like embedded conversion options, redemption features are also evaluated for bifurcation pursuant to ASC 815-15-25-1. Redemption is the repayment of the principal amount at or before maturity, but is most frequently used to describe repayment before maturity through exercise of a call or put option embedded in the debt instrument.

An embedded call option gives the issuer the right to fully or partially retire the debt before the scheduled maturity date, usually at par or at a premium (e.g., 101% of par). A call feature enables the issuer to refinance the debt at a lower borrowing rate if rates have declined since issuance.

An embedded put option is an option granted to the creditor by the issuer giving the debt holder the right to fully or partially sell the debt back to the issuer before the scheduled maturity date, usually at par or at a premium (e.g., 101% of par). The put option permits the creditor to force the issuer to redeem the debt when interest rates rise after the debt's issuance, enabling the creditor to reinvest the proceeds at higher market rates.

Frequently, debt agreements contain a put option that enables the investor to put the debt to the issuer upon the occurrence of a fundamental change (certain change in control transactions as defined in the agreement). This redemption feature is commonly referred to as a "change of control put." Although specific to each arrangement, the following are common examples of fundamental change events:

- A person or group becoming the direct or indirect ultimate beneficial owner of more than 50% of the voting power of the issuer's common equity
- Sale of all or substantially all of the issuer's net assets
- Consummation of any share exchange, consolidation or merger of the issuer into another entity
- Specified changes in the board of directors
- Shareholders approving any plan or proposal for the liquidation or dissolution of the issuing entity
- The issuer's common stock ceasing to be quoted or listed

Depending on the specific terms of the debt, embedded put or call options may be exercisable at any time after issuance, after the passage of time (e.g., on or after the fifth anniversary) or upon the occurrence of specified contingent events, and may coincide with each other.

Some redemption features may require the issuer to issue a variable number of shares with an aggregate fair value equal to the debt's outstanding principal to settle the debt prior to maturity. Because the settlement amount does not fluctuate with the fair value of the shares, this feature is generally considered a redemption, rather than a conversion option. Refer to section 2.2.4.6 for a discussion of share-settled debt.

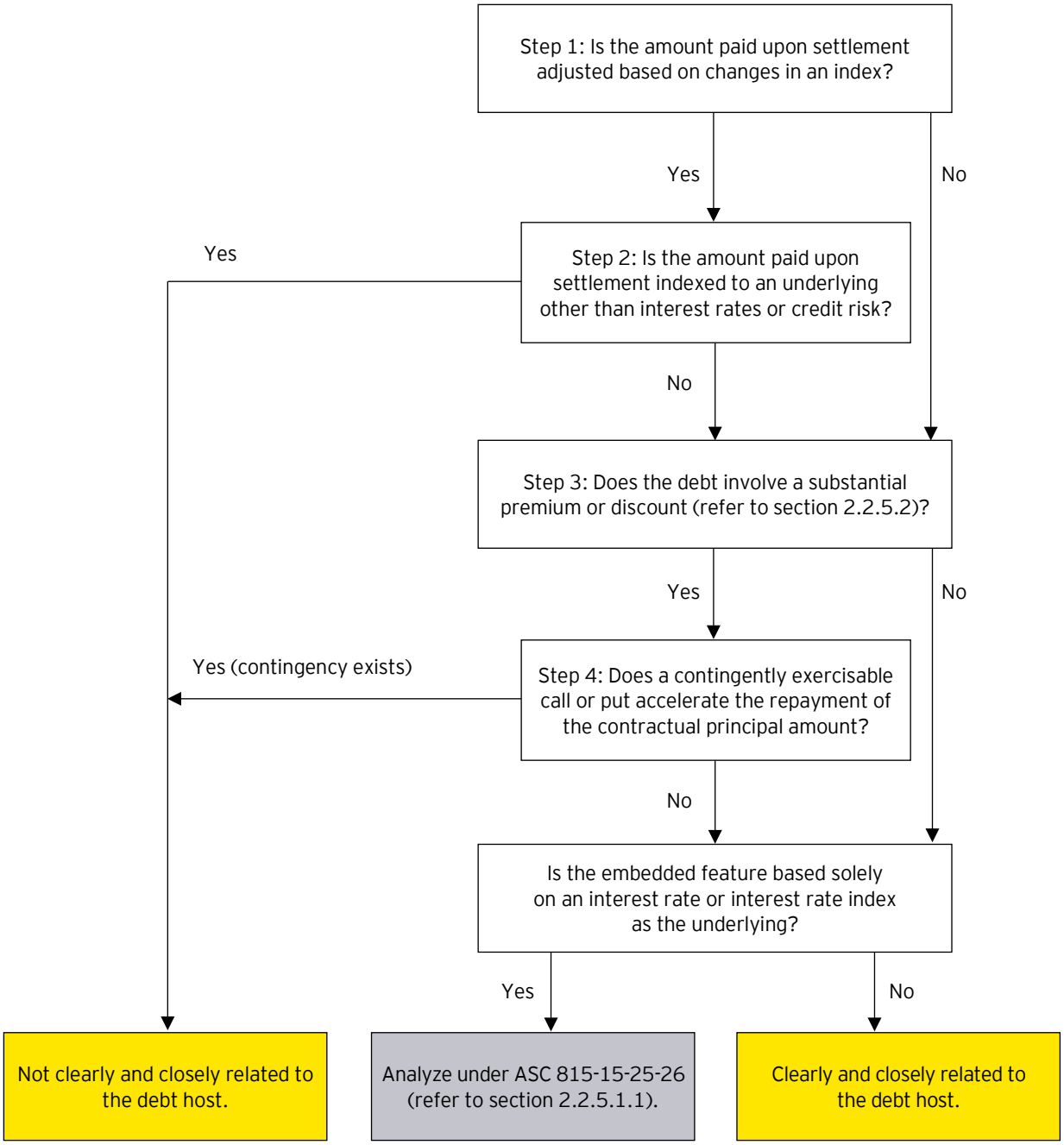
### 2.2.5.1 Determining whether put and call features are considered clearly and closely related to the debt host instrument

As discussed in section 2.2.3, if the economic characteristics and risks of an embedded feature are considered clearly and closely related to the economic characteristics and risks of the host contract or the embedded feature does not meet the definition of a derivative, the embedded feature should not be bifurcated pursuant to ASC 815.

ASC 815-15-25-41 provides guidance on call and put options that do not accelerate the repayment of principal on a debt instrument, but instead require a cash settlement that is equal to the price of the option at the date of exercise. Those options would not be clearly and closely related to the debt instrument and, therefore, would require bifurcation unless one of the other criteria in ASC 815-15-25-1 is not met.

ASC 815-15-25-42 provides a four-step decision sequence that is applied to determine whether a call or put that can accelerate the settlement of a debt instrument is considered clearly and closely related to the debt host instrument. When making this assessment, entities are not required to assess whether the event that triggers the ability to exercise a contingently exercisable put or call is indexed only to interest rates or credit risk of the entity.

The following chart illustrates the four-step decision sequence in ASC 815-15-25-42 (Steps 2, 3 and 4 are further discussed below):




The concepts in ASC 815-15-25-42 and 25-43 are illustrated with several examples in ASC 815-15-55-13.

### *2.2.5.1.1 Application of ASC 815-15-25-26 and the double-double test*

Steps 2, 3 and 4 may require calls and puts to be considered pursuant to ASC 815-15-25-26, as applicable.

ASC 815-15-25-26, as further interpreted in paragraphs ASC 815-15-25-27 through 25-29, is applicable only for embedded features in which the only underlying is an interest rate (including the debtor's market rate of interest) or an interest rate index.

Therefore, ASC 815-15-25-26 is not applicable to a put or call exercisable upon a contingency (e.g., put option exercisable upon a change in control), because that feature has an underlying other than an interest rate or interest rate index (i.e., the occurrence or nonoccurrence of the contingent event).

Puts and calls that are exercisable at any time or only after a certain time period (e.g., upon the fifth anniversary of the debt's issuance) are in the scope of ASC 815-15-25-26, because the passage of time is not a contingency or an underlying. If such a put or call's settlement is adjusted based on an underlying other than interest rates or credit, that feature would not be in the scope of ASC 815-15-25-26. However, ASC 815-15-25-42 and 25-43 should be considered to determine whether that feature is considered clearly and closely related.

ASC 815-15-25-26 through 25-29 indicate that if the embedded feature's only underlying is interest-rate related, and it alters net interest payments that otherwise would be paid or received on an interest-bearing host contract, the embedded feature meets the clearly and closely related criteria unless one of the following conditions is present:

(1) The hybrid instrument could be contractually settled in such a way that the investor would not recover substantially all of its initial recorded investment.

(2) The embedded derivative meets both of the following conditions:

   (a) There is a possible future interest rate scenario (even though it may be remote) under which the embedded derivative would at least double the investor's initial rate of return on the host contract.

   (b) For any of the possible interest rate scenarios under which the investor's initial rate of return on the host contract would be doubled (as discussed in (a) above), the embedded derivative would at the same time result in a rate of return that is at least twice what otherwise would be the then-current market return (under the relevant future interest rate scenario) for a contract that has the same terms as the host contract and that involves a debtor with a credit quality similar to the issuer's credit quality at inception.

Pursuant to ASC 815-15-25-29, the test under criterion (1) above applies only where the investor (creditor) could be forced by the contractual terms of the hybrid instrument (i.e., by the issuer) to accept settlement at an amount that causes the investor not to recover substantially all of its initial recorded investment. However, if the investor has the option to settle before maturity in a manner in which it would not recover substantially all of its investment (e.g., because of market interest rate fluctuations), the clearly and closely related presumption would not be invalidated.

The test under criterion (2) above is sometimes referred to as the "double-double test" because it focuses on doubling both the initial rate of the return and a then-current rate of return. ASC 815-15-25-37 through 25-39 provides that the double-double test does not apply to a noncontingent embedded call option in a debt host contract if the right to accelerate the settlement of the debt can be exercised only by the debtor.

If the double-double test is applicable, a debt instrument issued at par and redeemable at par will generally pass. However, for debt that can be redeemed at a premium such as 101% of par, the double-double test should be carefully considered. The issuer should assume the option will be exercised as soon as contractually possible. If the 101% of par redemption feature is assumed to be exercisable immediately, the feature will likely require bifurcation because the one-day rate of return for the investor is 1% if the put is exercised on the very next day. Assuming no compounding, a one-day rate of return of 1% on an instrument issued at par is the equivalent of a 365% per annum return, which should clearly double the investor's initial rate of return, and any then-current rate of return, in any interest rate environment. Many redemption features are exercisable only on specific dates established to pass the double-double test.

Refer to section 3 of our FRD publication, ***Derivatives and hedging***, for further discussion of the concept of clearly and closely related.

### 2.2.5.2 Meaning of 'involve a substantial premium or discount'

In connection with the evaluation under Step 3 in ASC 815-15-25-42 (as discussed in section 2.2.5.1), the issuer should determine whether the debt involves a significant premium or discount. For example, a premium or discount could exist in a debt instrument that (1) was issued with a premium or discount (e.g., zero-coupon debt), (2) was issued in a basket transaction that required an allocation of proceeds (refer to section 1.2.7) to the debt instrument and other freestanding instruments or (3) was assumed in a business combination. We do not believe that issuance costs paid to third parties should be considered a discount for the analysis. Importantly, however, a premium or discount may also exist if the debt instrument contains either other bifurcated derivatives or equity-classified components that are accounted for separately.

There is no authoritative guidance on what constitutes a substantial premium or discount. However, ASC 470-50-40-10 describes debt that is substantially different based on at least a 10% difference in cash flows on a present value basis. By analogy to the term "substantially different" in that guidance, some have argued that if a premium or discount (as discussed above) is approximately 10% or more of the principal amount of the note, it is substantial. This determination should be based on the specific facts and circumstances and requires professional judgment.

We generally believe a discount or premium resulting from the bifurcation of an embedded derivative that could be separately settled prior to or on redemption (e.g., those features are settled for consideration that is incremental to settlement of the contractual redemption feature) should be considered in analyzing a redemption feature. For example, a $1,000 debt instrument may be carried at $950 due to a bifurcated contingent interest feature of $50 that could be triggered and settled prior to the exercise of the redemption feature. This discount would be considered because the holder could receive both the $50 contingent interest feature prior to redemption and then the $1,000 on redemption.

However, a discount or premium from a bifurcated embedded derivative that could not separately settle on or before the redemption should not be considered in the redemption feature analysis. For example, assume a convertible bond was issued for $1,000 with an embedded conversion option that requires bifurcation at its fair value of $200. If that debt instrument were also puttable at par, one might first think there was a substantial discount (debt instrument of $800 puttable at $1,000, or a 20% discount). However, on redemption, the investor would not receive both $1,000 and the value of the conversion option. Instead, the investor would receive only the $1,000 initially invested in the single instrument purchased. Thus, the discount from the conversion option bifurcation should not be considered in evaluating the return provided from the redemption feature.

Another issue is how to determine whether the debt involves a substantial premium or discount. We generally believe it is important that the guidance uses the term "involves" and not "issued at." If the debt is callable at a premium or a discount, we generally believe that premium or discount should be considered in relation to the initial offering proceeds, when determining whether the debt involves a substantial premium or discount under Step 3 in ASC 815-15-25-42.

For example, if debt were issued at par with a redemption price of 110, we generally believe the debt redemption involves a premium even though the debt was issued at par. As another example, if debt were issued at 93, and were redeemable at 104, the premium involved on redemption is 11 (the difference between issuance proceeds and redemption price) rather than 4 (the difference between par and the redemption price) or 7 (the difference between the initial proceeds and par).

#### 2.2.5.3 Determining whether put and call features meet the definition of a derivative subject to derivative accounting

If the redemption feature is not considered clearly and closely related to the debt host, it should be evaluated to determine whether the feature would meet the definition of a derivative if it were freestanding. An embedded feature would be considered a derivative pursuant to ASC 815 only if all four characteristics of a derivative (discussed in section 2.2.3.4) were met. Typically, a redemption feature would meet all four criteria as outlined below:

- Underlying — The underlying is the fair value of the underlying debt instrument, which is a function of interest rates and credit risk.
- Notional amount — The principal amount of the debt instrument is the notional amount.
- No initial net investment — The fair value of the embedded redemption feature at inception is considered its initial investment (not the initial investment in the convertible debt instrument). That amount is generally less than the fair value of the underlying notes.
- Net settlement — Redemption features are generally physically settled and the underlying notes may or may not be publicly traded. ASC 815-10-15-107 through 15-109 concludes that the potential settlement of the debtor's obligation to the creditor that would occur upon exercise of the put option or call option meets the net settlement criterion because (1) the debtor does not receive an asset when it settles the debt obligation in conjunction with exercise of the put option or call option and (2) the creditor does not receive an asset associated with the underlying, so that "neither party is required to deliver an asset that is associated with the underlying … "

Share settlement features should be carefully evaluated to determine whether they represent redemption features in debt instruments. Refer to section 2.2.4.6 for further discussion on share-settled debt.

In general, redemption features will not qualify for any of the exceptions from derivative accounting in ASC 815. We generally believe this includes scenarios where the call or put premium is received in shares, even if the shares are not readily convertible to cash (since there is a net settlement of the redemption feature on its own). Therefore, if a redemption feature is not considered clearly or closely related to the debt host, the redemption feature will likely require bifurcation from the host debt instrument and will be accounted for in the same manner as a freestanding derivative pursuant to ASC 815, with subsequent changes in fair value recorded in earnings each period.

### 2.2.6 Box D(C) and Boxes D1, D2 and D3 — Evaluating other potential embedded features

A debt instrument may have a variety of features that can affect the timing and amount of future cash flows in a way similar to a derivative. Those features should be evaluated pursuant to the criteria in ASC 815 (discussed in section 2.2.3) to determine if they require bifurcation. A careful analysis of the underlying agreements is necessary to identify all potential features to be evaluated.

While not all instruments have potential embedded derivatives, some of the more common ones observed in practice are contingent interest features, interest make-whole features (which appear more often in convertible debt) and term-extending options.

#### 2.2.6.1 Contingent interest features

Some debt instruments contain features that require additional interest to be paid to the holder if certain events occur (e.g., the issuer fails to file SEC reports or fails to meet certain financial covenants or the price of its common stock exceeds a certain target).

Contingent interest features generally meet the definition of a derivative. If the economic characteristics of a contingent interest feature are not clearly and closely related to those of the debt host instrument, the contingent interest feature requires bifurcation from the host instrument. For example, a contingent interest feature that increases the interest rate on the instrument if the market price of the issuer's common stock falls (or rises) to a specified level should be bifurcated and separately accounted for pursuant to ASC 815 as the underlying (i.e., the issuer's common stock price) is not clearly and closely related to the debt host in a convertible debt instrument.

Another common example of a contingent interest feature is one requiring additional interest on a failure to comply with a debt covenant or in the event of a default, as defined in the debt agreement. Generally, an interest rate that adjusts on the creditworthiness of the issuer is clearly and closely related to a debt host instrument as discussed in ASC 815-15-25-46, which states:

> The creditworthiness of the debtor and the interest rate on a debt instrument shall be considered to be clearly and closely related. Thus, for debt instruments that have the interest rate reset in the event of any of the following conditions, the related embedded derivative shall not be separated from the host contract:
>
> a. Default (such as violation of a credit-risk-related covenant)
>
> b. A change in the debtor's published credit rating
>
> c. A change in the debtor's creditworthiness indicated by a change in its spread over US Treasury bonds

However, some default interest provisions are still required to be bifurcated. The guidance stresses that the default should be a violation of a credit-risk-related covenant and not simply labeled a "default" provision. Many covenants are not directly credit-risk-related. Therefore, the nature of the underlying trigger for the contingent interest should be carefully evaluated.

In some convertible debt instruments, the trigger for the contingent interest is expressed in terms of the market price of the entire hybrid instrument (such as a $120 market price on a $100 par convertible bond). In these instances, although the market price is affected by the interest rate and credit risk of the issuer, it is also affected by the equity share price. In other cases, it may be even more clear that the feature is not clearly and closely related to the debt host, because the contingent interest may be triggered based solely on the issuer's share price (e.g., whenever the share price exceeds 125% of the conversion price).

A contingently convertible debt instrument that provides holders with additional interest equal to the fair value of any dividends received by the holders of the stock into which the instrument may be converted should be analyzed to determine whether this contingent interest feature constitutes an embedded derivative requiring bifurcation under ASC 815. As the underlying (i.e., dividend payments) is not clearly and closely related to the debt host instrument, the other criteria for bifurcation, including the definition of a derivative, should be evaluated. This contingently convertible instrument should also be evaluated as a potential participating security for EPS purposes pursuant to ASC 260. Refer to section 5.2 of our FRD publication, ***Earnings per share***, for further discussion on determining whether a security is a participating security.

While less frequent, some contingent interest features may qualify for an exception to derivative accounting. For example, if a debt instrument required additional interest only if the issuer's sales volume failed to reach a specified threshold, that feature may meet the scope exception in ASC 815-10-15-59(d). If a contingent interest feature is not required to be bifurcated pursuant to ASC 815, interest expense related to the contingent feature generally should be recognized pursuant to the provisions in ASC 470-10-25-3 through 25-4 and 35-4 (refer to section 2.2.6.4 for indexed debt) or ASC 450 depending on the facts and circumstances. Judgment is required when determining whether the trigger is an index or a contingency.

Refer to section 3 of our FRD publication, ***Derivatives and hedging***, for further discussion on embedded derivatives. Also refer to the discussion of contingent interest payments in connection with registration rights agreements in section 5.11.

The following example illustrates the accounting for a contingent interest feature:

**Illustration 2-1: Convertible bonds with a contingent interest feature**

On 1 January 20X4, Company A issues at par a series of convertible bonds with a face amount of $1,000 that mature 31 December 20Y4. The bonds have a yield to maturity of 2% per annum, computed semiannually.

Each $1,000 par value bond is convertible into 10 shares of the issuer's common stock for a conversion price of $100 at any time (assume the conversion option is not bifurcatable).

Beginning 31 March 20X4, if the average market price of Company A's common stock is equal to or greater than 125% of the conversion price of the bonds (i.e., share price is $125) for any 20 out of the last 30 trading days before such date or any 1 January or 1 July thereafter, the coupon rate will be increased to 2.5%.

The contingent interest feature in this example meets the definition of a derivative and is indexed to the value of the common stock, which is not related to the economic characteristics of the debt host. Additionally, this feature is not eligible for the exception in ASC 815-10-15-74(a) used for a conversion option because the contingent interest feature, if freestanding, would not be classified in stockholders' equity as it is settled in cash. Accordingly, the contingent interest feature is considered an embedded derivative that should be bifurcated from the host instrument.

### 2.2.6.2 Interest make-whole features (updated August 2023)

Debt instruments may include an interest make-whole provision, which provides that, in certain circumstances (e.g., early conversion or redemption), the holder will receive an amount that is equal to the present value of the debt's remaining contractual interest cash flows, generally discounted at a specified small spread over the then-current US Treasury rate. This make-whole amount compensates the investor for forgoing future interest payments on the debt after conversion or redemption.

The triggers for those make-whole provisions can vary, but they frequently occur when a conversion or redemption is triggered by either by the passage of time or a change-in-control event. The consideration paid may be in cash or in a variable number of shares equal to the interest make-whole amount, usually at the issuer's option.

For example, assume that a five-year 10% convertible bond contains a conversion option that permits the holder to convert the note into common stock of the issuer at any time after issuance. The bond is callable at any time by the issuer after Year 2 at par plus an amount equal to the then-present value of all the future contractual interest cash flows discounted at the then-current US Treasury rate plus 50 basis points. The indenture also provides that upon conversion the holder receives, in addition to the common shares received for each $1,000 principal amount of the notes, a similarly calculated amount for future interest. The issuer has the option to settle this interest make-whole amount in either cash or shares.

Like a time value make-whole feature (discussed in section 2.2.4.5), the amounts that would be paid under an interest make-whole feature could be presented in a table. However, the amount to be paid under an interest make-whole feature for a given date would typically be the same, regardless of the stock price.

The bifurcation analysis of an interest make-whole feature can be complex and will depend on the terms of the transaction. Following are some considerations:

- When evaluating an interest make-whole feature in conjunction with a redemption event, the amount may be viewed as a premium in connection with the redemption feature and, therefore, should be analyzed as discussed in section 2.2.5.
- When evaluating an interest make-whole feature that is triggered by a conversion event, it may be viewed together with the conversion option as a single unit of analysis. If the feature is viewed as part of the conversion option, the entire conversion option would be bifurcated (assuming all other conditions in paragraph ASC 815-15-25-1 are met). This is because the conversion, including the interest make-whole feature, is not considered indexed to the issuer's stock, since a portion of the settlement amount (the interest make-whole amount) is not indexed to the issuer's stock.

There may be other acceptable views with respect to the unit of analysis. However, that determination requires a significant amount of judgment based on the facts and circumstances. Refer to section 2.2.3.1 for further discussion of unit of analysis considerations for embedded features.

### 2.2.6.3 Term-extension features

Section 2.1.2.3 describes debt with term-extending features. An embedded term extension feature is an embedded feature that unilaterally enables one party to extend significantly the remaining term to maturity or automatically extends the maturity when triggered by a specific event or condition.

Term-extending provisions should be analyzed to determine whether they constitute an embedded derivative. ASC 815-15-25-44 provides that if the instrument's interest rate is not reset to the approximate current market rate for the extended term and the debt instrument initially involved no significant discounts, the feature is not clearly and closely related to the debt host. The other criteria for bifurcation, including the definition of a derivative, should also be evaluated.

Some believe that term-extending options should be viewed similarly to term-shortening options such as calls and puts. For example, some believe there is no difference between 10-year debt that is callable in Year 5 and five-year debt that is extendable for another five years at the same rate. However, the derivatives guidance is clear that the form of the instrument and the term are important in the analysis. ASC 815-15-25-44 addresses only debt hosts, not other hosts such as leases, in which term-extending options are frequently embedded.

### 2.2.6.4 Debt indexed to inflation and other variables (indexed debt)

Indexed debt is described in section 2.1.2.5. Those debt instruments are typically issued with both fixed and contingent payments. The contingent payments are typically indexed to quoted market measures or broad economic statistics, such as prices of commodities (e.g., oil, gold) or indices (e.g., the S&P 500 index). The indexing feature may be a separate freestanding financial instrument.

Indexing features that are not freestanding financial instruments should be analyzed to determine whether they require bifurcation as embedded derivatives pursuant to ASC 815 (as discussed in section 2.2.3). The guidance in ASC 815-15-25-48 and 25-49 generally provide that changes in the fair value of a commodity or an equity security that affect the amount of interest and/or principal payments are not clearly and closely related to a debt instrument. Because these features typically meet the definition of a derivative and generally do not qualify for any exceptions, they are often bifurcated.

Pursuant to ASC 815-15-25-50, inflation-indexed interest payments that are based on the rate of inflation in the economic environment for the currency in which the debt instrument is denominated should be considered clearly and closely related if they are not leveraged (e.g., four times the change in an inflation index times the notional amount). Indexing features based on inflation indices that are not consistent with the currency in which the debt is denominated may represent embedded derivatives requiring bifurcation (e.g., USD-denominated debt that is indexed to the inflation rate in Japan).

If the indexing feature is not freestanding and is not required to be bifurcated as an embedded derivative pursuant to ASC 815 (e.g., because the debt was grandfathered from application of ASC 815's provisions or requires the delivery of a commodity that is not readily convertible to cash), the entire instrument should be accounted for pursuant to ASC 470-10-25-4 and 35-4.

If the indexing feature is a separate freestanding financial instrument that is not subject to derivative accounting pursuant to ASC 815, it should also be accounted for pursuant to ASC 470-10-25-4 and 35-4. That guidance generally provides that when the indexing feature is a separate freestanding financial instrument, the proceeds be allocated between the debt and the separate freestanding indexing feature. The resulting premium or discount on the debt should be amortized over the life of the debt using the effective interest method.

If the index value increases and the issuer would be required to pay the investor a contingent payment at maturity, the issuer should recognize a liability for the amount that the contingent payment exceeds the amount, if any, originally attributed to the indexing feature.

If the indexing feature is embedded in the debt (i.e., not a separate freestanding financial instrument) but bifurcation is not required, the additional liability resulting from the fluctuating index value should be accounted for as an adjustment of the carrying amount of the debt instrument.

The liability for the indexing feature should be based on the applicable index value at the balance sheet date and should not anticipate any future changes in the index value. The guidance does not address how changes in the indexed debt's settlement value should be recorded. We generally believe an increase in the carrying amount of the indexed debt (or the indexing feature that is a separate freestanding financial instrument from the debt) should be recorded in earnings but should not be adjusted below its initial carrying amount.[6]

If the indexing feature is embedded in the debt and bifurcation is required pursuant to ASC 815, the indexing feature should be subsequently measured at fair value with the change in fair value recorded in earnings.

Refer to section 5.1 for a discussion of debt exchangeable into the common stock of another entity.

### 2.2.6.5 Participating mortgages

A participating mortgage entitles the lender to participate in (1) the appreciation in the market value of a mortgaged real estate project and/or (2) the results of operations of the mortgaged real estate project. While the instrument has a provision that entitles the investor to participate in the appreciation of the real estate, bifurcation of this feature is not required because a separate contract with the same terms would be excluded from the scope of ASC 815 based on the exception in ASC 815-10-15-59, given that settlement is based on the value of a nonfinancial asset of one of the parties that is not readily convertible to cash.

ASC 470-30, *Debt — Participating Mortgage Loans*, provides that if a lender is entitled to participate in the appreciation of the market value of a mortgaged real estate project, the fair value of the participation feature at loan inception is recognized as a participation liability, with a corresponding debit to debt discount. The debt discount is then amortized using the interest method. In this case, interest expense consists of all of the following:

- Amounts designated in the mortgage agreement as interest
- Amortization of debt discount related to the lender's participation in the fair value appreciation of the mortgaged real estate project

[6] The SEC staff indicated that if the debt's terms did not provide for settlement below the original principal amount, the change should generally be recorded in the income statement because the substance of the accounting is that of a written option. See remarks by Russell B. Mallett at the Twenty-Third Annual National Conference on Current SEC Developments on 15 February 1996.

At the end of each subsequent reporting period, the balance of the participation liability should be adjusted to equal the current fair value of the participation feature. The corresponding debit or credit should be to the related debt discount account and should be amortized prospectively, using the interest method (i.e., the entire amount of the change in the fair value of the participation feature should not be recognized in the current period income statement).

On the other hand, if a lender is entitled to participate in the results of operations of the mortgaged real estate project, no liability is recognized at inception. Instead, amounts due to a lender pursuant to the lender's participation in the real estate project's results of operations shall be charged to interest expense in the period when incurred, with a corresponding credit to the participation liability. As above, interest expense would also include amounts designated in the mortgage agreement as interest.

In either case, each component of interest expense is eligible for capitalization pursuant to ASC 835-20, *Interest — Capitalization of Interest*. Once these expenses are capitalized, ASC 470-30-35-3 states that the amounts should not be adjusted for the effects of reversals of appreciation.

### 2.2.6.6 Increasing-rate debt

Increasing-rate debt instruments are described in section 2.1.2.9. At initial issuance, the embedded term-extending option of the increasing-rate debt instrument should be analyzed to determine whether it constitutes an embedded derivative that warrants separate accounting as a derivative pursuant to ASC 815. Refer to section 2.2.6.3 for further discussion.

ASC 470-10-35-2 provides that the issuer's periodic interest cost should be calculated using the interest method based on the estimated outstanding term of the debt. In estimating the term of the debt, the issuer considers its plans, ability and intent to service the debt. Debt issuance costs and discounts or premiums associated with the increasing-rate debt should be amortized over the same period used in the interest cost determination.

As discussed in ASC 470-10-45-8, if the debt is paid at par prior to its estimated maturity, any excess interest accrued would be recognized as an adjustment to interest expense and not a part of the gain or loss on extinguishment.

### 2.2.6.7 Debt denominated in a currency other than the issuing entity's functional currency

Debt payable in a foreign currency is initially measured and recorded in the functional currency using the exchange rate at the balance sheet date (i.e., the spot rate). There is no embedded derivative related to the foreign currency denomination pursuant to the exception to derivative accounting in ASC 815-15-15-5. However, if the debt is convertible the conversion option will require bifurcation as discussed in section 2.2.4.9.

### 2.2.6.8 Sales of future revenues (updated September 2024)

A sale of future revenue typically involves an entity receiving an up-front payment from an investor in exchange for granting the investor the right to receive a specified percentage or amount of the future revenue (or other measure of income such as gross margin, operating income or pretax income) of a particular product or service of the entity (e.g., a drug compound the entity intends to develop) for a defined period. While the transaction entitles the investor to cash flows that vary based on the entity's revenues (or other measure of income), bifurcation of this feature generally is not required because a separate contract with the same terms would be excluded from the scope of ASC 815 based on the exception in ASC 815-10-15-59(d). That exception excludes from derivative accounting non-exchange traded contracts where settlement is based on a specified volume of sales or service revenues of one of the parties to the contract.

Whether the up-front payment received from the investor should be classified as debt or deferred income depends on the specific facts and circumstances. ASC 470-10-25-2 provides a number of factors to be considered. Pursuant to that guidance, the presence of any one of the following factors independently creates a rebuttable presumption that debt classification is appropriate:

- The transaction does not purport to be a sale (that is, the form of the transaction is debt).
- The entity has significant continuing involvement in the generation of the cash flows due to the investor (for example, active involvement in the generation of the operating revenues of a product line, subsidiary or business segment).[7]
- The transaction is cancelable by either the entity or the investor through payment of a lump sum or other transfer of assets by the entity.
- The investor's rate of return is implicitly or explicitly limited by the terms of the transaction.
- Variations in the entity's revenue or income underlying the transaction have only a trifling effect on the investor's rate of return.
- The investor has any recourse to the entity relating to the payments due to the investor.

ASC 470-10-35-3 requires amounts recorded as debt to be amortized under the interest method as described in ASC 835-30. Accordingly, an entity would need to determine an effective interest rate based on future revenue streams expected to be paid to the investor. This rate represents the discount rate that equates estimated cash flows with the initial proceeds received from the investor and is used to compute the amount of interest expense to be recognized each period. When there is a change in estimated cash flows from future revenue, depending on the facts and circumstances, we generally believe that the following approaches may be appropriate to address those changes:

- Retrospective method — A new effective interest rate is calculated based on the original carrying amount, cash flows to date and the revised estimate of remaining cash flows. This new discount rate is then used to adjust the carrying amount of the debt to the present value of the revised estimated cash flows, discounted at the new effective interest rate. The offset is recognized in earnings. This method would result in an immediate adjustment to the carrying amount of the debt whenever the expected cash flows are updated.
- Catch-up method — After a change in estimated cash flows, the entity would adjust the carrying amount to the present value of the revised estimated cash flows, discounted at the original effective interest rate. The offset to the adjustment is recognized in earnings. While this method would result in an immediate adjustment to the carrying amount of the debt whenever the expected cash flows are updated, it maintains a constant effective yield throughout the life of the instrument.
- Prospective method — A new effective interest rate is determined based on the revised estimate of remaining cash flows. The new rate is the discount rate that equates the present value of the revised estimate of remaining cash flows with the carrying amount of the debt, and it will be used to recognize interest expense for the remaining periods. Under this method, the effective interest rate is not constant, and any change in expected cash flows is recognized prospectively as an adjustment to the effective yield. Unlike the other methods, changes in expected cash flows aren't recognized immediately in earnings.

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[7] At the 1997 AICPA Conference on Current SEC Developments, SEC staff member, Armando Pimentel, said, "The significant continuing involvement criteria appears very difficult to overcome in many cases. That is because the seller of the item generally continues to be involved in the marketing, promotion, or direct generation of the asset's cash flows. For example, if the seller continues to market and promote the asset, in order to preserve or improve the future cash flows to the investor, then the transfer would meet this rebuttable presumption."

We generally believe that a sale of future revenues classified as debt under ASC 470-10-25-1 through 25-2 should not be subsequently adjusted below the initially recognized amount until one of the conditions in ASC 405-20-40-1 is met (or the arrangement is subsequently modified or exchanged in such a way that the terms are substantially different under ASC 470-50) and, therefore, derecognition is appropriate. Refer to section 2.5 for the guidance on debt extinguishment.

The following example illustrates how the guidance in ASC 470-10-25 may be applied to a sale of future royalty payments:

**Illustration 2-2: Sale of future royalty payments**

On 1 January 20X0, Bio Tech A, a biotechnology company, entered into a license agreement granting an exclusive license to Pharma B to develop and commercialize a drug. Under the agreement, Pharma B is responsible for all costs relating to development and commercialization. In return for granting the license, Bio Tech A will receive 3% of the revenue from any of Pharma B's future sales of the drug (the royalty payments).

Bio Tech A determined that the license agreement is a contract with a customer accounted for under ASC 606. In accordance with the guidance, Bio Tech A does not recognize revenue or an asset (receivable) at inception of the agreement because of the constraints under the variable consideration guidance. Instead, Bio Tech A will recognize revenue as the royalty payments are received. For more information on accounting for revenue from contracts with customers, refer to our FRD publication, ***Revenue from contracts with customers (ASC 606)***.

On 1 January 20X5, Bio Tech A enters into a royalty purchase agreement with Investor C under which Bio Tech A receives $100 million in cash from Investor C up front. In return, Investor C receives the future royalty payments Bio Tech A is entitled to receive from Pharma B for sales of the drug from 1 January 20X5 through 31 December 20X9. The total royalty payments Investor C is entitled to receive from Bio Tech A cannot exceed $150 million over the term of the agreement.

Bio Tech A first evaluates whether the royalty purchase agreement should be accounted for as a derivative under ASC 815. Because the contract involves an underlying based on the specified volume of sales of one of the parties to the contract (i.e., Bio Tech A's royalty revenue), the company concludes that, while the contract meets the definition of a derivative, it would also qualify for the scope exception in ASC 815-10-15-59(d). As a result, the contract would not be accounted for as a derivative.

Bio Tech A further evaluates and concludes that the $100 million up-front payment received from Investor C on 1 January 20X5 should be classified as debt under ASC 470-10-25-2, rather than deferred income, because the transaction meets one or more of the rebuttable presumptions for debt classification (e.g., Investor C's return is explicitly limited due to the $150 million cap).

On 1 January 20X5, Bio Tech A records the following entry:

| | | |
|---|---|---|
| Cash | $ 100,000,000 | |
| Debt | | $ 100,000,000 |

Bio Tech A estimates the royalty payments it will receive from Pharma B and pay to Investor C during the term of the royalty purchase agreement as follows. It expects the cumulative royalty payments it will pay Investor C to exceed $150 million in 20X9. That is, while Bio Tech A expects to receive $55 million in royalties in 20X9, it will only pay $45 million to Investor C under the terms of the royalty purchase agreement.

| | Estimated cash outflows | Cash Inflow |
|---|---|---|
| 1 Jan 20X5 | | $ 100,000,000 |
| 31 Dec 20X5 | $ (15,000,000) | |
| 31 Dec 20X6 | (20,000,000) | |
| 31 Dec 20X7 | (30,000,000) | |
| 31 Dec 20X8 | (40,000,000) | |
| 31 Dec 20X9 | (45,000,000) | |
| Total cash flows | $ (150,000,000) | $ 100,000,000 |

Bio Tech A applies the effective interest method under ASC 835-30 and determines that the initial effective interest rate is 12.55%, which is the rate that equates the estimated future payments to Investor C under the royalty purchase agreement to the $100 million initial proceeds received from Investor C. This rate is used to compute the amount of interest expense that Bio Tech A will recognize under the royalty agreement each period based on the estimated cash flows.

Subsequently, the company will estimate the future cash flows for the remaining term at each year end and recalculate the effective interest rate to be used in the future periods.

The following table presents the cash flows estimated at inception, debt amortization and interest expense for each year, and the carrying amount of the debt at each year end (assuming the estimated cashflows do not change in subsequent periods):

| Date* | Cash inflow (outflow) | Debt amortization | Interest expense | Carrying amount |
|---|---|---|---|---|
| 1 Jan 20X5 | $ 100,000,000 | | | $ 100,000,000 |
| 31 Dec 20X5 | (15,000,000) | $ (2,449,467) | $ 12,550,533 | 97,550,533 |
| 31 Dec 20X6 | (20,000,000) | (7,756,888) | 12,243,112 | 89,793,645 |
| 31 Dec 20X7 | (30,000,000) | (18,730,419) | 11,269,581 | 71,063,227 |
| 31 Dec 20X8 | (40,000,000) | (31,081,186) | 8,918,814 | 39,982,041 |
| 31 Dec 20X9 | (45,000,000) | (39,982,041) | 5,017,959 | – |

* For simplicity, assume that Bio Tech A records the annual interest accrual and discount amortization on 31 December.

On 31 December 20X5, Bio Tech A records interest expense and debt amortization as follows:

| | | |
|---|---|---|
| Interest expense | $ 12,550,533 | |
| Debt | 2,449,467 | |
| Cash | | $ 15,000,000 |

Bio Tech A also reassesses the estimated remaining future cash flows and determines there is no change to the estimated cash flows at inception.

On 31 December 20X6, Bio Tech A records interest expense and debt amortization using the amounts in the table above. In addition, it determines that the royalty payments it expects to receive from Pharma B are less than it originally estimated. The revised estimated cash outflows are:

| | Revised estimated cash outflows |
|---|---|
| 31 Dec 20X7 | (27,000,000) |
| 31 Dec 20X8 | (35,000,000) |
| 31 Dec 20X9 | (40,000,000) |
| Total cash flows | $ (102,000,000) |

Bio Tech A elects to apply the prospective method to account for the change in estimated future cash flows. Under this method, Bio Tech A determines a new effective interest rate based on its revised estimate of remaining cash flows and the current carrying amount of the debt ($89,793,645 as of 1 Jan 2027), resulting in a new effective interest rate of 6.23%.

The following table presents the revised estimated cash flows as of 1 Jan 2027, debt amortization and interest expense for each year, and the carrying amount of the debt at each year end (assuming the estimated cashflows do not change in subsequent periods):

| Year | Cash inflow (outflow) | Debt amortization | Interest expense | Carrying amount |
|---|---|---|---|---|
| 1 Jan 20X7 | | | | $ 89,793,645 |
| 31 Dec 20X7 | (27,000,000) | $ (21,403,243) | $ 5,596,757 | 68,390,403 |
| 31 Dec 20X8 | (35,000,000) | (30,737,288) | 4,262,712 | 37,653,115 |
| 31 Dec 20X9 | (40,000,000) | (37,653,115) | 2,346,885 | – |

On 31 December 20X7, Bio Tech A records interest expense and debt amortization as follows:

| | | |
|---|---|---|
| Interest expense | $ 5,596,757 | |
| Debt | 21,403,243 | |
| Cash | | $ 27,000,000 |

Bio Tech A also determines that there is no change in the estimated remaining future cash flows for 20X8 and 20X9. As a result, Bio Tech A records interest expense and discount amortization using the respective amounts in the table above on 31 December 20X8 and 31 December 20X9.

At 31 December 20X9 (the maturity date), no balance remains outstanding. The cumulative amount of interest expense recognized through 31 December 20X9 is $37 million, which is the excess of the $137 million* paid by Bio Tech A to Investor C under the royalty agreement over the $100 million up-front payment made by Investor C to Bio Tech A.

* Calculated as the sum of the annual royalty payments of $15 million, $20 million, $27 million, $35 million and $40 million.

## 2.2.7 Box E — Bifurcation of a single embedded derivative

ASC 815-15-25-7 through 25-10 does not permit an entity to account separately for more than one derivative feature embedded in a single hybrid instrument. As a result, after identifying, evaluating and concluding on which features of a debt instrument (e.g., conversion option, redemption features, other embedded features) require bifurcation, a single derivative comprising all the features requiring bifurcation should be separated from the debt host instrument. This unit of account for bifurcation may be different than the unit of analysis for bifurcation that is discussed in section 2.2.3.1.

ASC 815-15-30-2 requires the embedded derivative (whether a single feature derivative or a compound derivative) to be recorded at fair value. The difference between the proceeds allocated to the hybrid debt instrument (refer to section 1.2.3.3) and the fair value of the bifurcated derivative is assigned to the host debt instrument.

Refer to section 3 of our FRD publication, ***Derivatives and hedging***, for further guidance on embedded and compound derivatives, including those described in this section.

### 2.2.7.1 Option-based embedded derivatives

ASC 815-15-30-6 states that the terms of an option-based embedded derivative should not be adjusted to result in the embedded derivative being at the money at the inception of the hybrid instrument. Rather, the option-based embedded derivative should be bifurcated based on the stated terms documented in the hybrid instrument whether the option is in the money, at the money, or out of the money at inception.

#### 2.2.7.2 Forward-based embedded derivatives

ASC 815-15-30-4 states that in separating a non-option (forward-based) embedded derivative from the host contract, the terms of that non-option embedded derivative should be determined in a manner that results in its fair value generally being equal to zero at the inception of the hybrid instrument.

For example, a loan and an embedded derivative can be bundled in a structured note that could have almost an infinite variety of stated terms all possessing the same economics. Therefore, it would be inappropriate to necessarily attribute significance to every one of the note's stated terms in determining the terms of the non-option embedded derivative. If a non-option embedded derivative has stated terms that are off-market at inception, that amount is quantified and allocated to the host contract because it effectively represents a borrowing. This concept is illustrated at ASC 815-15-55-160.

#### 2.2.7.3 Financial statement classification

While ASC 815 does not specifically address the classification of embedded derivatives (i.e., on the balance sheet and classification in the statement of operations), the SEC staff[8] shared the following example in comments made at the 2000 AICPA National Conference on Current SEC Developments:

> An entity issued a debt obligation with an interest rate that was indexed to the S&P 500. Since this embedded equity derivative was not considered clearly and closely related to the debt host, the equity derivative was measured at fair value separate from the debt obligation. The host debt contract was accounted for in accordance with generally accepted accounting principles applicable to debt instruments. While measured separately, the embedded derivative and the host contract together will result in principal and interest payments to the debt holder. The company asked if the embedded derivative could be netted with the host contract for financial statement presentation purposes. In this case, the staff believes presenting the embedded derivative and the host contract on a combined basis is an appropriate presentation of the company's overall future cash outflows for that debt instrument as the requirements in US GAAP for legal right of offset would be met. The staff believes Statement 133's bifurcation requirements for embedded derivatives do not extend beyond measurement to presentation in the financial statements.

As a result of the SEC staff comments, practice has generally combined the presentation of a bifurcated embedded derivative with the host contract, but the individual facts and circumstances should be considered. The disclosures in ASC 815 are required for bifurcated embedded derivatives.

### 2.2.8 Box F — Non-bifurcated features and conversion options

An individual feature that does not require bifurcation remains embedded in the debt instrument. However, if that embedded feature were a conversion option, separate accounting as an equity component may be required if the debt was issued at a substantial premium.

### 2.2.9 Boxes G and H — Debt issued at a substantial premium where the conversion option is not accounted for separately

If the conversion feature does not require bifurcation as an embedded derivative (Box D), the convertible debt should be classified and measured pursuant to the guidance for convertible debt in ASC 470-20.

ASC 470-20-25-13 states that when convertible debt is issued at a substantial premium, there is a presumption that the premium represents paid-in capital. Therefore, part of the debt proceeds equal to the premium amount should be classified as APIC.

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[8] See remarks by E. Michael Pierce at the Twenty-Eighth Annual National Conference on Current SEC Developments on 4 December 2000.

Convertible debt may be issued at a premium because the proceeds received upon issuance exceed the principal amount that will be paid at maturity. As another example, when a convertible debt is assumed by an acquirer in a business combination, ASC 805 requires the acquirer to measure the debt at fair value on the acquisition date. If the fair value of the convertible debt exceeds the par amount, it gives rise to a premium.

The authoritative guidance does not define the term "substantial premium." In accounting for debt modifications, ASC 470-50-40-10 states that debt is substantially different when there is at least a 10% difference in the present value of cash flows. Analogizing to that guidance, a premium (based on the net proceeds allocated to the debt instrument) that is approximately 10% or more of the principal amount of the note, might be considered substantial. However, in some cases a premium of less than 10% might still be considered substantial. For example, a premium of less than 10% might be substantial if an entity would recognize negative interest expense for convertible debt under the traditional model, which requires amortization of premiums (i.e., the amortization of the premium exceeds the contractual coupon interest expense).

Further analysis will also be required when a convertible debt instrument has other features that could affect the determination of whether debt is issued at a substantial premium. We generally believe that if there are any embedded derivatives that are bifurcated and could be separately settled before or at conversion (e.g., interest make-whole features), an issuer should adjust the proceeds it uses to determine whether a substantial premium exists. That is, the issuer should reduce the proceeds it initially allocated to the convertible debt by the fair value of the bifurcated embedded derivative and use the lower amount to determine whether the conversion feature resulted in a substantial premium. For example, assume a five-year convertible bond that is issued at 110% of par contains an interest make-whole in the event of conversion. The interest make-whole, which has a fair value of 7% of par, is concluded to be an embedded derivative that should be bifurcated. After bifurcating the interest make-whole feature, the bond would be valued at 103% of its par value, and the issuer would likely conclude that the convertible debt is not issued at a substantial premium.

When considered substantial, the entire premium is typically allocated to paid-in capital, based on ASC 470-20-25-13, which states that "such premium represents paid-in capital." There is no specific guidance on how to overcome the presumption in ASC 470-20-25-13 that the premium associated with debt issued at a substantial premium should be allocated to paid-in capital. That determination should be based on the specific facts and circumstances (e.g., stated interest rate was higher than the market rate despite a conversion option or another embedded feature significantly increased the fair value of the debt).

Issuers of convertible preferred shares that are classified as liabilities under ASC 480-10 should also apply the guidance in ASC 470-20. That is, they will evaluate whether the conversion feature needs to be accounted for separately under the substantial premium model if the feature is not required to be bifurcated under ASC 815.

### 2.2.10 Box I — No accounting is required for the conversion option

If the conversion feature does not require bifurcation as an embedded derivative (Box E), and the convertible debt was not issued at a substantial premium (Box G), ASC 470-20-25-12 states that all of the proceeds received from the issuance of convertible debt should be recorded as a liability on the balance sheet. That is, no portion of the proceeds from issuing convertible debt instruments should be attributed to the conversion feature at inception.

### 2.2.11 Box J — Temporary equity classification of the equity component separated from convertible debt

If a convertible debt instrument has a portion of its proceeds allocated to an equity component (e.g., substantial premium that is classified in equity pursuant to ASC 470-20), paragraphs 3(e), 12(d), 16(d) and 23 of ASC 480-10-S99-3A should be considered to determine whether a portion of the equity component should be classified in temporary equity.

Refer to sections C.2.9, C.3.1 and C.7 for further discussion of these concepts.

## 2.3 Costs and fees incurred upon debt issuances

ASC 835 requires entities to capitalize debt issuance costs paid to third parties (e.g., legal fees, printing costs, underwriters' fees) that are directly related to issuing debt and that otherwise wouldn't be incurred. Internal costs that meet the incremental and direct criteria (e.g., travel costs directly related to financing) may also be deferred, but costs such as salaries, rent and other period costs cannot be capitalized as issuance costs.

Amounts paid to the lender are a reduction in the proceeds received by the issuer and are considered a component of the discount on the issuance and not an issuance cost.

In some cases, fees paid to the lender may be compensation for services beyond their role as a creditor. For example, a loan syndication involving multiple lenders will generally be arranged by an investment bank that typically also assumes a role as a lender. Because of this dual role, fees paid to the investment bank may represent compensation for its role in arranging the syndication, its role as a lender, or both. Based on the individual facts and circumstances, the issuer should determine whether a portion of the fees paid to the lender should be properly identified and accounted for as a debt issuance cost. This distinction is important because fees paid to the lender and debt issuance costs are often treated differently. For example, fees paid to the lender and debt issuance costs are treated differently in accounting for debt modifications and extinguishments in ASC 470-50.

Direct and incremental costs may also be incurred when debt is issued and (1) a derivative is required to be bifurcated (e.g., bifurcated conversion option) or (2) another separate freestanding financial instrument (e.g., warrant) is also issued. There is no specific guidance on how such costs should be allocated between a debt instrument and a bifurcated derivative or separately issued freestanding financial instrument. We generally believe a systematic and rational approach based on the facts and circumstances should be applied.

Under one approach, all of the costs might be attributed to the debt instrument as those costs were primarily incurred to obtain debt financing. Under another approach costs might be allocated to the instruments issued (or bifurcated) in proportion to the allocation of proceeds or the relative amount of total costs that would have been incurred if each instrument were issued separately. Regardless of which method is used, it should be applied consistently.

Debt issuance costs should generally be amortized and recognized as additional interest expense over the life of the debt instrument using the effective interest method pursuant to ASC 835-30-35-2 through 35-3, including debt instruments that are convertible or callable. Refer to section 2.4.3.1 for a general discussion of the amortization of debt issuance costs, including estimating the life of a debt instrument (when appropriate).

When some portion of the costs are allocated to a bifurcated derivative or freestanding financial instrument that is being subsequently measured at fair value, those allocated costs would be expensed immediately. Debt issuance costs incurred in connection with debt that is measured at fair value pursuant to the election of the fair value option should be expensed.

ASC 340-10-S99-2 provides guidance on the accounting for debt issuance costs related to a bridge financing. It requires fees paid to the same underwriter for providing interim financing (i.e., bridge financing) and underwriting services in connection with a business combination to be allocated between direct costs of the acquisition and debt issuance costs on a relative fair value basis. That guidance provides that the debt issuance costs should be amortized over the expected life of the bridge financing without considering the expected life of the permanent financing. When the bridge financing is repaid, any unamortized issuance costs should be expensed.

## 2.3.1 Presentation of debt issuance costs

ASC 835-30-45-1A requires entities to present debt issuance costs related to a recognized liability on the balance sheet as a direct deduction from that liability rather than as an asset, consistent with the presentation of a debt discount.

Cash payments for debt issuance costs should be classified in the statement of cash flows as a financing activity pursuant to ASC 230-10-45-15(e).

### 2.3.1.1 Debt issuance costs related to revolving credit arrangements

Entities may incur debt issuance costs before a liability is recognized or when costs are incurred in securing a line of credit or a revolving credit arrangement (hereafter referred to as revolving credit arrangements) that has not been drawn. Furthermore, revolving credit arrangements often have balances that fluctuate as entities borrow and repay amounts.

Entities typically view costs in securing a revolving credit arrangement to be associated with the overall credit facility, not related to any specific draw. Therefore, presenting the costs as a reduction to a specific draw does not reflect the economic substance of the costs incurred.

ASC 835-30-S45-1 states that the SEC staff will not object to an entity presenting the cost of securing a revolving credit arrangement as a deferred asset, regardless of whether a balance is outstanding.

An entity that repeatedly draws on a revolving credit arrangement and then repays it could present the debt issuance costs as a deferred asset initially and reclassify all or a portion of them as a direct deduction from the liability whenever a balance is outstanding. The SEC staff's guidance provides a less cumbersome alternative.[9] Either way, the costs should be amortized over the term of the arrangement using an appropriate interest method, in part, based on the provisions in ASC 470-50-40-21.

The SEC staff's guidance does not affect the presentation of costs incurred before an associated liability is recognized in other situations. For example, an entity may incur costs to secure a term debt credit facility where the entity does not have outstanding borrowings at inception. In these situations, we generally believe entities should present the costs as a deferred asset initially and reclassify all or a portion of them as a direct deduction from the liability when all or a portion of the term loan is issued.

We generally believe it is not appropriate to present debt issuance costs as a contra-liability when there is no associated debt liability (e.g., before amounts are drawn from a revolving credit arrangement).

## 2.3.2 Fees paid to lenders

Fees paid to lenders on the issuance of debt are considered part of debt discount and presented in the balance sheet as a direct deduction from the carrying amount of the related debt. Debt discounts or premiums are amortized into interest expense using the effective interest method pursuant to ASC 835-30-35-2 through 35-3. Refer to section 2.4.3.1 for a general discussion of the amortization of debt issuance costs, premiums or discounts.

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[9] While the SEC staff's guidance addresses public entities, we generally believe that nonpublic entities can also apply this guidance.

An entity may also pay a lender fees to secure a term debt credit facility where the entity does not have outstanding borrowings at inception. Similar to debt issuance costs, we generally believe that in these situations entities should initially present the fees paid to lenders as a deferred asset and reclassify all or a portion of them as a direct deduction from the liability when all or a portion of the term loan is issued.

In addition, while the guidance in ASC 835-30-S45-1 only addresses the presentation of debt issuance costs (i.e., costs paid to third parties) associated with revolving credit arrangements, we generally believe an entity may also apply the SEC staff's guidance to fees directly paid to lenders to secure these arrangements and present those amounts as a deferred asset on the balance sheet, regardless of whether a balance is outstanding.

**Illustration 2-3: Lender fees related to term debt and a revolving credit arrangement**

On 1 January 20X1, Company A (borrower) enters into a credit facility with Bank B (lender) that allows Company A to borrow up to $10 million in term debt at a stated interest rate of 10% over a period of five years. The credit facility also has a $5 million revolving credit arrangement with the same terms as the term debt. Company A pays the lender a fee of $150,000 up-front to secure the credit facility.

Company A allocates the fee proportionally between the term debt and the line-of-credit arrangement, with $100,000 allocated to the term loan and $50,000 allocated to the revolving credit arrangement. Since Company A has not drawn any amount under the facility, it initially records the entire $150,000 as a deferred charge (i.e., asset) and amortizes the amount over the life of the credit facility.

On 1 February 20X1, Company A borrows the entire $10 million under the term loan arrangement and reclasses the remaining unamortized deferred asset related to the term loan of $98,333 as a reduction from the carrying amount of the liability recognized. Company A will amortize the $98,333 using the effective interest method over the remaining life of the term loan.

For the revolving credit arrangement, Company A has elected a policy to keep the allocated amount as an asset, regardless of whether an amount is drawn. As of 1 February 20X1, the remaining unamortized deferred asset related to the revolving credit arrangement is $49,167, which will be amortized over the remaining life of the line-of-credit arrangement.

## 2.4 Subsequent accounting and measurement

### 2.4.1 General

This section includes guidance for subsequent accounting and measurement of debt instruments for which the fair value option is elected as well as subsequent accounting for premium, discounts, debt issuance costs and embedded features.

### 2.4.2 Debt instruments for which the fair value option is elected

As discussed in section 2.2.1, entities may elect to measure debt at fair value (the fair value option) in certain situations. Fair value should be determined pursuant to ASC 820. ASC 825-10 requires that changes in the fair value of financial liabilities (e.g., debt) measured using the fair value option that are caused by changes in instrument-specific credit risk be presented separately in other comprehensive income (OCI). This requirement does not apply to derivative liabilities since they are required to be measured at fair value in accordance with ASC 815.

For simple (e.g., non-hybrid) financial liabilities, an entity may consider the change in fair value caused by a change in instrument-specific credit risk to be the difference between the total change in the fair value of the instrument and the amount resulting from a change in a base market rate (e.g., a risk-free interest rate such as the US Treasury rate, a benchmark interest rate such as SOFR). However, an entity may use

another method that it believes results in an amount that faithfully represents the portion of the total change in fair value attributable to a change in instrument-specific credit risk. Entities should apply the method consistently to each financial liability from period to period. This guidance applies, regardless of whether an entity has designated a financial liability under the fair value option in accordance with ASC 825[10] or ASC 815-15.

For hybrid financial liabilities, where the change in fair value of the financial instrument may be affected by factors other than interest and credit, questions arose about whether it is appropriate to apply the base-rate method described above. For example, consider a financial liability whose cash flows are indexed to an external index (e.g., S&P 500, gold). For that instrument, the difference between the total change in fair value of the instrument and the component of the change in fair value of the financial instrument attributable to changes in the risk-free or benchmark rate will be affected by changes in the external index and would not solely represent the change in fair value attributable to instrument-specific credit risk.

At the 2016 AICPA National Conference on Current SEC and PCAOB Developments, a member of the SEC staff[11] provided perspectives on this and other aspects on the measurement of instrument-specific credit risk for certain types of financial liabilities in which the fair value option has been elected. The SEC staff member discussed the application of the presentation guidance to a hybrid financial liability that consists of a debt obligation indexed to the price of gold that requires cash settlement and noted:

> "The fair value of the hybrid financial liability will be impacted, in part, by the price of gold. In this circumstance, I do not believe application of the base rate method will faithfully represent the portion of the total change in fair value resulting from instrument-specific credit risk. The takeaway in this scenario is that application of the base rate method may not be appropriate in all circumstances. As the terms of a financial liability become more complex, more judgment is needed to determine if an alternative method is required."

The SEC staff member also provided perspectives on the application of the presentation guidance to nonrecourse financial liabilities for which payments are tied solely to the value of cash flows of assets pledged as collateral:

> "… consider a financial liability for which the payment is solely tied to the value or cash flows of an asset pledged as collateral. That is, there is no recourse to the debtor. The risk of nonpayment, and the corresponding changes in the financial liability's fair value, will be directly impacted by the risk that the underlying asset will perform poorly (or not at all). In this fact pattern, I believe that no portion of the total change in the financial liability's fair value would be attributable to instrument-specific credit risk. Instead, the financial liability's fair value will be solely tied to the risks inherent in the specific asset pledged as collateral. Therefore, I would expect all changes in the financial liability's fair value to be reported in earnings."

Upon derecognition of a financial liability, the accumulated gains and losses due to changes in instrument-specific credit risk are reclassified from OCI to net income.

#### 2.4.2.1 Debt with an inseparable third-party credit enhancement that is measured at fair value for accounting or disclosure purposes

Liabilities are often issued with credit enhancements obtained from a third party. In many circumstances, the issuer purchases a guarantee from a third party that requires the third party to make payments on the issuer's behalf in the event the issuer fails to meet its payment obligations. If the guarantor is required to make payments, the issuer becomes obligated to the guarantor for such payments.

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[10] ASC 825-10-45-5.

[11] Brian Staniszewski, 2016 — Refer to the SEC website at **https://www.sec.gov/news/speech/staniszewski-2016-aicpa.html**.

When permitted under other US GAAP, issuers of debt with an inseparable third-party credit enhancement may elect to subsequently measure the debt at fair value. For those issuers, the "Liabilities Issued with an Inseparable Third-Party Credit Enhancement" guidance under the subtopics in ASC 825 requires that those liabilities be measured at fair value on a recurring basis excluding the effect of the credit enhancement. This guidance also applies for the disclosures (pursuant to ASC 825-10-25) for those issuers who did not elect the fair value option.

Refer to section 5.15 for further discussion of these instruments.

## 2.4.3 Debt instruments for which the fair value option is not elected

If debt is not subsequently measured at fair value (e.g., the fair value option was not elected), the amount recorded is classified as a liability and generally accreted or amortized to par. The subsequent accounting for indexed debt is different, as discussed in section 2.2.6.4.

Subsequent changes in market interest rates or the issuer's credit rating are generally not considered, but the carrying amount of debt may be adjusted for hedge accounting pursuant to ASC 815 or foreign currency transaction gains or losses pursuant to ASC 830.

Other features of an instrument or units of account that should be considered include:

- Premiums, discounts and deferred debt issuance costs (section 2.4.3.1)
- Paid-in-kind (PIK) interest (section 2.4.3.2)
- Embedded features not bifurcated from the host debt instrument (section 2.4.3.3)
- Embedded features bifurcated from the host debt instrument as a derivative and classified as an asset or liability (e.g., conversion options, certain term-extending options and certain contingent interest features) (section 2.4.3.4)
- Embedded conversion features separated from the host debt instrument and classified as a component of equity (section 2.4.3.5)
- Debt payable in a currency other than the issuing entity's functional currency (refer to section 1.1.2 of our FRD publication, ***Foreign currency matters***, for further guidance)

### 2.4.3.1 Premiums, discounts and debt issuance costs

Debt may be issued either at par, a discount or a premium. Debt premiums or discounts may arise for several reasons, including the following:

- A difference between the market rate of interest upon issuance and the contractual rate of interest specified in the instrument (e.g., issuing debt with a stated coupon of 6% when the market yield for a debt instrument with similar terms and similar risks is 8%, resulting in initial proceeds of less than par to compensate investors for the lower coupon return)
- Allocating proceeds to multiple instruments upon issuance (e.g., when debt is issued with detachable warrants and the proceeds are allocated between the two elements)
- Bifurcating embedded derivatives in accordance with ASC 815 (e.g., certain put/call features or contingent interest)

If debt is issued between coupon payment dates, as a matter of convenience the investor may pay an amount equal to the interest accrued to the issuance date to facilitate the issuer simply making a full coupon payment at the next interest payment date. This amount does not represent a premium.

A discount or premium is not an asset or liability separable from the associated debt instrument. Rather, the premium or discount is reported in the balance sheet as an adjustment to the carrying amount of the debt liability and not presented as a deferred charge or deferred credit, pursuant to ASC 835-30-45-1A. Debt discounts or premiums and debt issuance costs are amortized into interest expense using the effective interest method pursuant to ASC 835-30-35-2 through 35-3.

Prepayment and other features (e.g., put option held by the creditor) may result in the amortization period being shorter than the instrument's stated contractual life. Costs incurred to secure lines of credit or revolving credit arrangements are generally deferred and amortized over the life of the line-of-credit or revolving credit arrangement using an appropriate interest method based, in part, on the provisions in ASC 470-50-40-21.

#### *2.4.3.1.1 Effective interest method*

Application of the effective interest method results in the recognition of interest expense equal to a constant rate of interest that is applied to the carrying amount of the debt at the beginning of each period (i.e., the outstanding face amount less any unamortized discount plus any unamortized premium less deferred issuance costs).

Other methods of amortization may be used if the results obtained are not materially different from the results under the effective interest method, as stated in ASC 835-30-35-4.

ASC 835-30-35-5 states that the amounts chargeable to interest expense under the guidance in ASC 835-30, which includes the amortization of any premiums or discounts, is eligible to be capitalized pursuant to ASC 835-20.

**Illustration 2-4 Applying the effective interest method to debt issued at a discount**

On 1 January 20X2, ABC Co. issues $100 million of debt for cash proceeds of $97 million. Each $1,000 par value note bears a fixed interest rate of 5% payable annually on 31 December. The entire principal amount is due at maturity on 31 December 20Y2 (10 years).

ABC Co. concludes that there are no embedded features that require bifurcation. In addition, for purposes of this illustration, assume that there are no debt issuance costs.

*Recognition and initial measurement*

On 1 January 20X2, ABC Co. records the following entry for its issuance of debt:

| | | |
|---|---|---|
| Cash | $ 97 million | |
| Debt discount | 3 million | |
| Debt | | $ 100 million |

*Subsequent measurement*

ABC Co., a calendar year-end reporting entity, applies the effective interest method to amortize the debt discount through interest expense each period. ABC Co. determines that the effective interest rate for the debt is 5.396% and applies this constant rate to the carrying amount of the debt (i.e., the outstanding face amount less any unamortized discount) as of the beginning of each period to recognize the interest expense for the period.

The following table presents the contractual cash flow, discount amortization and interest expense for each year, and the carrying amount of the debt at each year end (i.e. face amount less unamortized discount).

| Date* | Contractual cash flow | Discount amortization | Interest expense | Carrying amount at 31 December |
|---|---|---|---|---|
| 1 Jan 20X2 | $97,000,000 | | | $ 97,000,000 |
| 31 Dec 20X2 | (5,000,000) | $ (234,140) | $ 5,234,140 | 97,234,140 |
| 31 Dec 20X3 | (5,000,000) | (246,774) | 5,246,774 | 97,480,914 |
| 31 Dec 20X4 | (5,000,000) | (260,090) | 5,260,090 | 97,741,005 |
| 31 Dec 20X5 | (5,000,000) | (274,125) | 5,274,125 | 98,015,129 |
| 31 Dec 20X6 | (5,000,000) | (288,917) | 5,288,917 | 98,304,046 |
| 31 Dec 20X7 | (5,000,000) | (304,507) | 5,304,507 | 98,608,553 |
| 31 Dec 20X8 | (5,000,000) | (320,938) | 5,320,938 | 98,929,491 |
| 31 Dec 20X9 | (5,000,000) | (338,256) | 5,338,256 | 99,267,746 |
| 31 Dec 20Y1 | (5,000,000) | (356,508) | 5,356,508 | 99,624,225 |
| 31 Dec 20Y2 | (105,000,000) | (375,745) | 5,375,745 | – |

On 31 December 20X2, ABC Co. records the interest expense and discount amortization as follows:

| | | |
|---|---|---|
| Interest expense | $ 5,234,140 | |
| Cash | | $ 5,000,000 |
| Debt discount | | 234,140 |

* For simplicity, assume that ABC Co. records the annual interest accrual and discount amortization on 31 December.

Each subsequent year, ABC Co. records interest expense and discount amortization using the amounts in the table until the debt's maturity date. At 31 December 20Y2 (the maturity date), the $100 million principal balance is repaid. The cumulative amount of interest expense is $53 million, composed of $50 million of contractual interest and $3 million of discount amortization.

### *2.4.3.1.2 Determining the expected life of a debt instrument*

For perpetual debt, which is described in section 2.1.2.8, interest expense is typically recognized based on an assumption of the life of the instrument. For other debt instruments, pursuant to ASC 835-30-35-2, initial issuance premiums, discounts and costs are generally amortized over the contractual life of a debt contract. However, entities need to evaluate the amortization period when a debt contract includes substantive embedded features, such as investor put options. We generally believe that amortization to the first put date is a preferable accounting policy for debt with a non-contingent put option.

Whatever accounting policy is chosen for debt that contains a non-contingent put option, we generally believe that an entity should follow that policy if that debt becomes due on demand due to covenant violations. For example, if an entity's accounting policy is to amortize issuance premiums, discounts and costs over the contractual life of a debt instrument that contains a non-contingent put option, and that debt becomes due on demand due to covenant violations, we generally believe that previously capitalized issuance premiums, discounts and issuance costs should not be immediately written off. However, if an entity's accounting policy for such a debt instrument is to amortize to the first put date, we generally believe that the premiums, discounts and issuance costs should be immediately written off if that debt becomes due on demand due to covenant violations.

While facts and circumstances should be carefully evaluated, the amortization period should generally not be to the first call date. The basis for conclusions in FASB Staff Position (FSP) APB (Accounting Principles Board) 14-1, *Accounting for Convertible Debt Instruments That May Be Settled in Cash upon Conversion (Including Partial Cash Conversion),* which was not codified, acknowledged diversity in practice in this area.

### 2.4.3.2 Paid-in-kind interest

Some debt instruments may require or permit the issuer to make coupon payments in the form of additional underlying debt instruments. This type of interest is often referred to as PIK interest.

While the accounting for PIK interest is not clearly defined in the accounting guidance, the following methods may be appropriate, based on the facts and circumstances:

- Required (nondiscretionary) PIK interest — An instrument that requires interest to be paid in kind functions much the same as a zero-coupon bond, as no cash interest payments are required until maturity or upon redemption of the debt. In that regard, interest should be accrued at its stated rate assuming that the interest compounds.

  For example, 10% interest PIK on three-year debt with a principal amount of $100 would accrue (assuming annual compounding for simplicity) interest expense of $10 (10% X $100) in the first year (paid with additional debt), $11 (10% X $110) in the second year (paid with additional debt) and $12.10 (10% X $121.00) in the third year (paid as additional debt), with the entire $133.10 settled at maturity. The same result would have been achieved by issuing a zero-coupon instrument for $100 that matures in three years for $133.10. However, if the instrument accrued simple interest of 10% each year on the initial principal (i.e., no compounding), only $130 would be due at maturity. We generally believe this also represents PIK interest, and the issuer should derive an effective interest rate that, when applied to $100 at issuance, would result in $130 at maturity.

- Discretionary PIK interest — If an instrument permits the issuer to elect to pay the interest in kind or in cash, we generally believe that interest should be accrued at the contractual rate for cash interest. If the interest is paid in kind, we generally believe the issuer may either (1) adjust the interest expense to the fair value of the incremental instruments issued or (2) not adjust the interest accrued at the contractual rate and assume that the value of the payment in kind is equal to the amount accrued, based on the individual facts and circumstances. The approach followed should be consistently applied. If the contractual rate for PIK interest is higher than the interest rate for cash payments, the issuer should accrue interest based on the expected method of payment and adjust the accrual at the payment date if settled differently.

### 2.4.3.3 Embedded features not bifurcated from the host debt instrument

The accounting for embedded features that are not bifurcated from debt hosts is generally based on the nature of the feature. Following are common examples:

- Contingent interest — A non-bifurcated contingent interest feature in a debt instrument is accounted for pursuant to the provisions of ASC 450, or the provisions of ASC 470-10-25-3 through 25-4 and 35-4, depending on the facts and circumstances.

- Call option — A non-bifurcated call feature in debt that is callable (prepayable) by the issuer generally is not accounted for until the debt is called, at which time extinguishment accounting is applied.

- Put option — A non-bifurcated put feature in debt that is puttable (redeemable) at par by the investor generally is not accounted for until the debt is redeemed, at which time extinguishment accounting is applied. However, the put feature should generally be considered in determining the amortization period for premiums, discounts or deferred debt issuance costs, as discussed in section 2.4.3.1.

- Conversion option — A non-bifurcated or non-separated conversion feature in a debt instrument is not accounted for until conversion occurs. At that time, conversion accounting is applied, as discussed in section 2.5.2.

#### *2.4.3.3.1 Embedded derivative reassessment*

Embedded features that were not bifurcated from the host debt instrument upon issuance either because the embedded feature (1) did not meet the definition of a derivative under ASC 815 or (2) met that definition but also qualified for an exception from derivative accounting (refer to section 2.2.4.3 for further discussion) should be reassessed at each reporting date.

In reassessing embedded features for bifurcation, the initial conclusion of whether that feature was clearly and closely related to the host debt instrument pursuant to ASC 815-15-25-1(a) is not reevaluated (by reference to ASC 815-15-25-27). Accordingly, if initially deemed clearly and closely related (and therefore not bifurcated), that feature would not be bifurcated in the future. While this is not clear in the guidance, we generally believe that a modification of a debt instrument that was not accounted for as an extinguishment pursuant to ASC 470-50-40 may require the embedded features to be reevaluated given that the modification results in a different legal arrangement. This determination should be made based on the individual facts and circumstances.

In reassessing the definition of a derivative, the characteristics of having an underlying or an initial net investment generally will not change with time. However, the application of the net settlement criteria may change. ASC 815 requires the reconsideration of market mechanism and readily convertible cash criteria pursuant to ASC 815-10-15-118 and 15-139, respectively. A contract that was (or was not) net settleable by its contractual terms will likely remain as such through its life. However, a market mechanism to facilitate net settlement may emerge over time or an asset to be delivered in a physical settlement may become readily convertible to cash. ASC 815 requires the reconsideration of those elements (refer to ASC 815-10-15-118 and 15-139, respectively).

For example, a typical equity-linked embedded feature (e.g., conversion option), may not have met the definition of a derivative if gross settlement were required and the issuer was not a public company (i.e., the underlying shares were not readily convertible to cash). That condition could change if the company underwent an IPO and its shares now were readily convertible to cash. In that case, the embedded feature would meet the definition of a derivative for the first time and should be further evaluated for bifurcation (i.e., evaluated for an exception from bifurcation). That initial analysis would occur on the date the feature met the definition of a derivative (i.e., on the IPO date).

As another example, a public issuer with limited transaction volume for its shares compared with the conversion shares may develop additional volume such that the conversion shares are now considered readily convertible to cash (refer to ASC 815-10-55-101 through 55-108).

With respect to the reassessment of any scope exceptions, the most common exception from bifurcation for equity-linked embedded features is under ASC 815-10-15-74(a), which requires evaluation of whether the feature is indexed to the issuer's own stock and would be classified in stockholders' equity. This reassessment should be performed at each reporting date for those features that meet the definition of a derivative, as follows:

- Reassessment of the indexation guidance — The conclusion under the indexation guidance generally would not be expected to change unless the contractual terms have changed.

  For an embedded equity-linked feature (e.g., conversion feature) that meets the definition of a derivative for the first time (e.g., underlying stock becomes actively traded making it readily convertible to cash), the embedded feature should be assessed at that time for the exception pursuant to ASC 815-10-15-74(a). That assessment would be made under the then-current circumstances to determine whether the feature is considered indexed to the issuer's shares.

- Reassessment of the equity classification guidance — In reassessing the criteria for equity classification related to settlement alternatives, a particular focus should be on the availability of shares to settle the instrument.

#### *2.4.3.3.2 Subsequent bifurcation*

While ASC 815 requires the reassessment of certain embedded features (e.g., those linked to an entity's own equity) for potential bifurcation at each reporting date, it does not provide explicit guidance on how to bifurcate an embedded feature after the issuance date. We generally believe the most literal application of ASC 815 would be to bifurcate the embedded derivative as of the date it was required to be bifurcated at its then-current fair value from the carrying amount of the host debt instrument. Other approaches also may exist.

Under this approach, the bifurcated derivative should be recognized as an asset or liability with subsequent changes in fair value recognized in earnings. This accounting is the same as if bifurcation was performed upon the initial issuance of the instrument.

When determining the fair value of the feature to be bifurcated, an option-based feature would use the contractual terms (refer to section 2.2.7.1) and a forward-based feature would use the terms that would have implied a fair value generally being equal to zero at the date the holder entered into the instrument (refer to section 2.2.7.2).

Any incremental discount or premium on the host instrument that results from the bifurcation would be amortized using the effective interest method over the remaining life of the instrument (refer to section 2.4.3.1.1). Because an unusual effective interest rate may result, other methods for accounting for a post-issuance bifurcation may result in a more reasonable effective interest rate.

### 2.4.3.4 Embedded features bifurcated from the host debt instrument as a derivative and classified as an asset or liability

Embedded features bifurcated from the host debt instrument upon issuance and classified as an asset or a liability are measured at fair value at each reporting date with changes in the fair value recognized in earnings. Refer to section 3 of our FRD publication, ***Derivatives and hedging***, for further discussion on embedded derivatives.

Bifurcated derivatives should be reassessed every reporting period to determine if they continue to require bifurcation. That is, they are reassessed to see if they still meet the definition of a derivative and still fail to qualify for any scope exception from derivative accounting. For example, an embedded feature may subsequently qualify for the exception from derivative accounting pursuant to ASC 815-10-15-74(a) for reasons including:

- The provision that caused the embedded feature not to be considered indexed to the issuer's own stock may no longer apply. For example, assume the strike price of a conversion feature (exercisable at any time) would be reduced by 5% if the issuer does not achieve $100 million in revenue at the end of the six months immediately after the convertible notes are issued. Once the initial six-month period lapses, the conversion feature could be considered indexed to the issuer's own stock under the indexation guidance.
- The issuer subsequently increases its number of authorized and unissued shares sufficient to cover the settlement of the embedded feature. This increase could result by obtaining additional share authorization from shareholders or purchasing additional treasury shares in the market.

An issuer may amend the terms of an agreement to qualify for the exception from derivative accounting (e.g., the issuer may add a cap to the number of shares required for settlement if it had previously issued a convertible debt instrument without a cap). In those cases, the issuer should consider the accounting for the modification of the instrument.

ASC 815-15-35-4 requires a previously bifurcated conversion option that no longer requires bifurcation to be reclassified from a liability to equity at its then-current fair value on the date of reclassification. The conversion option is not recombined with the host debt instrument. Gains or losses recognized when the bifurcated conversion option was accounted for at fair value during the period that the conversion option was classified as a liability are not reversed. We generally believe the same accounting would apply to any previously bifurcated equity-linked embedded feature, such as a bifurcated forward contract classified as an asset or liability, that no longer requires bifurcation.

#### 2.4.3.5 Embedded conversion features separated from the host debt instrument and classified as a component of equity

There are three situations when a non-bifurcated conversion feature may require separate accounting within equity: (1) when convertible debt is issued at a substantial premium, (2) when a previously bifurcated conversion feature in convertible debt is subsequently reclassified to equity and (3) when a conversion feature in convertible debt is modified. Refer to section 2.2.9 for a discussion on convertible debt issued at a substantial premium; section 2.4.3.4 for further discussion on a previously bifurcated conversion feature in convertible debt that is subsequently reclassified to equity; and section 2.6.2.4 for further discussion on a conversion feature in convertible debt that is modified.

##### *2.4.3.5.1 Application of ASC 480-10-S99-3A*

The SEC staff's guidance on temporary equity in ASC 480-10-S99-3A requires that certain redeemable equity instruments be classified as temporary (or mezzanine) equity in order to distinguish them from permanent equity. That guidance also establishes that, for convertible debt instruments with equity-classified components, the equity-classified component of the convertible debt instrument should be considered redeemable if at the balance sheet date the issuer can be required to settle the convertible debt instrument for cash (i.e., the instrument is currently redeemable or convertible for cash).[12]

If the equity-classified component is considered redeemable, the portion of the equity-classified component that is presented in temporary equity (if any) is measured as (1) the amount of cash that would be required to be paid to the holder upon redemption or conversion in excess of (2) the current carrying amount of the liability-classified component of the convertible debt instrument. Refer to sections C.2.9 and C.4.3 for further discussions on the application of ASC 480-10-S99-3A for convertible debt instruments that contain a separately classified equity component.

## 2.5 Debt extinguishment and conversions

Except for perpetual debt, debt will either be extinguished (i.e., mature or settle early if put or called) or converted (or exchanged) in a final settlement. This section includes guidance for extinguishments (section 2.5.1) and conversions (section 2.5.2).

### 2.5.1 Extinguishment of liabilities

The guidance in ASC 405 on the extinguishment of liabilities applies to all liabilities, including financial and nonfinancial liabilities, unless other guidance applies to a liability (e.g., the derecognition guidance for gaming chips in Subtopic 924-405).

For liabilities in the scope of ASC 405, ASC 405-20-40-1 provides that a liability may be derecognized only when it has been extinguished. A liability has been extinguished if the debtor either:

- Pays the creditor and is relieved of its obligation for the liability
- Is legally released from being the primary obligor under the liability, either judicially or by the creditor

[12] When a convertible debt instrument is redeemable or convertible for cash, consideration also must be given to the appropriate balance sheet classification for the liability component as current or noncurrent. Refer to section 2.7.6.

ASC 405-20 provides a narrow scope exception for the derecognition of liabilities related to certain prepaid stored-value products redeemable for goods, services or cash at third-party merchants. Refer to section 5.21 for additional discussion.

ASC 405-20-55-9 provides guidance on accounting for extinguishments through legal defeasances, while ASC 405-20-55-3 through 55-4 discusses in-substance defeasances. In a legal defeasance, generally the creditor legally releases the debtor from being the primary obligor under the liability. In an in-substance defeasance, the debtor places assets in a trust to repay the debt, but because the debtor is not legally released, the liability should not be extinguished.

Whether the debtor has in fact been released and the condition in ASC 405-20-40-1(b) has been met in a legal defeasance or any other transaction is a matter of law. In some cases a legal opinion may be needed to make that determination.

A debt is not extinguished if the entity has the intent to extinguish the liability or accepted an irrevocable offer to repurchase debt. Therefore, debt issuance costs should not be written off and a call premium should not be recognized pursuant to ASC 450 because ASC 470-50-40-2 provides that these amounts are part of the measurement of the extinguishment gain or loss, which is to be recognized only upon extinguishment.

An entity that buys back its own debt should account for that purchase as a debt extinguishment (even if the debt is not formally retired). The same is true even if the entity intends to hold the debt for a short period until it is reissued.

Debt may also be considered extinguished when it has been modified and the terms of the new debt and old debt are substantially different, as that term is defined in the debt modification guidance in ASC 470-50.

#### 2.5.1.1 Measurement of debt extinguishments

Generally, ASC 470-50-40-2 indicates that for all extinguishments of debt, the difference between the reacquisition price (which includes any premium) and the net carrying amount of the debt being extinguished (which includes any deferred debt issuance costs) should be recognized as a gain or loss when the debt is extinguished.[13] Gain or loss recognition may not be appropriate if the extinguishment of debt is with related parties. ASC 470-50-40-2 indicates that such an extinguishment transaction may be in essence a capital transaction (refer to section 2.5.1.5 for further discussion).

Adjustments to the debt's carrying amount resulting from fair value hedge accounting pursuant to ASC 815-25-35-1(b) and 35-8 are considered in calculating the debt extinguishment gain or loss. In contrast, for extinguished debt subject to a cash flow hedge, any amounts reclassified from accumulated comprehensive income to earnings should be excluded from the debt extinguishment gain or loss, as described in ASC 815-30-35-44.

The fair value of nonmonetary assets (e.g., land or investments in common stock) transferred to settle debt obligations should be used to measure debt extinguishment gains or losses. As a result, when nonmonetary assets are used in the extinguishment of debt, the total gain or loss usually will be composed of two elements: (1) the gain or loss resulting from the difference between the carrying value and fair value of the assets transferred and (2) the gain or loss from the debt extinguishment. Refer to section 5.1 for an example of the settlement of debt exchangeable into common stock of another issuer.

[13] ASC 470-50-40-2A clarifies the accounting for a debt extinguishment when the fair value option is elected. Upon extinguishment an entity shall include in net income the cumulative amount of the gain or loss previously recorded in other comprehensive income for the extinguished debt that resulted from changes in instrument-specific credit risk.

### 2.5.1.2 Extinguishment of debt with a separately recorded equity component (updated September 2024)

As discussed in section 2.4.3.5, a conversion feature that is not bifurcated from its debt host contract may require separate accounting within equity. When such a convertible debt instrument is extinguished, the issuer needs to consider whether to derecognize the related equity component.

If the convertible debt instrument had a previously bifurcated conversion feature that has been reclassified to shareholders' equity pursuant to ASC 815-15-35-4 and the instrument is extinguished before its maturity, the portion of the reacquisition price equal to the fair value of the conversion feature at the date of the extinguishment should be allocated to equity in accordance with ASC 815-15-40-4. The remaining reacquisition price is allocated to the extinguishment of the debt to determine the amount of a gain or loss.

There is no guidance addressing the extinguishment of a convertible debt instrument with an equity component that resulted from the issuance of the debt at a substantial premium or a modification of the conversion feature. We believe one acceptable approach would be to first allocate the portion of the reacquisition price equal to the carrying amount of the equity component at the date of the extinguishment, with the remainder allocated to the debt to determine the extinguishment gain or loss. That is, the reacquisition price used to calculate the debt extinguishment gain or loss would be reduced by the carrying amount of the equity component that is also derecognized. There may be other acceptable approaches.

### 2.5.1.3 Transition from a primary to a secondary obligor

If an entity is released from being a primary obligor and becomes a secondary obligor, ASC 405-20-40-2 states that the entity should recognize the guarantee as would a guarantor that had never been primarily liable to that creditor. The guarantee obligation should be initially measured at fair value, and that amount reduces the gain or increases the loss recognized on extinguishment.

### 2.5.1.4 Classification of debt extinguishment gains or losses

ASC 470-50-40-2 provides that gains and losses from the extinguishment of debt shall be presented as a separate item within the income statement.[14]

ASC 470-50-40-2 also states that extinguishment transactions between related entities may be in essence capital transactions. Therefore, when related parties are involved, recognition of the difference between the retired debt's reacquisition price and carrying amount as either a gain or loss may not be appropriate. Refer to section 2.5.1.5 for further discussion.

Public companies that trade in securities they issue outside their normal operations should consider the disclosure requirements of ASC 220-20-45-1 or the management's discussion and analysis (MD&A) disclosures pursuant to Regulation S-K (Rule 229.303(b)(2)(i)), unless the effects of such transactions are insignificant to the company's results of operations. In addition, we generally believe private companies should consider making similar disclosures.

[14] ASC 470-50-40-2A clarifies the accounting for a debt extinguishment when the fair value option is elected. Upon extinguishment an entity shall include in net income the cumulative amount of the gain or loss previously recorded in other comprehensive income for the extinguished debt that resulted from changes in instrument-specific credit risk.

#### 2.5.1.5 Debt extinguishments with related parties

ASC 470-50-40-2 provides that a debt extinguishment transaction with related parties may be in essence a capital transaction. While there is no specific guidance that addresses when an early debt extinguishment should be treated as a capital transaction, a member of the SEC staff discussed its view on these types of transactions in a speech at the 2010 AICPA conference[15] and provided the following:

> "To be clear, the staff has not formed any bright line views on these types of transactions and analyzes these questions individually on a specific facts and circumstances basis.
>
> To illustrate one example and how we thought about the issue, consider the following fact pattern. A Company has non-convertible debt outstanding to a related party[4] ([a]n executive of the Company who is also a significant shareholder). Assume that at a later date the related party accepts an offer from the Company to exchange the debt for the Company's common stock. At the date of exchange, assume that the value of the common stock that was accepted by the related party was significantly lower than the carrying value of the Company's debt.
>
> At issue is whether the Company's exchange of common stock for the debt held by the related party should be accounted for as an early extinguishment gain or as a capital contribution. As part of its considerations on this issue, the staff approached the analysis by asking the following questions (please note that this is not an exhaustive list):
>
> - What was the role of the related party in the transaction?
> - Why would the related party accept the Company's offer, which resulted in the related party accepting common stock that was significantly lower in value than the carrying value of the debt?
> - Was the substance of the arrangement a forgiveness of debt that was owed to a related party?
>
> Based on its analysis, which included the information provided in response to these questions, the staff believed the substance of the transaction was in essence a capital contribution from a related party. The staff believes that a full analysis is required in assessing the substance of these types of transactions. Accordingly, the staff would expect that registrants consider all of the facts and circumstances and related party relationships in a particular transaction when making its accounting assessment."

[4] Based on the definition of related party as articulated in FASB ASC Topic 850.

We generally believe that a debt extinguishment transaction that involves third-party investors along with a related party, where all parties receive identical terms (e.g., the same reacquisition price), is not, in substance, a capital transaction with a related party. Therefore, an extinguishment gain or loss should be recognized.

### 2.5.2 Conversion of convertible debt instruments

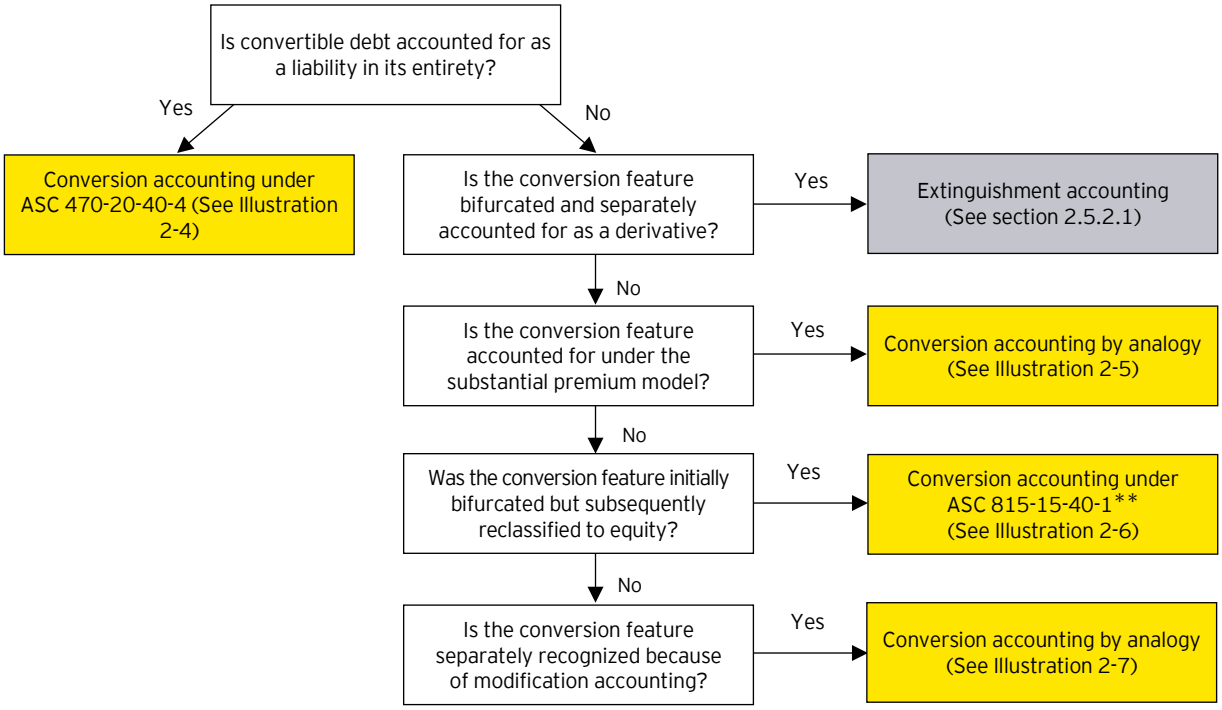
The conversion of debt that is accounted for as a liability in its entirety does not result in any gain or loss if the conversion feature is exercised in accordance with the original conversion terms (ASC 470-20-40-4). If those terms allowed the issuer to include cash or other assets as part of the settlement of the convertible instrument, the issuer will first reduce the carrying amount of the convertible debt, including any unamortized premium, discount or issuance costs, by the fair value of the cash or other assets transferred and then recognize the remaining carrying value of the debt in the capital accounts.

[15] Sagar S. Teotia, 2010 — Refer to the SEC website at **https://www.sec.gov/news/speech/2010/spch120610sst.htm**.

The guidance doesn't address the conversion accounting for a convertible debt instrument that is not accounted for as a liability in its entirety. We generally believe (1) extinguishment accounting should be applied when the conversion feature is bifurcated and accounted for separately as a derivative in accordance with ASC 815 and (2) the conversion accounting model should generally be applied in other situations (e.g., when the conversion feature is separately accounted for in APIC under the substantial premium model), but given the lack of guidance, extinguishment accounting may also be acceptable. We believe the choice of a method is an accounting policy election that should be consistently applied.

The flowchart and illustrations below provide what we believe are acceptable approaches to account for conversions of certain types of convertible debt instruments. Given the lack of guidance for conversions when a convertible debt instrument is not accounted for as a liability in its entirety, other approaches may also be acceptable.

**Accounting upon conversions of debt instruments***




* Assumes conversions are not subject to the induced conversion guidance in ASC 470-20-40-13 through 40-17.

** In accordance with ASC 815-15-40-1, any unamortized discount remaining at the date of conversion should be recognized as interest expense.

**Illustration 2-5: Conversion of convertible debt that is accounted for as a liability in its entirety**

Company A, a privately held corporation, issued convertible debt on 1 January 20X1 with a par amount of $100 million, an annual coupon rate of 2% and a maturity in 10 years. The conversion feature can be exercised at any time and settled in cash, common stock (par value of $1 per share) or any combination of the two at the option of Company A. Assume that the conversion feature meets the equity derivative scope exception in ASC 815-40, and there are no other embedded features in the convertible debt. The conversion price is $100 per share, and the fair value of each underlying share is $104 per share at issuance. Company A issued the convertible debt to Investor X for proceeds of $104 million in cash.

Company A first determines whether the conversion feature should be bifurcated and accounted for as a derivative in accordance with ASC 815-15. Because the conversion feature meets the derivative scope exception, the embedded conversion feature is not bifurcated from the debt host.

Company A then determines whether the debt should be accounted for under the substantial premium model. Company A does not view the 4% premium over the par value to be substantial and does not apply the model.

Therefore, the instrument is accounted for as a liability without any bifurcation or separation of the embedded conversion feature. Company A initially records the following entry:

| | | |
|---|---|---|
| Cash | $ 104 million | |
| Debt | | $ 104 million |

From Year 20X1 to Year 20X5, Company A records the following entry each year to amortize the premium and record interest expense and the cash disbursement:

| | | |
|---|---|---|
| Debt (premium) | $ 0.4 million* | |
| Interest expense | 1.6 million | |
| Cash | | $ 2 million |

* For simplicity, assume that the straight-line amortization method approximates the effective interest method.

At the end of Year 20X5, Investor X exercises the conversion feature in accordance with the original conversion terms. Company A elects to settle the debt by paying $50 million in cash and issuing 500,000 shares of its common stock. The following entry will be recorded:

| | | |
|---|---|---|
| Debt | $ 102 million | |
| Cash | | $ 50.0 million |
| Common stock (par) | | 0.5 million |
| Additional paid-in capital | | 51.5 million |

**Illustration 2-6: Conversion of convertible debt with a substantial premium**

Assume the same facts as in Illustration 2-5, except that Company A received proceeds of $115 million in cash. Company A views the 15% premium over the par value to be substantial and concludes that the convertible debt should be accounted for under the substantial premium model. Company A initially records the following entry:

| | | |
|---|---|---|
| Cash | $ 115 million | |
| Debt | | $ 100 million |
| Additional paid-in capital | | 15 million |

From Year 20X1 to Year 20X5, Company A records the following entry each year to reflect interest expense and the cash disbursement each year:

| | | |
|---|---|---|
| Interest expense | $ 2 million | |
| Cash | | $ 2 million |

At the end of Year 20X5, Investor X exercises the conversion feature in accordance with the original conversion terms. Company A elects to settle the debt by paying $50 million in cash and issuing 500,000 shares of its common stock.

Because there is no specific conversion accounting guidance for convertible debt instruments accounted for under the substantial premium model, we believe it would be appropriate to analogize to the conversion accounting guidance in ASC 470-20-40-4. Other alternatives may also be acceptable. Company A elects to apply the conversion accounting model and records the following entry:

| | | |
|---|---|---|
| Debt | $ 100 million | |
| Cash | | $ 50.0 million |
| Common stock (par) | | 0.5 million |
| Additional paid-in capital | | 49.5 million |

**Illustration 2-7: Conversion of convertible debt with a conversion feature initially bifurcated and subsequently reclassified into equity**

Assume the same facts as in Illustration 2-5, except that Company A initially determines that the conversion feature does not meet the derivative scope exception because Company A does not have a sufficient number of authorized shares to satisfy its obligation to deliver shares upon conversion. Therefore, the conversion feature should be bifurcated and accounted for as a derivative in accordance with ASC 815-15 at inception. Assume that the fair value of the conversion feature is $14 million at issuance. Company A initially records the following entry:

| | | |
|---|---|---|
| Cash | $ 104 million | |
| Debt | | $ 90 million |
| Derivative liability | | 14 million |

From Year 20X1 to Year 20X2, the fair value of the derivative liability increased by $1 million. In addition, Company A increased the number of authorized shares and met all equity classification criteria in ASC 815-40 at the end of Year 20X2. Accordingly, Company A first remeasures the derivative liability to its fair value at that time and then reclassifies it to equity as follows:

| | | |
|---|---|---|
| Expense | $ 1 million | |
| Derivative liability | | $ 1 million |
| Derivative liability | $ 15 million | |
| Additional paid-in capital | | $ 15 million |

From Year 20X1 to Year 20X5, Company A records the following entry each year to accrete the discount and reflect interest expense and the cash disbursement:

| | | |
|---|---|---|
| Interest expense | $ 3 million | |
| Cash | | $ 2 million |
| Debt (discount) | | 1 million* |

* For simplicity, assume that the straight-line amortization method approximates the effective interest method.

At the end of Year 20X5, Investor X exercises the conversion feature in accordance with the original conversion terms. Company A elects to settle the debt by paying $50 million in cash and issuing 500,000 shares of its common stock. Under ASC 815-15-40-1, any unamortized discount remaining at the date of conversion should be recognized as interest expense, so Company A records the following entry:

| | | |
|---|---|---|
| Interest expense | $ 5 million | |
| Debt (discount) | | $ 5 million |

However, ASC 815-15-40-1 does not specify the conversion accounting for convertible debt instruments with embedded conversion features that no longer meet the bifurcation criteria at the time of conversion. We believe it would be appropriate in this case to follow the conversion accounting guidance in ASC 470-20-40-4. Other alternatives may also be acceptable.

Company A elects to apply the conversion accounting model and records the following entry:

| | | |
|---|---|---|
| Debt | $ 100 million | |
| Cash | | $ 50.0 million |
| Common stock (par) | | 0.5 million |
| Additional paid-in capital | | 49.5 million |

**Illustration 2-8: Conversion of convertible debt with an equity component recognized due to modification accounting**

Assume the same facts as in Illustration 2-5. Company A initially records the following entry:

| | | |
|---|---|---|
| Cash | $ 104 million | |
| Debt | | $ 104 million |

From Year 20X1 to Year 20X3, Company A records the following entry each year to amortize the premium and reflect interest expense and the cash disbursement:

| | | |
|---|---|---|
| Debt (premium) | $ 0.4 million* | |
| Interest expense | 1.6 million | |
| Cash | | $ 2 million |

* For simplicity, assume that the straight-line amortization method approximates the effective interest method.

At the end of Year 20X3, Company A modifies the terms of the conversion feature, resulting in an increase of $0.7 million in its fair value. The modification is not accounted for as an extinguishment under ASC 470-50. Furthermore, ASC 470-50-40-15 requires an increase in the fair value of an embedded conversion feature due to a modification not accounted for as an extinguishment to be recognized as a debt discount (or as a reduction of a debt premium) with a corresponding increase in additional paid-in capital. Accordingly, Company A records the following entry to reduce debt premium to $2.1 million from $2.8 million, reflecting an increase in the fair value of the conversion feature due to modification:

| | | | | |
|---|---|---|---|---|
| Debt (premium) | $ | 0.7 million | | |
| Additional paid-in capital | | | $ | 0.7 million |

From Year 20X4 to Year 20X5, Company A records the following entry each year to amortize the premium and record interest expense and the cash disbursement:

| | | | | |
|---|---|---|---|---|
| Debt (premium) | $ | 0.3 million** | | |
| Interest expense | | 1.7 million | | |
| Cash | | | $ | 2 million |

** For simplicity, assume that the straight-line amortization method approximates the effective interest method.

At the end of Year 20X5, Investor X exercises the conversion option in accordance with the original conversion terms. Company A elects to settle the debt by paying $50 million in cash and issuing 500,000 shares of its common stock.

There is no specific conversion accounting guidance for convertible debt instruments with a separate equity component recognized due to modification accounting. We believe it would be appropriate in this case to follow the conversion accounting guidance in ASC 470-20-40-4. Other alternatives may also be acceptable. Company A elects to apply the conversion accounting model and records the following entry:

| | | | | |
|---|---|---|---|---|
| Debt | $ | 101.5 million | | |
| Cash | | | $ | 50.0 million |
| Common stock (par) | | | | 0.5 million |
| Additional paid-in capital | | | | 51.0 million |

### 2.5.2.1 Conversion of debt with a bifurcated conversion option

For accounting purposes, two instruments are outstanding when a conversion option is bifurcated in accordance with ASC 815. We generally believe that the conversion of debt with a bifurcated conversion option should be accounted for under the debt extinguishment accounting model. That is, both the debt and the bifurcated conversion option that is accounted for as a derivative should be derecognized at their carrying amounts (after a final mark to the bifurcated conversion option's fair value), and the consideration transferred (e.g., shares issued) should be measured at its then-current fair value, with any difference recorded as a gain or loss on the extinguishment of the two separate liabilities.

### 2.5.2.2 Induced conversions of convertible debt (updated September 2024)

Induced conversions may involve revised terms that reduce the original conversion price (thereby resulting in the issuance of additional shares of stock), the issuance of warrants or other securities not provided for in the original conversion terms or payment of cash or other consideration (sometimes called a convertible debt sweetener) to those debt holders who convert during a specified time period. The additional consideration is usually offered to induce a prompt conversion of the debt to equity.

Entities should apply the guidance on induced conversions of convertible debt in ASC 470-20-40-13 through 40-17 to all induced conversions of debt. That guidance defines induced conversions as conversions that both (1) occur pursuant to changed conversion privileges that are exercisable only for a limited period of time and (2) include the issuance of all of the equity securities issuable pursuant to conversion privileges included in the terms of the debt at issuance. ASC 470-20-40-14 further explains that:

> A conversion includes an exchange of a convertible debt instrument for equity securities or a combination of equity securities and other consideration, **whether or not the exchange involves legal exercise of the contractual conversion privileges included in terms of the debt.** [Emphasis added.]

The induced conversion guidance applies regardless of which party initiates the offer or whether the offer relates to all debt holders, as discussed in ASC 470-20-40-13(b). For example, even if a debt holder makes the offer to the issuer and only that holder's debt receives the right to convert at the sweetened conversion price, the accounting requirements of the induced conversion guidance in ASC 470-20 apply.

Induced conversions are not subject to the debt modification guidance in ASC 470-50. Under the guidance on induced conversions, the fair value of the additional securities or other consideration issued to induce conversion is recognized as an expense. The consideration issuable under the original terms of the debt is accounted for under the conversion accounting guidance in ASC 470-20-40-4, which does not give rise to gains or losses, regardless of whether the settlement is in the form of cash, shares or a combination of cash and shares.

#### FASB update

In December 2023, the FASB issued a proposed ASU[16] that would clarify the requirements for determining whether to account for certain early settlements of convertible debt instruments as induced conversions or extinguishments.

The proposal would require an entity to account for a settlement as an induced conversion if the inducement offer includes the issuance of all of the consideration (in form and amount) issuable under the conversion privileges provided in the terms of the existing convertible debt instrument. The issuer would assess whether this criterion is satisfied as of the inducement offer acceptance date.

Under the proposal, induced conversion accounting would apply to all convertible debt instruments that have a substantive conversion feature at the time of issuance and are in the scope of ASC 470-20, regardless of whether the instrument is currently convertible.

In addition, entities would be permitted to apply the guidance either prospectively to convertible debt instruments settled during the fiscal year beginning after the effective date or retrospectively, as of the beginning of the first comparative reporting period, to convertible debt instruments settled after the adoption of ASU 2020-06. See our To the Point publication, ***FASB proposes clarifying accounting for induced conversion of convertible debt instruments***, for more information.

[16] Proposed Accounting Standards Update, *Debt — Debt with Conversion and Other Options (Subtopic 470-20) — Induced Conversions of Convertible Debt Instruments (a consensus of the Emerging Issues Task Force).*

During redeliberations, the Board tentatively decided that an entity would be required to assess whether a conversion feature is substantive as of both the issuance date and the offer acceptance date. The Board also decided that the guidance would be effective for fiscal years, including interim periods within fiscal years, beginning after 15 December 2025 for all entities. Early adoption would be permitted as of the beginning of the fiscal year for all entities that have adopted the amendments in ASU 2020-06.

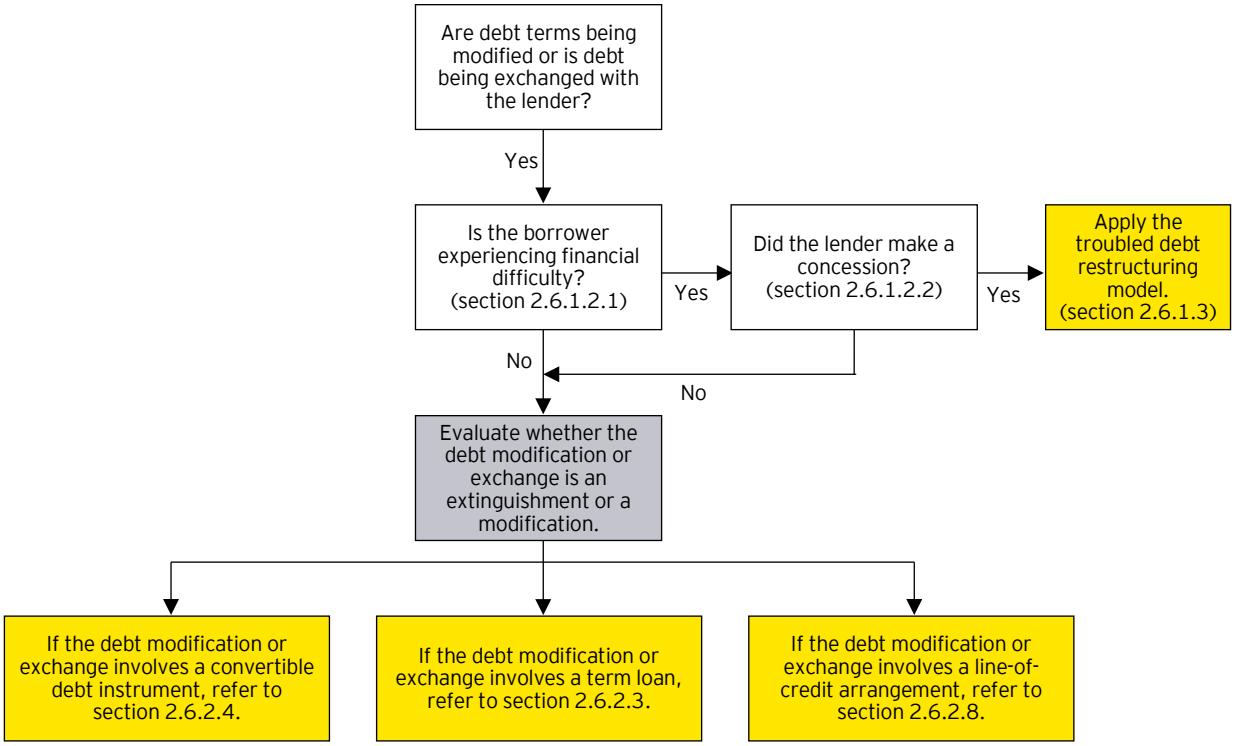
At the time of this publication, the Board had completed its redeliberations and directed the staff to draft a final ASU. We encourage readers to monitor developments.

## 2.6 Troubled debt restructurings and debt modifications

After issuance, the terms of debt may be modified or debt may be exchanged with the same lender prior to final settlement. Debt modifications or exchanges may be considered a troubled debt restructuring if the debtor is experiencing financial difficulty and the creditor grants a concession in connection with the restructuring. Modifications and exchanges that are not considered troubled debt restructurings are accounted for as either (1) an extinguishment (if the terms are substantially different) or (2) a modification.

This section addresses the troubled debt restructuring guidance in ASC 470-60, *Debt — Troubled Debt Restructurings by Debtors* (section 2.6.1), and debt modifications guidance in ASC 470-50, *Debt — Modifications and Extinguishments* (section 2.6.2).

Debtors should first determine whether the transaction is a troubled debt restructuring pursuant to ASC 470-60 before applying ASC 470-50. The following flowchart illustrates the steps to be used in assessing debt modifications or exchanges under both the troubled debt restructuring guidance and debt modification guidance.



### Reference rate reform considerations

ASC 848, Reference Rate Reform, provides temporary optional expedients and exceptions to the US GAAP guidance on contract modifications and hedge accounting to ease the financial reporting burdens of the expected market transition from London Interbank Offering Rate (LIBOR) and other interbank offered rates to alternative reference rates, such as SOFR.

**Relevant relief:** In accordance with this guidance, contracts that are modified as a result of reference rate reform are eligible for relief from the modification accounting requirements in US GAAP (including ASC 470-50), if certain criteria are met. Accordingly, an entity that modifies a contract as a result of reference rate reform is not required to determine whether a modification results in the establishment of a new contract or the continuation of an existing contract. That is, the modified contract is accounted for and presented as a continuation of the existing contract.

**Effective date:** This guidance became effective upon issuance and generally can be applied through the earlier of 31 December 2024 or until the criteria to apply the relief is no longer met. For most entities, the ability to apply the relief will cease prior to 31 December 2024 because the required criteria will no longer be met once the entity has completed its transition away from LIBOR or other discontinued rates. For example, given that all USD LIBOR settings ceased being published after 30 June 2023, most eligible contracts would have been modified by this date.

For more information on reference rate reform, refer to ASC 848 and our Technical Line, ***A closer look at the FASB accounting relief related to reference rate reform***.

## 2.6.1 Troubled debt restructurings

A debt restructuring is considered troubled if the creditor, for economic or legal reasons related to the issuer's financial difficulties, grants a concession to the issuer it would not otherwise consider. In a troubled debt restructuring, the creditor's objective is to maximize recovery of its investment by granting relief to the debtor.

For a debt restructuring to be considered troubled, the debtor must be experiencing financial difficulty and the creditor must have granted a concession. Those criteria are discussed in ASC 470-60-55-4 through 55-14. Generally, a restructuring involving a debtor that is currently servicing the old debt and can obtain funds from sources other than the existing creditor at market interest rates at or near those for non-troubled debt is not considered a troubled debt restructuring if the creditors restructured the old debt solely to reflect a decrease in market rates or positive changes in the debtor's creditworthiness when the debt was issued.

The accounting for a troubled debt restructuring by a debtor depends on the type of restructuring. Legal fees and other direct costs incurred in granting an equity interest to a creditor reduce the fair value of the equity interest issued. All other direct costs incurred in connection with a troubled debt restructuring should generally be charged to expense as incurred.

### 2.6.1.1 Scope of the troubled debt restructuring guidance in ASC 470-60

Liabilities that may be involved in a troubled debt restructuring include accounts payable, notes, debentures and bonds and related accrued interest. ASC 470-60-15-4 states that the unit of account in applying ASC 470-60 should be the individual payables, even if those payables are restructured together. However, a creditor-by-creditor analysis may be helpful with evaluating whether a concession was granted, as discussed below.

Troubled debt restructurings may take different forms but generally include one or a combination of the following:

- Transfer from the debtor to the creditor of receivables from third parties, real estate or other assets to satisfy fully or partially a debt (including a transfer resulting from foreclosure or repossession)
- Issuance or other granting of an equity interest to the creditor by the debtor in full or partial satisfaction of debt unless the equity interest is granted pursuant to existing terms for converting the debt into an equity interest
- Modification of debt terms, such as one or a combination of:
    a. Reduction of the stated interest rate for the remaining original life of the debt
    b. Extension of the maturity date or dates at a stated interest rate lower than the current market rate for new debt with similar risk
    c. Reduction of the face amount or maturity amount of the debt as stated in the instrument or other agreement
    d. Reduction of accrued interest
- Any combination of the above items (e.g., a transfer of some assets and some equity interest in partial satisfaction, combined with a modification of the terms of the debt)

For purposes of applying ASC 470-60, the following are not considered troubled debt restructurings:

- Lease modifications, employment-related agreements or unrecorded commitments
- Debtors' failures to pay trade accounts according to their terms or creditors' delays in taking legal action to collect overdue amounts of interest and principal, unless they involve an agreement between a debtor and creditor to restructure
- Restructurings consummated under reorganization, arrangement or other provisions of the Federal Bankruptcy Act or other related Federal statutes in which the debtor restates its liability generally; however, ASC 470-60 would apply to an isolated troubled debt restructuring by a debtor involved in bankruptcy proceedings if such restructuring did not result in a general restatement of the debtor's liabilities

In addition, ASC 470-60-15-12 states that a troubled debt restructuring is not involved if any of the following conditions exist even if the debtor is experiencing financial difficulty:

- The fair value of cash, other assets or an equity interest accepted by a creditor from a debtor in full satisfaction of its receivable at least equals the creditor's recorded investment in the receivable
- The fair value of cash, other assets or an equity interest transferred by a debtor to a creditor in full settlement of its payable at least equals the debtor's carrying amount of the payable
- The creditor reduces the effective interest rate on the debt primarily to reflect a decrease in market interest rates in general or a decrease in the risk so as to maintain a relationship with a debtor that can readily obtain funds from other sources at the current market interest rate
- The debtor issues in exchange for its debt new marketable debt having an effective interest rate based on its market price that is at or near the current market interest rates of debt with similar maturity dates and stated interest rates issued by non-troubled debtors

### 2.6.1.2 Distinguishing a troubled debt restructuring from a modification or exchange

The guidance in ASC 470-60-55-4 through 55-14 (referred to herein as "the guidance for distinguishing a troubled debt restructuring") provides a two-step decision tree for determining whether a modification or an exchange of debt instruments is within the troubled debt restructuring guidance:

Step 1: Is the debtor experiencing financial difficulty (ASC 470-60-55-8 and 55-9)?

Step 2: Has the creditor granted a concession (ASC 470-60-55-10 through 55-14)?

If the answer to either of the questions above is no, the debt restructuring is not within the scope of the troubled debt restructuring guidance in ASC 470-60, and the debt modification guidance in ASC 470-50 should be applied. Refer to section 2.6.2 for a discussion of debt modification accounting.

ASC 470-60-55-6 provides a list of factors that should not be considered in determining whether a modification or exchange constitutes a troubled debt restructuring:

- The amount invested in the old debt by the current creditors
- The fair value of the old debt immediately before the modification or exchange compared to the fair value of the new debt at issuance
- Transactions among debt holders
- The length of time the current creditors have held the investment in the old debt (unless all the current creditors recently acquired the debt from the previous debt holders to effect what is in substance a planned refinancing).

#### *2.6.1.2.1* Debtor experiencing financial difficulties

If a debtor's creditworthiness has deteriorated since the debt was originally issued, ASC 470-60 requires the debtor to evaluate whether it is experiencing financial difficulties. The guidance provides that while a decline in credit rating from investment to noninvestment grade is considered a deterioration in the debtor's creditworthiness for purposes of ASC 470-60, a change within the range of investment-grade credit ratings is not.

ASC 470-60-55-8 provides a list of indicators of financial difficulties:

- The debtor is currently in default on any of its debt.
- The debtor has declared or is in the process of declaring bankruptcy.
- There is significant doubt as to whether the debtor will continue to be a going concern.
- Currently, the debtor has securities that have been delisted, are in the process of being delisted or are under threat of being delisted from an exchange.
- Based on estimates and projections that only encompass the current business capabilities, the debtor forecasts that its entity-specific cash flows will be insufficient to service the debt (both interest and principal) in accordance with the contractual terms of the existing agreement through maturity.
- Absent the current modification, the debtor cannot obtain funds from sources other than the existing creditors at an effective interest rate equal to the current market interest rate for similar debt for a non-troubled debtor.

These indicators are examples of financial difficulties and no single indicator is determinative of whether the debtor is experiencing financial difficulties. All aspects of the debtor's current financial situation should be considered in making this determination.

Notwithstanding other evidence of financial problems, the debtor is not deemed to be experiencing financial difficulties (and thus the restructuring is outside the scope of ASC 470-60) if both of the following conditions are met:

- The debtor is currently servicing the old debt and can obtain funds to repay the old prepayable debt from sources other than the existing creditors at an effective interest rate equal to the current market interest rate for a non-troubled debtor
- The creditors agree to restructure the old debt solely to reflect a decrease in current market interest rates for the debtor or positive changes in the creditworthiness of the debtor since the debt was originally issued

#### *2.6.1.2.2 Creditor granting concession*

For the creditor to be considered to have granted a concession, the effective borrowing rate on the restructured debt must be less than the effective borrowing rate of the old debt immediately prior to the restructuring. The effective borrowing rate of the restructured debt should be calculated by projecting all the cash flows under the new terms including new or revised sweeteners (e.g., options, warrants, guarantees, letters of credit)[17] and solving for the discount rate that equates the present value of the cash flows under the new terms to the debtor's current carrying amount[18] of the old debt.

**Illustration 2-9: Debt restructuring involving granting concession**

**Assumptions:**

Company C has subordinated convertible debt outstanding with a face amount of $100 million (increments of $1,000) and a fixed interest rate of 7% (Old Debt). Old Debt has a conversion price of $35 and the fair value of Company C's common stock was $30 at issuance. Both Old Debt and the common stock are publicly traded. The current fair value of Old Debt is $450 per $1,000 increment (aggregate fair value of $45 million).

Company C is in an industry that is experiencing financial difficulties, and Company C has defaulted on its senior debt. It is doubtful whether Company C can meet all cash requirements as they come due over the next 12 months. However, Company C has made all principal and interest payments on Old Debt when due. Further assume Company C issued $50 million (face amount) of new subordinated convertible debt at 8% per annum that has a conversion price of $8 (New Debt) to the current lenders in exchange for Old Debt. Company C's common stock is trading at $5 per share at the time of the exchange. The fair value of New Debt is $50 million at issuance.

**Analysis:**

The debt exchange would be accounted for as a troubled debt restructuring under ASC 470-60 because (1) the debtor is experiencing financial difficulties as it is in default on its senior debt and it is doubtful it can service Old Debt and (2) the creditor has granted a concession because the effective borrowing rate of the restructured debt is less than the effective borrowing rate of Old Debt immediately prior to the restructuring primarily after considering the reduction in the principal amount of the debt and the change in fair value of the conversion option. The fact that the fair value of New Debt is greater than the fair value of Old Debt is not considered in determining whether the transaction is a troubled debt restructuring.

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[17] When determining the effect of any new or revised sweeteners, the fair value of the new sweetener or change in fair value of the revised sweetener would be included in day one cash flows. Timing of the exercisability of the sweeteners should be reflected in the estimation of their initial fair value.

[18] The carrying amount for purposes of this calculation would not include any hedging effects but would include any unamortized premium, discount, issuance costs and accrued interest payable.

Further assume Company C exchanges Old Debt for New Debt with the same holders and issues an additional $10 million face amount of New Debt to new investors for $10 million in proceeds.

It could be viewed that the exchange does not represent a troubled debt restructuring because the issuance of the $10 million New Debt to investors other than existing creditors could be considered evidence of Company C's ability to issue debt at market interest rate consistent with that of non-troubled borrowers.

However, we generally do not believe the additional debt issued should be considered when evaluating Company C's ability to issue debt at a non-troubled borrower's market rate if it were unlikely that Company C could have issued the additional debt without restructuring Old Debt.

ASC 470-60-55-14 provides that if an entity recently restructured the debt and is restructuring that debt again, the debtor's previous carrying amount of the debt immediately preceding the earlier restructuring would be used in obtaining the effective borrowing rate of the restructured debt. The effective borrowing rate of the restructured debt should be compared with the effective borrowing rate of the debt immediately preceding the earlier restructuring to determine whether the effective borrowing rate has decreased.

### 2.6.1.3 Debtor's accounting for a troubled debt restructuring

The accounting for a troubled debt restructuring by a debtor depends on the type of restructuring as follows:

- A debtor that transfers its assets to a creditor in full settlement of a payable recognizes a gain measured as (1) the carrying amount of the payable settled in excess of (2) the fair value of the assets transferred to the creditor. Additionally, any difference between the fair value and carrying amount of the assets transferred is recognized as a gain or loss on the disposition of those assets.
- The issuance of an equity interest to a creditor in full settlement of a payable should be accounted for similar to the transfer of assets as described previously, with the equity interest being measured at its fair value, less legal fees and other direct costs.
- A debt restructuring involving a modification of terms of a payable is accounted for prospectively from the time of restructuring, and the carrying amount of the payable is not changed unless its carrying amount exceeds the total undiscounted future cash payments specified by the new terms. Interest expense is computed using the interest method, with the interest rate determined as the amount that equates the present value of the future cash payments specified by the new terms (excluding amounts contingently payable) with the carrying amount of the payable.
- A troubled debt restructuring involving a combination of term modifications, transfer of assets and/or equity instruments is accounted for similarly to a restructuring through a modification of terms except that, first, assets transferred or equity interests issued are measured at fair value and the carrying amount of the payable reduced by the total fair value of those assets or equity interests.

Legal fees and other direct costs incurred in granting an equity interest to a creditor reduce the fair value of the equity interest issued. In all other instances, such costs incurred by a debtor should be deducted in measuring the gain on restructuring or included in expense for the period if no gain is recognized.

#### *2.6.1.3.1 Full satisfaction of a payable through transfer of assets or equity interest*

When a debtor transfers its receivables from third parties, real estate or other assets or issues an equity interest to the creditor in full satisfaction of its payable, the transaction is accounted for on the basis of the fair value of the assets transferred or equity interest issued. The fair value of the equity interest transferred is reduced by legal fees and other direct issuance costs.

ASC 470-60 requires that the excess of the carrying amount of the payable over the fair value of the assets or equity interest transferred be recognized as a gain.[19] In addition, the debtor recognizes a gain or loss on disposition of assets to the extent the fair value of those assets differs from their carrying amount (and that gain or loss should not be offset against the debt extinguishment gain).

Consistent with ASC 820 the fair value of the assets transferred is the amount that the debtor would receive for them in a current sale between a willing buyer and a willing seller (i.e., other than in a forced or liquidation sale).

Although the fair value of the assets transferred or the fair value of an equity interest granted should be used in accounting for the settlement of a payable, the fair value of the payable settled may be used if it is more clearly evident than the fair value of the assets transferred or of the equity interest granted in a full settlement of a payable. However, in a partial settlement of a payable (refer to section 2.6.1.3.3), the fair value of the assets transferred or of the equity interest granted should be used in all cases to avoid the need to allocate the fair value of the payable between the part settled and the part still outstanding.

**Illustration 2-10: Debt restructuring involving transfer of real estate**

In connection with a troubled debt restructuring on 31 December 20X8, ABC Company transfers real estate under construction with a carrying value of $15,000,000 to XYZ Bank in full settlement of a debt of $16,000,000. Because current quoted market prices are not available for either the asset or similar assets, fair value is determined by discounting cash flows related to the real estate at a rate commensurate with the risk involved. Both parties estimate it will require $5,000,000 (to be incurred ratably over the next 12 months) to complete construction and that the property would be sold immediately upon completion for $20,000,000. Assuming a discount factor of 12%, the fair value based on discounted future cash flows would be estimated as follows:

| | |
|---|---|
| Estimated selling price of property at completion | $ 20,000,000 |
| Apply a discount factor for 12% for 12 months | 0.89299 |
| | 17,858,000 |
| Less present value of estimated costs to be incurred ratably over the 12 months | (4,689,629) |
| Estimated fair value | $ 13,168,371 |

The following journal entries summarize the accounting for the restructuring at 31 December 20X8 by the debtor:

| | | |
|---|---|---|
| Payable to XYZ Bank | $ 16,000,000 | |
| Loss on disposition of assets ($15,000,000 − $13,168,371) | 1,831,629 | |
| Real estate under construction | | $ 15,000,000 |
| Gain on debt restructuring ($16,000,000 − $13,168,371) | | 2,831,629 |

To record transfer of real estate with an estimated fair value of $13,168,371 in satisfaction of payable to XYZ Bank.

[19] Gain recognition may not be appropriate if the restructuring is with related parties. ASC 470-50-40-2 indicates that such a restructuring may be in essence a capital transaction.

**Illustration 2-11: Debt restructuring involving transfer of note receivable**

ABC Company transfers a $10,000,000 mortgage note receivable from a third party to XYZ Bank in full settlement of $9,000,000 debt of ABC. The mortgage has a remaining term of 10 years and is payable in monthly installments of $121,000, including interest at 8%. Assuming a current market interest rate of 12% for similar financing, the fair value of the mortgage would be determined as follows:

| | |
|---|---|
| Monthly payment | $ 121,000 |
| Apply a discount factor for 120 monthly payments at 1% (12% per year compounded monthly) | 69.701 |
| Estimated fair value | $ 8,433,821 |

The following journal entries summarize the accounting for the restructuring by the debtor:

| | | |
|---|---|---|
| Payable to XYZ Bank | $ 9,000,000 | |
| Loss on disposition of assets ($10,000,000 − $8,433,821) | 1,566,179 | |
| Mortgage loan receivable | | $ 10,000,000 |
| Gain on debt restructuring ($9,000,000 − $8,433,821) | | 566,179 |

To record transfer of mortgage in satisfaction of payable to XYZ Bank.

**Illustration 2-12: Debt restructuring involving transfer of equity interest**

ABC Company issues 2,000,000 shares of its common stock to XYZ Bank in full settlement of debt totaling $8,000,000. The common stock is selling at $1 per share in the open market. In accounting for the debt restructuring, ABC would recognize a gain of $6,000,000 ($8,000,000 less $2,000,000, the estimated fair value of the shares issued).

### *2.6.1.3.2 Modification of terms in a troubled debt restructuring*

When a troubled debt restructuring involves a modification of terms, ASC 470-60 requires the debtor to account for the modification on a prospective basis. The carrying amount of the payable is not adjusted (except in the circumstances discussed below), and the effects of the changes are reflected in future periods. Interest expense for future periods (exclusive of contingent interest) is computed by the interest method. That is, a constant effective interest rate is applied to the carrying amount of the payable at the beginning of each period between restructuring and maturity. The effective interest rate is the discount rate that equates the present value of the future cash payments specified by the new terms (excluding amounts contingently payable) with the carrying amount of the payable.

The accounting described in the preceding paragraph is based on the premise that a troubled debt restructuring involving a modification of terms does not involve the transfer of resources or obligations and is a continuation of an existing debt. A creditor's primary objective is to recover its investment by reducing the effective interest rate between the restructuring date and maturity. The effect on cash flows is essentially the same whether the modifications involve changes in amounts designated as face amount or interest and that accounting for restructured debt should be based on the substance of the modification — the effect on cash flows — not on labels chosen to describe those cash flows.

However, an adjustment to the carrying amount of the restructured debt is required when the carrying amount exceeds the aggregate undiscounted future principal and interest payments specified in the new terms. When this occurs, the debtor recognizes a gain equal to the carrying amount of the payable in excess of future cash payments. However, no gain on a restructured payable may be recognized if the maximum total undiscounted future cash payments could exceed the carrying amount of the payable (refer to section 2.6.1.3.4 for discussions on payables involving variable cash flows).

If the carrying amount of the payable is in excess of the maximum total undiscounted future cash flows, a gain is recognized by the debtor for the excess. Subsequently, all cash receipts and payments under the terms of the restructured debt, whether designated as interest or as face amount, reduce the carrying amount of the payable and no interest expense is recognized (contingent payments can affect this accounting as discussed in section 2.6.1.3.4).

**Illustration 2-13: Debt restructuring involving modification of terms (no gain recognized)**

On 31 December 20X1, a $10,000,000 note is restructured by (1) forgiving $1,000,000 of principal and $1,200,000 of accrued interest, (2) extending the maturity date from 31 December 20X1 to 31 December 20X6 and (3) reducing the interest rate from 12% to 6%. The aggregate undiscounted future cash flows under the new terms total $11,700,000 (principal of $9,000,000 and interest of $2,700,000), which exceeds the aggregate pre-restructuring carrying amount of $11,200,000. Consequently, no adjustment would be made to the debtor's carrying amount of the payable.

To compute interest expense in future periods, the debtor would calculate a new effective interest rate that equates the future cash flows under the restructured terms to the aggregate pre-restructuring carrying amount of $11,200,000.

The following schedule summarizes the payments under the new terms and the amount of interest based on a calculated effective interest rate of 0.9682%, the rate necessary to discount the future stream of cash payments to a present value equal to the carrying amount of the debt.

| Date | Payment | Nature of payment under new terms | Interest at effective interest rate | Balance |
|---|---|---|---|---|
| 12-31-X1 | | | | $ 11,200,000 |
| 12-31-X2 | $ 540,000 | Interest | $ 108,437 | 10,768,437 |
| 12-31-X3 | 540,000 | Interest | 104,259 | 10,332,696 |
| 12-31-X4 | 540,000 | Interest | 100,040 | 9,892,736 |
| 12-31-X5 | 540,000 | Interest | 95,781 | 9,448,517 |
| 12-31-X6 | 540,000 | Interest | 91,483 | 9,000,000 |
| 12-31-X6 | 9,000,000 | Principal | – | |
| | $ 11,700,000 | | $ 500,000 | |

Note that the amounts to be recognized as interest expense are not the amounts designated as "interest" under the terms of the debt. The following journal entries summarize the accounting by the debtor for future cash payments under the restructured terms:

20X2:

| | | |
|---|---|---|
| Debt | $ 431,563 | |
| Interest expense | 108,437 | |
| Cash | | $ 540,000 |

To record payment of $540,000 on 31 December 20X2 as a partial reduction in the carrying amount of the debt and a charge to interest expense based on the calculated interest rate (0.9682%) under the new debt terms. Similar entries would be made for each year 20X3–20X6.

Upon maturity, the following entry would be made:

| | | |
|---|---|---|
| Debt | $ 9,000,000 | |
| Cash | | $ 9,000,000 |

To record payment of stated principal amount due under the terms of the restructured debt on 31 December 20X6.

**Illustration 2-14: Debt restructuring involving modification of terms (gain recognized)**

Assume the above facts as in the preceding illustration, except that the interest rate is reduced to 2%. Aggregate undiscounted future cash payments total $9,900,000, which is $1,300,000 less than the pre-restructuring amounts. In this case, the debtor would reduce the carrying amount of the payable by $1,300,000 and recognize a gain equal to this amount. Future cash payments reduce the payable, and no interest expense would be recognized as the effective interest rate is 0%.

The following journal entries summarize the accounting by the debtor for this transaction:

**20X1:**

| | | | |
|---|---|---|---|
| Debt | $ 1,300,000 | | |
| Gain on restructuring of debt | | $ | 1,300,000 |

To adjust carrying amount of the debt to reflect modification of terms.

**20X2 through 20X6:**

| | | | |
|---|---|---|---|
| Debt | $ 180,000 | | |
| Cash | | $ | 180,000 |

To record annual payment of amounts under the terms of the payable for each year 20X2 through 20X6 as reductions in the carrying amount of the debt (0% interest rate).

**20X6:**

| | | | |
|---|---|---|---|
| Debt | $ 9,000,000 | | |
| Cash | | $ | 9,000,000 |

To record payment of principal amount due under the terms of the restructured debt on 31 December 20X6.

### *2.6.1.3.3 Combination of types including partial satisfaction*

Debt restructurings may include a combination of transferring an asset or equity interest and modifying the terms of the debt. The accounting for these restructurings is the same as that for a modification of terms. The fair value of assets transferred or equity interest granted should be accounted for as a partial cash payment. The accounting for debt restructurings including a combination of terms is as follows:

- The carrying amount of the payable is reduced by the fair value of the assets or equity interest transferred (the guidance precludes the use of fair value of debt in these situations).
- The debtor recognizes a gain or loss resulting from any disposition of assets (based on the difference between the fair value of the assets disposed and their respective carrying amount).
- No gain on restructuring is recognized unless the remaining balance of the debt exceeds total undiscounted future cash payments specified in the new terms (refer to section 2.6.1.3.4 on a discussion of variable interest and contingent interest).
- Future interest expense (if any) is computed using the interest method.

**Illustration 2-15: Debt restructuring involving a combination of types including partial satisfaction**

On 31 December 20X8, XYZ Bank agrees to restructure a $10,000,000 loan receivable from ABC Company by accepting:

- Real estate with a fair value of $6,000,000 (ABC's carrying amount was $6,500,000).
- A 10% note for $3,000,000 from ABC due 31 December 20Y6.

The debtor would reduce the $10,000,000 debt by $6,000,000, the fair value of the real estate transferred. Whether a gain on restructuring should be recognized would be determined as follows:

Total undiscounted future cash payments:

| | |
|---|---|
| Principal | $ 3,000,000 |
| Interest ($3,000,000 x 10% for 8 years) | 2,400,000 |
| | 5,400,000 |
| Less remaining debt: | (4,000,000) |
| Excess of future cash payments over remaining debt | $ 1,400,000 |

Because the total of future cash payments is more than the remaining carrying amount, no gain should be recognized on the restructuring. ABC would recognize loss on disposition of assets of $500,000 ($6,500,000 − $6,000,000). Interest for future periods would be computed using a new effective interest rate of 4.8697%, which is the rate necessary to discount the future stream of cash payments to the remaining debt.

The following schedule summarizes the payments under the new terms and the amount of interest to be recognized in future periods:

| Date | Payment | Nature of payment under new terms | Interest at effective interest rate | Balance |
|---|---|---|---|---|
| 12-31-X8 | | | | $ 4,000,000 |
| 12-31-X9 | $ 300,000 | Interest | $ 194,789 | 3,894,789 |
| 12-31-Y0 | 300,000 | Interest | 189,665 | 3,784,454 |
| 12-31-Y1 | 300,000 | Interest | 184,292 | 3,668,746 |
| 12-31-Y2 | 300,000 | Interest | 178,658 | 3,547,404 |
| 12-31-Y3 | 300,000 | Interest | 172,748 | 3,420,152 |
| 12-31-Y4 | 300,000 | Interest | 166,552 | 3,286,704 |
| 12-31-Y5 | 300,000 | Interest | 160,053 | 3,146,757 |
| 12-31-Y6 | 300,000 | Interest | 153,243 | 3,000,000 |
| 12-31-Y6 | 3,000,000 | Principal | – | – |
| | $ 5,400,000 | | $ 1,400,000 | |

### *2.6.1.3.4 Contingent payments and payments based on variable interest rates*

*Contingent payments*

Troubled debt restructurings often include provisions that require payment of additional amounts if certain conditions are met in the future. Generally, those conditions will require additional payments based on a specified improvement in the debtor's financial condition or operating results within a specified period. Generally, no gain is recognized on a restructured payable that involves indeterminate cash payments as long as it is possible that the maximum total future cash payments on an undiscounted basis may exceed the carrying amount of the payable.

Pursuant to ASC 470-60-35-7, contingent payments should be included in the total future cash payments specified by the new terms to the extent necessary to prevent recognizing a gain at the time of restructuring that may be offset by future interest expense. A gain should be recognized only when the total future payments are certain to be less than the then-carrying amount of the restructured payable.

As described in ASC 470-60-35-10, after the time of restructuring, the debtor recognizes interest expense and a payable for contingent payments when it is probable that a liability has been incurred and the amount can be reasonably estimated (i.e., a loss contingency), pursuant to the provisions of ASC 450. However, accrual or payment of those amounts should be first deducted from the carrying amount of the restructured payable to the extent that the contingent payments were included in total future cash payments specified by the new terms and prevented recognition of a gain at the time of restructuring.

*Payments based on variable interest rates*

In some cases, future payments on the restructured payable are expected to fluctuate because the restructured debt involves a variable interest rate. Although these cash flows could be viewed as indeterminate, ASC 470-60-35-11 requires the estimate of the maximum total future cash payments for variable interest payments to be based on the contractual variable interest rate in effect at the time of the restructuring (the "TDR rate"). We generally believe a gain can be recognized only when the maximum total future payments, estimated using the TDR rate, is less than the carrying value of the restructured payable. In circumstances where a gain is recognized, the carrying value of the debt will equal the maximum total future payments, estimated using the TDR rate. If there are any other contingent or indeterminate cash flows, gain recognition would not be appropriate if it is possible that the maximum total future cash payments on an undiscounted basis, plus the estimate of variable cash flows based on the TDR rate, may exceed the carrying amount of the payable.

If the interest rate remains unchanged after the restructuring, all future principal and interest payments will reduce the carrying amount resulting in no amounts being charged to interest expense. Fluctuations in the contractual interest rate after the restructuring from changes in the variable rate index should be accounted for as changes in estimates in the periods in which the changes occur (prospectively). To the extent the contractual interest rate increases above the TDR rate in a subsequent period, we generally believe interest expense should be recognized in the subsequent period equal to the amount the interest payment exceeds the payment estimated using the TDR rate. A decrease in the contractual interest rate below the TDR rate should not result in recognizing a gain for that particular interest payment, as that gain may be offset by future higher cash payments. Rather, future cash payments should reduce the carrying amount until the time that any gain recognized cannot be offset by future cash payments. Because the interest rate can increase in the future, we generally believe no gain should be recognized until the entire debt balance is extinguished.

**Illustration 2-16: Debt restructuring involving a variable rate payable**

On 31 December 20X8, an $8,000,000 note and related accrued interest of $1,000,000 are restructured by:

- Forgiving $1,500,000 of the face amount of the note and forgiving the accrued interest of $1,000,000
- Extending the maturity date five years from 31 December 20X8 to 31 December 20Y3
- Reducing the interest rate from 12% to a rate equal to the prime interest rate

Based on the interest rate in effect at time of the restructuring (the prime interest rate at 31 December 20X8 is 7%), future cash payments under the new terms total $8,775,000 (principal of $6,500,000 and interest of $2,275,000 — calculated as five years times 7% times $6,500,000), which is $225,000 less than the pre-restructured carrying amount of the debt.

The following schedule summarizes the payments under the new terms (note the actual payments and estimated maximum payments reflect the actual prime rate of 7% for 20X9, 8% for 20Y0, 6.5% for 20Y1 and 20Y2, and 6% for 20Y3):

| Date | Estimated maximum total future cash payments based on prime rate as of restructuring date | Actual payments | Carrying amount of payable | Income statement effect Income/(expense) |
|---|---|---|---|---|
| 12-31-X8 before restructuring | | | $ 9,000,000 | |
| 12-31-X8 after restructuring | | | 8,775,000[1] | $ 225,000 |
| 12-31-X9 | $ 455,000 | $ 455,000 | 8,320,000 | – |
| 12-31-Y0 | 455,000 | 520,000 | 7,865,000 | (65,000)[2] |
| 12-31-Y1 | 455,000 | 422,500 | 7,442,500 | – |
| 12-31-Y2 | 455,000 | 422,500 | 7,020,000 | – |
| 12-31-Y3 interest | 455,000 | 390,000 | 6,630,000 | – |
| 12-31-Y3 principal | 6,500,000 | 6,500,000 | – | 130,000 |
| Total | $ 8,775,000 | $ 8,710,000 | | $ 290,000 |

(1) After recognition of gain on restructuring. The gain is the difference between the carrying amount of $9,000,000 (principal and accrued interest before restructuring) less the estimated maximum total future undiscounted cash flows of $8,775,000 at the restructuring date.

(2) Because the interest rate has increased above the TDR rate, interest expense is recognized in the amount of $65,000 ($520,000 − $455,000).

We generally believe that in situations where interest payments are expected to fluctuate, a gain should be recognized at the time of restructuring when the maximum total future cash payments, estimated using the interest rate in effect at the time of restructuring, is less than the carrying amount of the restructured payable. Because the prime rate increased in 20Y0 above the interest rate at the date of restructuring, additional interest expense is recognized in 20Y0. In years subsequent to 20Y0, the interest rate decreased below the interest rate at the date of restructuring. No gain is recognized in those periods and the cash payments reduce the carrying amount. A gain is not recognized until the entire debt is extinguished.

#### *2.6.1.3.5 Notes payable 'on demand' or with prepayment provisions*

If the number of interest payments is not determinable because the principal and interest are or become payable on demand, estimates of the total future cash payments under the restructured terms should be based on the maximum number of periods that payments may possibly be made by the debtor.

In situations in which a debtor is permitted to prepay a reduced face amount without penalty, total future cash payments could be less than the carrying amount of the debt. ASC 470-60 gives no recognition to prepayment provisions in determining gain or loss at the date of restructuring. Likewise an investor's put option would be ignored. If the debtor does prepay, a change in estimate should be recognized at the time of prepayment.

**Illustration 2-17: Debt restructuring involving payable "on demand"**

On 31 December 20X8, a $1,000,000 note is restructured by

- Forgiving $200,000 of principal and total accrued interest of $100,000
- Extending the maturity date from 31 December 20X8 to 31 December 20Y3
- Reducing the interest rate from 10% to 8%.

In addition, the new terms provide that the principal becomes payable on the investor's demand if management's profit projections are not met during any year after 31 December 20Y0. The earliest payment date for the borrower is three years after restructuring, 31 December 20Y1.

The aggregate future cash payments are determined based on the maximum number of periods and payments, ignoring the potential for an early redemption by the investors. Under the new terms, assuming the maximum possible term (5 years), the aggregate possible future cash payments total $1,120,000, which is $20,000 greater than the pre-restructuring carrying amount. Consequently, no adjustment would be made to the debtor's carrying amount of the payable on restructuring.

If actual aggregate future cash flows differ from the estimated amounts, as determined above, the effect should be accounted for as a change in estimate in the period the change occurs.

#### *2.6.1.3.6 Costs incurred in connection with troubled debt restructurings*

Direct costs incurred in granting equity interests in a troubled debt restructuring should be recognized as a reduction to the carrying amount of the equity interests. All other direct costs incurred should be deducted in measuring gain on restructuring of payables or expensed for the period if no gain recognized on restructuring.

## 2.6.2 Modifications or exchanges of debt instruments

### 2.6.2.1 General

Modifications or exchanges of debt that are not considered troubled debt restructuring pursuant to ASC 470-60 should be evaluated under ASC 470-50, which states that modifications or exchanges are considered extinguishments with gains or losses recognized in current earnings if the terms of the new debt and original instrument are substantially different. The instruments are considered "substantially different" pursuant to ASC 470-50 (generally in ASC 470-50-40-6 through 40-23) when the present value of the cash flows under the terms of the new debt instrument is at least 10% different from the present value of the remaining cash flows under the terms of the original instrument.

If the original and new debt instruments are substantially different, the original debt is derecognized and the new debt should be initially recorded at fair value, with the difference recognized as an extinguishment gain or loss. Gain or loss recognition may not be appropriate if the restructuring is with related parties.

ASC 470-50-40-2 indicates that such a restructuring may be in essence a capital transaction. When modifications or exchanges are not considered extinguishments, they are accounted for prospectively as yield adjustments, based on the revised terms.

The accounting for (1) fees paid by the debtor to the creditor or received by the debtor from the creditor and (2) costs incurred with third parties directly related to the exchange or modification depends on whether the exchange or modification is to be accounted for as an extinguishment or modification.

Modifications to or exchanges of line-of-credit or revolving arrangements should be evaluated pursuant to ASC 470-50-40-21 through 40-23. The accounting for unamortized deferred costs, costs paid to third parties and fees paid to or received from the creditor depends on whether the borrowing capacity — the product of the remaining term and the maximum available credit — has increased or decreased.

### 2.6.2.2 Scope of the debt modification guidance in ASC 470-50

ASC 470-50 provides the accounting for a modification or exchange of a debt instrument between the same debtor and creditor. An exchange of debt instruments with different terms but with the same creditor has the same economic effect of modifying the terms of an existing debt instrument and thus is in the scope of ASC 470-50.

When the debtor and creditor agree to modify existing debt or exchange old debt for new debt, they have, in effect, renegotiated the old debt by changing its cash flows. While the modification or exchange of debt does not meet the conditions specified in ASC 405-20 for extinguishment accounting, substantial changes in the cash flows are viewed to represent extinguishments of the old debt and the creation of new debt, resulting in recognition of gain or loss by the debtor.

ASC 470-50 does not apply to:

- Conversion of debt into equity securities of the debtor pursuant to the conversion right contained in the terms of the debt instrument
- A troubled debt restructuring
- Transactions entered into between a debtor (or its agent) and a third party that is not the creditor
- Transactions among creditors

When there is more than one creditor in a debt arrangement (e.g., a loan syndication), the debt modification guidance should be applied on a creditor-by-creditor basis. In certain cases, it may not be clear who the "creditor" is for purposes of applying the modification guidance. For example, when multiple limited partnership funds, managed by a general partner, participate as lenders in a loan syndication for which a debt modification or exchange occurs, the question arises as to whether the individual funds should be viewed as separate creditors or as one creditor. When identifying the creditors, the specific facts and circumstances should be considered. In this case the debtor may consider (1) how the funds are structured and managed; (2) whether the funds are consolidated by the general partner; and (3) what the roles of the general partner and the funds are in the negotiation of the debt modification or exchange.

#### *2.6.2.2.1 Contemporaneous exchange of cash between the same debtor and creditor from issuance of new debt and satisfaction of an existing debt by the debtor*

A contemporaneous exchange of cash between the same debtor and creditor in connection with the issuance of a new debt instrument and satisfaction of an existing debt instrument by the debtor is covered by the scope of the debt modification guidance, according to ASC 470-50-40-9. That is, the transaction would be accounted for as a debt extinguishment only if the existing and new debt instruments have substantially different terms.

#### *2.6.2.2.2 Debtor with an irrevocable offer to redeem a debt instrument at a future date*

An issuer's irrevocable offer to redeem a debt instrument does not require the application of the debt modification guidance in ASC 470-50 because the irrevocable offer is not a binding contract between the debtor and creditor and thus neither a modification nor an exchange has occurred.

### 2.6.2.3 Determining whether debt instruments are substantially different

Modified terms are considered substantially different pursuant to ASC 470-50 (thus requiring extinguishment accounting) if, after an exchange or modification of debt instruments with the same creditor, the present value of cash flows under the terms of the new debt instrument differs by at least 10% from the present value of the remaining cash flows under the terms of the original debt instrument (commonly referred to as the "10% cash flow test").

We believe that this assessment should be performed at the reporting entity level. For example, if a subsidiary's debt is exchanged for new debt issued to the same lender by the parent entity, the 10% cash flow test would be performed on a consolidated basis, for the purposes of the consolidated financial statements. If the subsidiary has a standalone financial reporting requirement, the subsidiary's debt would be considered extinguished in the exchange transaction.

For the purposes of this calculation, the cash flows of the original and new instruments should be discounted at the effective interest rate used for accounting purposes of the original debt instrument. We believe the original debt's effective interest rate should generally be the rate under the interest method described in ASC 835-30-35-2 and 35-3, which is the rate that was computed using the original debt's face amount, stated interest rate and unamortized premium or discount, as appropriate. We generally do not believe that the effect of (1) debt issuance costs or (2) subsequent hedging (including basis adjustments to the old debt under a fair value hedge) should be included in computing the debt's original effective rate.

The effect of changes in principal amounts, interest rates or maturity should be considered in determining whether the terms of the original debt and new debt are substantially different. The 10% cash flow test should be performed using the gross cash inflows and outflows, including all principal increases and decreases.[20] For example, if a debtor and creditor modify the debt by reducing the interest rate and concurrently the debtor borrows an additional amount, the additional borrowing is considered a day one cash flow when performing the 10% cash flow test. Refer to Illustrations 2-21 and 2-22 in section 2.6.2.3.3 for examples of applying the 10% cash flow test that involve changes in principal amounts.

Cash flows can also be affected by fees exchanged between the debtor and creditor attributable to changes in recourse features, collateralization, debt covenants and option features. For example, fees paid to a creditor in exchange for a waiver of a debt covenant should be viewed as a modification of the debt instrument, and that cash flow should be considered in the calculation of the present value of cash flows. Any amounts paid by the debtor to the creditor less any amounts received by the debtor from the creditor as part of the transaction are to be included as part of the cash flows of the new debt instrument.

The debt modification guidance in ASC 470-50 also requires the following items to be considered in the calculation of the present value of cash flows:

- If the original debt instrument and/or the new debt instrument has a floating interest rate, the variable rate in effect at the date of the exchange or modification should be used to determine future cash flows.

[20] Refer to the discussion on accounting for fees for prepayable debt below in section 2.6.2.5.

- If the debt instruments contain contingent payment terms or unusual interest rate terms, judgment should be used to determine the appropriate cash flows.
- If the debt was exchanged or modified within a year before the current exchange or modification and the debt was not deemed to be substantially different at that time (i.e., the exchange or modification was not accounted for as an extinguishment), the debt terms that existed before the earlier exchange or modification should be used to determine whether the debt is substantially different after the current exchange or modification.

There may be instances in which a debtor has multiple debt instruments outstanding with a single creditor. The debtor and creditor may modify one instrument, a combination of instruments or all of those instruments. While this is not addressed in ASC 470-50, we believe judgment should be applied to determine whether the debt instruments should be evaluated individually or collectively. In some cases it may be appropriate or necessary to combine multiple instruments into a single unit of analysis to accurately capture the economics of the transaction. That is, if some or all of the instruments are modified contemporaneously to achieve a desired economic effect, they may need to be evaluated collectively. All facts and circumstances should be considered when making this determination.

To the extent some or all of the debt instruments should be combined into a single unit of analysis, the debtor should use a blend of the effective interest rates of the original debt instruments before they were modified. The result of the 10% cash flow test should be applied to all debt instruments outstanding that were combined into the single unit of analysis (e.g., if the terms are considered to be substantially different, all of the debt instruments combined for analysis are considered extinguished).

Refer to section 2.6.2.3.3 for examples of applying the 10% cash flow test to modifications and exchanges of nonconvertible debt instruments.

If the modification or exchange involves a convertible debt instrument, the change in the fair value of an embedded conversion option resulting from the modification or exchange should not be included in the 10% cash flow test calculation, and the specific guidance in ASC 470-50 on convertible instruments should be considered (refer to section 2.6.2.4).

#### *2.6.2.3.1 Performing the cash flow test involving exchange of noncash consideration*

Modifications or exchanges of debt instruments may involve issuance of noncash consideration (e.g., warrants, options, shares) to the creditor. ASC 470-50-40-12 states that the cash flows of the new instrument should include all cash flows specified by the terms of the new instrument plus any amounts paid or exchanged between the debtor and the creditor in connection with the exchange or modification.

While the guidance is not specific as to what is considered "any amount paid," we generally believe that the fair value of the noncash consideration issued as part of the modification or exchange transaction should be included as a day one cash flow in the 10% cash flow test. This treatment is consistent with the guidance in ASC 470-60-55-12 for troubled debt restructurings when determining whether a concession is made by the creditor. That guidance requires the fair value of any new or changes in the fair value of revised sweeteners (e.g., warrants, options, guarantees) be included in day one cash flows in determining whether the creditor has made concession.

#### *2.6.2.3.2 Performing the cash flow test when debt instruments are prepayable prior to maturity*

If either the new debt instrument or the original debt instrument is callable or puttable (prepayable), separate cash flow analyses should be performed assuming exercise and non-exercise of the call or put. The cash flow assumptions that generate the smaller change should be used as the basis for determining whether the 10% threshold is met. If the instrument is callable and/or puttable at several points during its life (e.g., puttable or callable at any time), the present value of the remaining cash flows should be

computed using each call or put date and amount. Because the cash flow assumptions that generate the smaller change are used to determine whether the 10% threshold is met, if any of the call or put exercises results in less than a 10% difference, extinguishment accounting should not be followed.

As discussed above, even though existing debt may be prepayable, we generally believe the 10% cash flow test must include any principal repayment when the debt remaining after prepayment is modified.

### *2.6.2.3.3 Illustrations — 10% cash flow test*

**Illustration 2-18: Reduced interest rate on non-callable debt**

On 1 January 20X1, Debtor borrows $100,000 from Creditor at par with a stated interest rate of 14%. No fees were paid by Debtor to Creditor, so the debt was initially recorded at par. Subsequently, market interest rates decline. On 1 January 20X4, Debtor and Creditor modify the debt, which under its new terms has a stated interest rate of 12%. The original terms and the terms of the modified debt are as follows:

| Terms | Original | Modified |
|---|---|---|
| Principal: | $100,000 | $100,000 |
| Term (from modification date): | 7 years | 7 years |
| Rate: | 14% | 12% |
| Callable: | Non-callable | Non-callable |

Summary of cash outflows:

| Year | Remaining interest | Original principal | Total | Modified interest | Principal | Total |
|---|---|---|---|---|---|---|
| X4 | $ 14,000 | – | $ 14,000 | $ 12,000 | – | $ 12,000 |
| X5 | 14,000 | – | 14,000 | 12,000 | – | 12,000 |
| X6 | 14,000 | – | 14,000 | 12,000 | – | 12,000 |
| X7 | 14,000 | – | 14,000 | 12,000 | – | 12,000 |
| X8 | 14,000 | – | 14,000 | 12,000 | – | 12,000 |
| X9 | 14,000 | – | 14,000 | 12,000 | – | 12,000 |
| Y0 | 14,000 | $ 100,000 | 114,000 | 12,000 | $ 100,000 | 112,000 |
| Total | $ 98,000 | $ 100,000 | $198,000 | $ 84,000 | $ 100,000 | $184,000 |

Present value test:

Using the effective interest rate of the original debt, which in this case is also the stated interest rate (14%) as there are no unamortized premium or discount, the present values of (1) the cash flows under the terms of the modified debt instrument and (2) the remaining cash flows under the original debt's terms, are as follows:

| | |
|---|---|
| Present value of modified debt's cash flows | $ 91,424 |
| Present value of original debt's remaining cash flows | $ 100,000 |

The original and modified debt instruments are not considered substantially different as the difference between the present value of the remaining cash flows under the original and the modified terms is less than 10% (i.e., the difference is 8.58%).

Because the original and new debt instruments are not considered substantially different, extinguishment accounting does not apply. A new effective interest rate should be determined at the date of modification that equates the revised cash flows to the carrying amount of the original debt.

**Illustration 2-19: Reduced interest rate in return for giving up call privilege**

On 1 January 20X1, Debtor borrows $100,000 from Creditor at par with a stated interest rate of 14.5%. No fees were paid by Debtor to Creditor, so the debt was initially recorded at par. The debt is callable at the end of Year 5 for 109. Since issuance, market interest rates have declined. On 1 January 20X4, Debtor agrees to give up its call privilege two years before the exercise date. In exchange for giving up the call privilege, Debtor will pay a reduced interest rate of 9.5%, which is still above the then-current market rate of 8.5%.

| Terms | Original | Modified |
|---|---|---|
| Principal: | $100,000 | $100,000 |
| Term (from modification date): | 7 years | 7 years |
| Rate: | 14.5% | 9.5% |
| Callable: | End of Year 5 | Non-callable |
| Call Premium: | 9% | N/A |

Summary of cash outflows:

| Year | Remaining interest | Original principal | Total | Modified interest | Principal | Total |
|---|---|---|---|---|---|---|
| X4 | $ 14,500 | – | $ 14,500 | $ 9,500 | – | $ 9,500 |
| X5 | 14,500 | – | 14,500 | 9,500 | – | 9,500 |
| X6 | 14,500 | – | 14,500 | 9,500 | – | 9,500 |
| X7 | 14,500 | – | 14,500 | 9,500 | – | 9,500 |
| X8 | 14,500 | – | 14,500 | 9,500 | – | 9,500 |
| X9 | 14,500 | – | 14,500 | 9,500 | – | 9,500 |
| Y0 | 14,500 | $ 100,000 | 114,500 | 9,500 | $ 100,000 | 109,500 |
| Total | $ 101,500 | $ 100,000 | $ 201,500 | $ 66,500 | $ 100,000 | $ 166,500 |

Present value test:

If either the new debt instrument or the original debt instrument is callable, the debt modification guidance in ASC 470-50 requires separate cash flow analyses to be performed assuming exercise and non-exercise of the call. The cash flow assumptions that generate the smaller change would be the basis for determining whether the 10% threshold is met.

Discounting the cash flows at the original debt's effective rate of 14.5% (which is also the stated interest rate in this case as there are no unamortized premium or discount), the present values of the original and revised cash flows are as follows:

| | |
|---|---|
| Present value of modified debt's cash flows | $ 78,882 |
| Present value of original debt's remaining cash flows, call exercised | $ 106,865 |
| Present value of original debt's remaining cash flows, call not exercised | $ 100,000 |

The present value of the original cash flows is calculated both assuming the call is not exercised (present value is $100,000) and assuming the call is exercised on 31 December 20X5 (present value is $106,865). The present value of the modified cash flows is only calculated through maturity as the call no longer exists (present value is $78,882). The debt modification guidance in ASC 470-50 requires the smaller difference between the modified $78,882 present value and the original $100,000 present value to be used in the substantially different test. Because the difference between the $78,882 and $100,000 represents a change of 21.12% (which is greater than the 10% threshold), the terms of the modified debt are considered substantially different from the original loan terms.

Once becoming callable, debt may remain callable (at decreasing call premiums) until maturity. The debt modification guidance in ASC 470-50 requires that the present value of the original debt's remaining cash flows be computed using each call date and amount. Because the cash flow assumptions that generate the smaller change are determining whether the 10% threshold is met, if any of the calculations of the call exercises result in less than a 10% difference from the present value of the modified debt's cash flows, extinguishment accounting would not apply. Debt may be callable at any time, which would require a calculation as if the debt were repaid immediately after the modification, suggesting no discounting of the principal amount and no future interest payments.

**Illustration 2-20: Debtor pays fee for release from restrictive covenants**

On 1 January 20X1, Debtor borrows $100,000 from Creditor at par with a stated interest rate of 10.5%. No fees were paid by Debtor to Creditor, so the debt was initially recorded at par. On 1 January 20X4, Debtor pays a 3% fee to Creditor for a release from certain restrictive covenants.

| Terms | Original | Modified |
|---|---|---|
| Principal: | $100,000 | $100,000 |
| Term (from modification date): | 7 years | 7 years |
| Rate: | 10.5% | 10.5% |
| Covenants: | Yes | No |

Summary of cash outflows:

| Year | Remaining interest | Original principal | Total | Modified interest | Fee | Principal | Total |
|---|---|---|---|---|---|---|---|
| X4 | $ 10,500 | – | $ 10,500 | $ 10,500 | $ 3,000 | – | $ 13,500 |
| X5 | 10,500 | – | 10,500 | 10,500 | – | – | 10,500 |
| X6 | 10,500 | – | 10,500 | 10,500 | – | – | 10,500 |
| X7 | 10,500 | – | 10,500 | 10,500 | – | – | 10,500 |
| X8 | 10,500 | – | 10,500 | 10,500 | – | – | 10,500 |
| X9 | 10,500 | – | 10,500 | 10,500 | – | – | 10,500 |
| Y0 | 10,500 | $ 100,000 | 110,500 | 10,500 | – | $ 100,000 | 110,500 |
| Total | $ 73,500 | $ 100,000 | $173,500 | $ 73,500 | $ 3,000 | $ 100,000 | $ 176,500 |

Present value test:

Using the effective interest rate of the original debt, which is also the stated interest rate (10.5%) in this case as there are no unamortized premium or discount, the present values of (1) the cash flows under the terms of the new debt instrument (the $3,000 fee is treated as day one undiscounted cash flow) and (2) the remaining cash flows under the original debt's terms are as follows:

| | |
|---|---|
| Present value of modified debt's cash flows | $ 103,000 |
| Present value of original debt's remaining cash flows | $ 100,000 |

The original and modified debt instruments are not considered substantially different as the difference between the present value of the remaining cash flows under the original terms and the modified terms is less than 10% (i.e., the difference is 3.0%).

At the modification date the following entry would be required to record the $3,000 fee paid to Creditor as a discount on the debt (rather than being expensed):

| | | |
|---|---|---|
| Debt | $ 3,000 | |
| Cash/payable | | $ 3,000 |

Because the original and new debt instruments are not substantially different, extinguishment accounting does not apply. A new effective interest rate should be determined based on the carrying amount ($97,000) and the revised cash flows.

**Illustration 2-21: Additional borrowings with reduction in interest rate**

On 1 January 20X1, Debtor borrows $100,000 from Creditor at par with a stated interest rate of 14%. No fees were paid by Debtor to Creditor, so the debt was initially recorded at par. Subsequently, market interest rates declined. On 1 January 20X4, Debtor and Creditor modify the debt, reducing the interest rate to 12%. In addition, Debtor borrows an additional $50,000. The terms of the original and modified debt are as follows:

| Terms | Original | Modified |
|---|---|---|
| Principal: | $100,000 | $150,000 |
| Term (from modification date): | 7 years | 7 years |
| Rate: | 14% | 12% |
| Callable: | Non-callable | Non-callable |

Summary of cash (inflows)/outflows:

| Year | Interest | Remaining principal | Original total | Modified interest | Modified principal | Total |
|---|---|---|---|---|---|---|
| X4 | $ 14,000 | – | $ 14,000 | $ 18,000 | $ (50,000) | $ (32,000) |
| X5 | 14,000 | – | 14,000 | 18,000 | – | 18,000 |
| X6 | 14,000 | – | 14,000 | 18,000 | – | 18,000 |
| X7 | 14,000 | – | 14,000 | 18,000 | – | 18,000 |
| X8 | 14,000 | – | 14,000 | 18,000 | – | 18,000 |
| X9 | 14,000 | – | 14,000 | 18,000 | – | 18,000 |
| Y0 | 14,000 | $ 100,000 | 114,000 | 18,000 | 150,000 | 168,000 |
| Total | $ 98,000 | $ 100,000 | $ 198,000 | $ 126,000 | $ 100,000 | $ 226,000 |

Present value test:

Using the effective interest rate of the original debt, which is also the stated interest rate (14%) in this case as there are no unamortized premium or discount, the present values of (1) the cash flows under the terms of the new debt instrument and (2) the remaining cash flows under the original debt's terms are as follows:

| | |
|---|---|
| Present value of modified debt's cash flows | $ 87,135* |
| Present value of original debt's remaining cash flows | $ 100,000 |

* Calculated as PV of principal ($150,000 in 7 years at 14%) plus PV of interest annuity ($18,000 per year for 7 years at 14%) less additional borrowings of $50,000 (treated as a day one cash inflow on the modified debt).

The terms of the instruments would be considered substantially different because the difference in the present value of the remaining cash flows under the old terms and the new terms is greater than 10% (i.e., the difference is 12.87%). The modification is to be accounted for in the same manner as a debt extinguishment.

**Illustration 2-22: Debtor prepays a portion of principal on non-callable debt and Debtor and Creditor agree to a reduced interest rate and a two-year extension of the maturity date**

On 1 January 20X1, Debtor borrows $100,000 from Creditor at par with a stated interest rate of 10%. No fees were paid by Debtor to Creditor, so the debt was initially recorded at par. The debt is not prepayable by its terms. Subsequently, market interest rates decline. On 1 January 20X4, Debtor negotiates to prepay $25,000 of the principal balance. In addition, the Debtor and Creditor modify the debt, reducing the interest rate to 8% and extending the maturity date two years. The original terms and the terms of the modified debt are as follows:

| Terms | Original | Modified |
|---|---|---|
| Principal: | $100,000 | $75,000 (reduced by negotiated prepayment) |
| Term (from modification date): | 7 years | 9 years |
| Rate: | 10% | 8% |
| Callable: | Non-callable | Non-callable |

Summary of cash outflows:

| Year | Interest | Remaining principal | Original total | Modified interest | Modified principal | Total |
|---|---|---|---|---|---|---|
| X4 | $ 10,000 | – | $ 10,000 | $ 6,000 | $ 25,000 | $ 31,000 |
| X5 | 10,000 | – | 10,000 | 6,000 | – | 6,000 |
| X6 | 10,000 | – | 10,000 | 6,000 | – | 6,000 |
| X7 | 10,000 | – | 10,000 | 6,000 | – | 6,000 |
| X8 | 10,000 | – | 10,000 | 6,000 | – | 6,000 |
| X9 | 10,000 | – | 10,000 | 6,000 | – | 6,000 |
| Y0 | 10,000 | $ 100,000 | 110,000 | 6,000 | – | 6,000 |
| Y1 | – | – | – | 6,000 | – | 6,000 |
| Y2 | – | – | – | 6,000 | 75,000 | 81,000 |
| Total | $ 70,000 | $ 100,000 | $ 170,000 | $ 54,000 | $ 100,000 | $ 154,000 |

Present value test:

Using the effective interest rate of the original debt, which is also the stated interest rate (10%) in this case as there are no unamortized premium or discount, the present values of (1) the cash flows under the terms of the new debt instrument and (2) the remaining cash flows under the original debt's terms are as follows:

| | |
|---|---|
| Present value of modified debt's cash flows | $ 91,361* |
| Present value of original debt's remaining cash flows | $ 100,000 |

* Calculated as PV of principal ($75,000 in nine years at 10%) plus PV of interest annuity ($6,000 per year for nine years at 10%) plus the prepayment of $25,000 (treated as an undiscounted day one cash flow on the modified debt).

The terms of the new and modified instruments would not be considered substantially different because the difference in the present values is less than 10% (i.e., the difference is 8.63%).

The debtor should reduce the debt balance by $25,000 for the cash paid to the creditor on the modification date and determine a new effective interest rate based on the carrying amount ($75,000) and the revised cash flows.

Although the original debt was not prepayable in this example, we believe the approach would be the same if the original debt was prepayable.

### 2.6.2.4 Modifications or exchanges of convertible debt instruments

Issuers may modify the terms of convertible debt (e.g., changing the maturity date or the number of shares of common stock issuable upon conversion of the debt). The debt modification guidance in ASC 470-50 has specific criteria that apply to modifications of convertible debt when the conversion feature is not bifurcated either before or after the transaction.

ASC 470-50-40-10 provides that the change in the fair value of an embedded conversion option resulting from an exchange or modification is not included in the debt modification guidance's 10% cash flow test. However, if the 10% cash flow test does not result in a conclusion that a substantial modification or an exchange has occurred, a further step is required and an extinguishment is deemed to have occurred if the change in the fair value of the embedded conversion option (calculated as the difference between the fair value of the embedded conversion option immediately before and after the modification or exchange) is at least 10% of the carrying amount of the original debt instrument immediately prior to the modification or exchange.

For example, assume the carrying amount of convertible debt is $1,000 and it is convertible into 20 shares at a conversion price of $50. On the date that the share price is $30 and the fair value of the embedded derivative option is $5, the conversion option is modified to allow for conversion into 40 shares at a conversion price of $25. That new in-the-money conversion option has a fair value of $230. Despite having no changes in cash flows, this modification would be accounted for as an extinguishment because the fair value of the conversion option changed by $225 ($230–$5), or 22.5% ($225/$1,000), which is at least 10% of the carrying amount of the original debt immediately before the modification.

ASC 470-50-40-10 also provides that a modification or an exchange that adds or eliminates a substantive conversion option as of the conversion date would always be considered substantial and require extinguishment accounting. ASC 470-20-40-7 defines a substantive conversion feature to be at least reasonably possible[21] of being exercised in the future. For example, if the conversion price of a convertible instrument is extremely high as compared to the fair value of the underlying equity instrument at the date of modification (i.e., a deep out-of-money conversion option), the conversion feature might not be considered substantive. In addition, ASC 470-20-40-8 states that conversion features that are exercisable only upon the issuer's exercise of its call option should not be considered substantive. In determining whether a conversion feature is reasonably possible of being exercised, the assessment should not consider the holder's intent.

ASC 470-20-40-9 provides the following considerations in determining whether the conversion option is substantive:

- The fair value of the conversion feature relative to the fair value of the debt instrument
- The effective annual interest rate per the terms of the debt instrument relative to the estimated effective annual rate of a nonconvertible debt instrument with an equivalent expected term and credit risk
- The fair value of the debt instrument relative to an instrument that is identical except for which the conversion option is not contingent
- Qualitative evaluation of the conversion provisions, such as the nature of the conditions under which the instrument may become convertible

[21] The term "reasonably possible" has the same meaning as in ASC 450, *Contingencies*.

Pursuant to ASC 470-50-40-15, if the modification or exchange of a convertible debt instrument is not accounted for as an extinguishment, the accounting for the change in the fair value of the embedded conversion option depends on whether the change (calculated as the difference between the fair value of the embedded conversion option immediately before and after the modification or exchange) is an increase or decrease, as follows:

| Change | Accounting |
|---|---|
| Increase in fair value of the embedded option | Reduce carrying amount of debt instrument (increasing a debt discount or reducing a debt premium) with a corresponding increase in APIC |
| Decrease in fair value of the embedded option | No accounting required |

The convertible debt provisions of the debt modification guidance in ASC 470-50 are illustrated below:

**Illustration 2-23: Modify fixed-rate convertible debt by reducing the conversion price and extending the term**

On 1 January 20X1, Debtor borrows $100,000 from Creditor bearing 6% interest that matures in 10 years and is convertible into Debtor's common stock. No fees were paid by Debtor to Creditor, so the debt was initially recorded at par. On 1 January 20X4, Debtor and Creditor agree to modify the debt by reducing the conversion price and extending the debt term, as follows:

| Terms | Original | Modified |
|---|---|---|
| Principal: | $100,000 | $100,000 |
| Term (from modification date): | 7 years | 12 years |
| Rate: | 6.0% | 6.0% |
| Conversion ratio: | 20 shares per $1,000 | 40 shares per $1,000 |
| Conversion price: | $50 | $25 |
| Share price of common stock: | $40 (at issuance) | $30 (at modification date) |
| Fair value of embedded conversion option (at modification date): | $5,000 | $28,000 |

Summary of cash outflows:

| Year | Remaining interest | Original principal | Total | Modified interest | Principal | Total |
|---|---|---|---|---|---|---|
| X4 | $ 6,000 | – | $ 6,000 | $ 6,000 | – | $ 6,000 |
| X5 | 6,000 | – | 6,000 | 6,000 | – | 6,000 |
| X6 | 6,000 | – | 6,000 | 6,000 | – | 6,000 |
| X7 | 6,000 | – | 6,000 | 6,000 | – | 6,000 |
| X8 | 6,000 | – | 6,000 | 6,000 | – | 6,000 |
| X9 | 6,000 | – | 6,000 | 6,000 | – | 6,000 |
| Y0 | 6,000 | $ 100,000 | 106,000 | 6,000 | – | 6,000 |
| Y1 | – | – | – | 6,000 | – | 6,000 |
| Y2 | – | – | – | 6,000 | – | 6,000 |
| Y3 | – | – | – | 6,000 | – | 6,000 |
| Y4 | – | – | – | 6,000 | – | 6,000 |
| Y5 | – | – | – | 6,000 | $ 100,000 | 106,000 |
| Total | $ 42,000 | $ 100,000 | $ 142,000 | $ 72,000 | $ 100,000 | $ 172,000 |

**Step 1: Present value test**

Using the effective interest rate of the original debt, which is also the stated interest rate (6.0%) in this case as there are no unamortized premium or discount, the present values of the cash flows (1) under the terms of the new debt instrument and (2) the remaining cash flows under the original debt's terms, are as follows:

| | |
|---|---|
| Present value of modified debt's cash flows | $ 100,000 |
| Present value of original debt's remaining cash flows | $ 100,000 |

As the change in the present value of the cash flows is less than 10% (no change in the above example), the modification does not result in extinguishment accounting. Step 2 is required to evaluate the change in the fair value of the conversion option.

**Step 2: Fair value of conversion option test**

(1) Calculate the change in fair value of the conversion option

| | |
|---|---|
| Fair value of the embedded conversion option, immediately before the modification | $ 5,000 |
| Fair value of the embedded conversion option, immediately after the modification | $ 28,000 |
| Change in fair value of the conversion option | $ 23,000 |

(2) Compare the change in the fair value to the carrying amount of the debt

| | |
|---|---|
| Change in fair value of the conversion option | $ 23,000 |
| Carrying amount of the debt instrument, immediately prior to the modification | $ 100,000 |

As the change in fair value of the embedded conversion option is at least 10% of the carrying amount of the debt instrument immediately prior to the modification, a substantial modification or exchange of the debt instrument has occurred and the issuer should apply extinguishment accounting.

#### *2.6.2.4.1 Modifications or exchanges involving convertible debt instruments with a conversion option that is bifurcated*

ASC 470-50-40-11 states the tests related to the change in fair value of a conversion option and the addition or deletion of a substantive conversion option do not apply to modifications or exchanges of convertible debt instruments in circumstances in which the embedded conversion option is separately accounted for as a derivative before the modification, after the modification or both.

While ASC 470-50 does not specifically address the accounting for modifications or exchanges of these convertible debt instruments, based on the individual facts and circumstances, we generally believe the following approaches may be considered in accounting for these transactions:

- *Conversion option is bifurcated both before and after the modification or exchange* — The debt instrument without the conversion option is evaluated under the guidance in ASC 470-50 for nonconvertible debt using the 10% cash flow test. Since the bifurcated conversion option is accounted for at fair value both before and after the modification, any changes in the fair value of the conversion option would be reflected in earnings.
- *Conversion option is not bifurcated before the modification or exchange but is bifurcated after the transaction* — The 10% test for the change in the conversion option's fair value relative to the carrying amount of the debt (refer to section 2.6.2.4) and the 10% cash flow test (refer to section 2.6.2.3) are applied. If the modification or exchange is not accounted for as an extinguishment (because the change in the conversion option's fair value is less than 10% of the carrying amount of the debt and the terms of the new instrument are not considered "substantially different" under the 10% cash flow test), the issuer would (a) reflect any increase in the fair value of the conversion option from the

modification or exchange as an adjustment to the carrying amount of the debt as an additional discount with an offset to equity as described in ASC 470-50-40-15 and (b) bifurcate the conversion option at fair value and determine the new effective interest rate for the debt based on the new carrying amount and new terms.

Alternatively, based on the specific facts and circumstances, the issuer could conclude (as an accounting policy election) that because the accounting for the conversion option has changed after the modification or exchange, the modified debt was fundamentally different from the existing debt and therefore apply extinguishment accounting.

- *Conversion option is bifurcated before the modification or exchange but is not bifurcated after the transaction* — If the change in the conversion option's fair value is at least 10% of what would have been the carrying amount of the original debt absent the bifurcation at inception (i.e., a pro forma carrying amount) or the new debt is considered "substantially different" under the 10% cash flow test, the transaction would be accounted for as an extinguishment with (a) the bifurcated conversion option being first marked to its pre-modification or exchange fair value, (b) the new debt recorded at fair value and (c) the old debt and bifurcated conversion option removed with any difference between the fair value of the new debt and the sum of the pre-modification or exchange carrying amount of the old debt and the bifurcated conversion option's fair value recognized as a gain or loss upon extinguishment.

  If the modification or exchange is not accounted for as an extinguishment, the issuer would (a) mark the conversion option to its new fair value based on the modified terms and reclassify the derivative liability to equity and (b) determine the new effective interest rate for the modified debt based on its carrying amount and new terms. Alternatively, based on the specific facts and circumstances, the issuer could conclude (as an accounting policy election) that because the accounting for the conversion option has changed after the modification or exchange, the modified debt was fundamentally different from the existing debt and therefore, apply extinguishment accounting.

### 2.6.2.5 Accounting for debt modification or exchange and fees paid and costs incurred

If a modified instrument is considered substantially different from the original debt instrument, the modification or exchange is accounted for as an extinguishment. The new instrument should be recorded at its fair value and that fair value is used to determine the extinguishment gain or loss.

If the modification or exchange is not accounted for as an extinguishment (i.e., the modified instrument is not considered substantially different from the original debt instrument), a new effective interest that equates the revised cash flows to the carrying amount of the original debt is computed and applied prospectively.

The following chart summarizes the accounting treatment for fees paid or received by the debtor as part of the exchange or modification as well as costs incurred with third parties in connection with the transaction:

| | Exchange or modification accounted for as debt extinguishment | Exchange or modification not accounted for as debt extinguishment |
|---|---|---|
| Fees paid by debtor to creditor (or received by debtor from creditor) | Included in calculation of gain or loss | Reflected as additional debt discount and amortized as an adjustment of interest expense over remaining term of exchanged or modified debt using interest method |
| Costs incurred with third parties directly related to exchange or modification (such as legal fees) | Capitalized as deferred debt issuance costs and associated with new debt and amortized over term of new debt using interest method | Expensed as incurred |
| Previously deferred fees and costs for existing debt | Included in calculation of gain or loss | Amortized as an adjustment of interest expense over remaining term of exchanged or modified debt using interest method |

#### *2.6.2.5.1 Accounting for fees and costs when principal is partially repaid or prepaid*

When debt is not prepayable by its contractual terms, any transaction that occurs that involves a partial repayment of principal at a time and/or for an amount other than that originally scheduled should be evaluated under the 10% cash flow test to determine whether the repayment represents a modification or extinguishment of the entire instrument. Generally, any costs and fees associated with the original and remaining debt will be accounted for as described in section 2.6.2.5 above.

However, some debt instruments' contractual terms permit prepayment. If such debt is partially prepaid in accordance with its contractual terms (i.e., strictly under a condition and for an amount contractually specified) and the terms of the remaining debt are not modified, the amount prepaid should be treated as a partial extinguishment. Therefore, a proportion of any deferred debt issuance costs, fees or other elements of premium or discount would be written off with that extinguishment. This conclusion is reached without regard to any consideration of the 10% cash flow test, because nothing in the debt instrument was modified as it was simply prepaid (in whole or in part) according to its original terms.

When debt is prepayable by its contractual terms, and a transaction occurs that involves both a partial prepayment and amendment to the terms of the remaining debt, the 10% cash flow test should be applied. That test should incorporate the prepayment as a "day one" cash outflow with the future, originally scheduled, principal payment (or payments if amortizing debt) reduced appropriately. In some cases, the application of the 10% cash flow test may result in a modification, not an extinguishment, of the original debt instrument.

However, the accounting treatment for unamortized deferred fees and costs in a debt exchange or modification that is not accounted for as an extinguishment may lead to a counter-intuitive result. For example, even though a large proportion of the debt may be prepaid pursuant to its contractual terms and only a small remaining portion modified, literal application of the guidance in ASC 470-50 could suggest that no unamortized deferred fees or costs should be written off. Rather, those amounts would continue to be amortized against a much lower debt balance, which could result in an effective interest rate that appears unusually high.

Based on discussions with the SEC staff, we believe that it would be acceptable for an entity to write down a proportionate amount of a debt instrument's unamortized deferred fees and costs, as well as any debt premium or discount (e.g., original issuance discount), if the original debt was prepaid in accordance with its contractual terms. This would be a matter of accounting policy that should be applied consistently.

### 2.6.2.6 Effect of third-party intermediary's involvement

A third-party intermediary may be involved in a debtor's modification or exchange of its debt instrument. Although the third-party intermediary may be acting as a principal for legal purposes, a separate determination should be made as to whether the third-party intermediary is acting as the debtor's agent or as a principal for accounting purposes.

In transactions involving a third-party intermediary acting as an agent on behalf of a debtor, the actions of the intermediary should be viewed as those of the debtor to determine whether an exchange or modification of debt instruments has occurred between a debtor and a creditor. That is, when a third-party intermediary acts as an agent, the analysis should "look through" the intermediary. In a transaction whereby the intermediary acquires existing debt instruments from the current holders and then sells the modified debt entirely to new investors, a determination that the intermediary is acting as the debtor's agent will automatically require the debtor to account for the transaction as an extinguishment as the debtor would be deemed to have settled debt with existing creditors using proceeds from new investors.

Conversely, in transactions involving a third-party intermediary acting as principal, the intermediary should be viewed as a third-party creditor to determine whether there has been a modification or exchange of debt instruments between a debtor and a creditor. That is, when a third party acts as principal, the analysis should not "look through" the intermediary. The issuer will evaluate its interactions directly with the intermediary.

While all of the relevant facts and circumstances should be considered in determining whether a third-party intermediary is acting as an agent or a principal, ASC 470-50-55-7 provides four indicators that should be considered in that evaluation:

- If the intermediary's role is restricted to placing or reacquiring debt for the debtor without placing its own funds at risk, that would indicate the intermediary is an agent. For example, that may be the case if the intermediary's own funds are committed and those funds are not truly at risk because the intermediary is made whole by the debtor (and therefore is indemnified against loss by the debtor). If the intermediary places and reacquires debt for the debtor by committing its funds and is subject to the risk of loss of those funds, that would indicate the intermediary is acting as principal.
- In an arrangement where an intermediary places notes issued by the debtor, if the placement is done under a best-efforts agreement, that would indicate the intermediary is acting as an agent. Under a best-efforts agreement, an agent agrees to buy only those securities that it is able to sell to others; if the agent is unable to remarket the debt, the issuer is obligated to pay off the debt. The intermediary may be acting as principal if the placement is done on a firmly committed basis, which requires the intermediary to hold any debt that it is unable to sell to others.
- If the debtor directs the intermediary and the intermediary cannot independently initiate an exchange or modification of the debt instrument, that would indicate the intermediary is an agent. The intermediary may be a principal if it acquires debt from or exchanges debt with another debt holder in the market and is subject to loss as a result of the transaction.
- If the only compensation derived by an intermediary from its arrangement with the debtor is limited to a pre-established fee, that would indicate the intermediary is an agent. If the intermediary derives gains based on the value of the security issued by the debtor, that would indicate the intermediary is a principal.

In evaluating a third-party intermediary that is an investment bank or similar entity, based on the guidance above and SEC staff comments made at the 2003 AICPA National Conference on Current SEC Developments,[22] we generally believe an issuer may consider the following questions in determining whether the intermediary's funds are at risk:

- Has the investment bank obtained "soft bids" for the sale of the debt prior to or concurrent with the closing of the debt issuance? "Soft bids" reduce the investment bank's exposure to market risk and may indicate the investment bank's role is that of an agent.
- What period of time will the investment bank hold the new debt before reselling it? We generally do not believe that there is a bright line for the number of days the investment bank must hold the new debt in order to indicate it is acting as a principal. However, the period should generally be long enough for the holder to be at risk for the type of instrument held.
- Has the investment bank been compensated for any costs associated with hedging its exposure to market risk on the new debt? Are all fees paid to the investment bank at market as underwriter? Payments to the investment bank through fees or other means to reduce its market risk may indicate the investment bank's role is that of an agent.

[22] Robert J. Comerford, 2003 — Refer to the SEC website at **https://www.sec.gov/news/speech/spch121103rjc.htm.**

- How volatile is the market price of the debt? The combination of the debt's underlying price volatility and the length of time the investment bank will hold the debt before reselling it may provide an indicator as to whether the investment bank has substantive market risk.

### 2.6.2.7 Loan participations and loan syndications

In a loan syndication, a group of lenders may jointly fund loans because a debtor may request loans in amounts greater than any one lender is willing to lend. Each lender loans a specific amount to the debtor and has the right to repayment from the debtor. Accordingly, separate debt instruments exist between the debtor and the individual creditors participating in the syndication. This may be the case even if a single creditor has been appointed to negotiate on behalf of the collective group of creditors. Therefore, the guidance in ASC 470-50 should be applied to modified or exchanged syndicated loans on a creditor-by-creditor basis.

In a loan participation, the debtor borrows from a lead lender who typically sells participating interests that may take the legal form of either assignments or participations. In this case, the debt instrument is a contract between the debtor and the lead creditor, and the lead creditor is the only entity with legal rights against the debtor. Therefore, the debtor should account for a modification or exchange between it and the lead lender pursuant to the debt modification guidance in ASC 470-50. The debtor does not account for transactions that may occur between or among lenders to the participation agreement because the debtor is not a party to the transaction (its only legal obligation is to the lead lender).

### 2.6.2.8 Modification of line-of-credit arrangements

ASC 470-50-40-21 through 40-23 provides guidance on accounting for any unamortized deferred debt issuance costs, fees paid to the creditor and any third-party costs incurred in connection with the modification or exchange of line-of-credit or revolving arrangements. That guidance requires the debtor to compare the product of the remaining term and the maximum available credit of the old arrangement (the borrowing capacity) with the borrowing capacity of the new arrangement.

The accounting for the costs and fees depends on whether the borrowing capacity of the new arrangement is greater than or equal to the borrowing capacity of the old arrangement. The following chart summarizes the provisions applicable to the modification of a line-of-credit.

| | **Accounting for fees and costs** |
|---|---|
| Borrowing capacity of new greater than or equal to borrowing capacity of old | All fees and costs are deferred and amortized over the term of new arrangement, including:<br>▸ Unamortized deferred debt issuance costs<br>▸ Any fees paid to creditors<br>▸ Any third-party costs incurred |
| Borrowing capacity of new less than borrowing capacity of old | Any fees paid to creditor and any third-party costs incurred should be deferred and amortized over the term of new arrangement.<br>Unamortized deferred debt issuance costs are written off in proportion to the decrease in borrowing capacity of old arrangement. Remaining unamortized deferred costs are amortized over the term of new arrangement. |

### 2.6.2.9 Modifications of credit facilities

Credit facilities often include both term loans and line-of-credit or revolving arrangements. ASC 470-50 has separate guidance for a modification of term loans (refer to sections 2.6.2.3 and 2.6.2.5) and a modification of line-of-credit or revolving arrangements (refer to section 2.6.2.8). However, it does not address how the debtor should apply the two accounting models (i.e., whether each component should be separately evaluated or viewed in the aggregate), when a modification is made to a credit facility that contains both term loans and line-of-credit or revolving arrangements.

In those transactions, there may be new investors joining the credit facility, old creditors departing the facility or existing creditors continuing to be involved. Accounting for the modification may be different for each creditor. Extinguishment accounting is applied for creditors involved in the facility before the amendment but not after. Creditors not involved initially but holding a portion of the amended facility, are considered new issuances.

Accounting for continuing creditors that were involved before and after the amendment (e.g., held a different amount of the term loan or line-of-credit or reallocated its position between the two components) depends on the individual facts and circumstances and requires professional judgment. An issuer may consider the following approaches:

- For a creditor holding only term loans both before and after the modification, apply the 10% cash flow test (refer to section 2.6.2.3)
- For a creditor holding only a line-of-credit both before and after the modification, apply the line-of-credit model (refer to section 2.6.2.8)
- For a creditor that had holdings reallocated such that amounts previously drawn under the line-of-credit that are now outstanding as additional term loan borrowings, consider applying the line-of-credit model in the examples in ASC 470-50-55-12(c) and 55-12(d) (where a line-of-credit is replaced with a term loan)
- For a creditor that had holdings reallocated such that amounts previously outstanding as term loan borrowings are now outstanding as draws under the line-of-credit, consider applying the 10% cash flow test to the amounts outstanding under the line-of-credit as if it were a term loan borrowing

### 2.6.2.10 Modifications or exchanges involving public debt issuances

ASC 470-50-55-3 states that, for purposes of applying the debt modification guidance, the debt instrument is the individual security and the creditor is the security holder for a public debt issuance (defined as when a debtor issues a number of identical debt instruments to an underwriter that sells the debt instruments (in the form of securities) to various investors). If a modification or exchange offer were made to all investors and only some accepted, the debt modification guidance should be applied only to those investors.

When an issuer refinances its public debt by repurchasing existing debt in the market and simultaneously issuing new public debt with different terms, there may be investors that both held the old debt and invested in the new debt, resulting in the contemporaneous exchange of cash between the same creditor and debtor as discussed in ASC 470-50-40-9. Determining this fact may be difficult given the number of potential investors involved. In addition, public debt repurchases through new public debt issuances are frequently not negotiated transactions between the debtor and the existing creditors.

In certain cases, we believe it is reasonable that the old debt be viewed collectively as the entire public issuance with a deemed single creditor (i.e., the public, without regard to the individual investors) that is refinanced with another distinct single issuance (another public issuance) with a different creditor and that the transaction should be accounted for as an extinguishment without the application of the 10% cash flow test on either the entire issuance or at the individual creditor level.

Said differently, the nature of a public-to-public refinancing with no indications of a negotiated economic outcome based on a mutually agreed-upon realignment of economic interests, would be one of extinguishment. Such a public-to-public refinancing is likely to include the following characteristics: (1) no single investor or small group of investors holds a significant concentration of both the old and the new public debt issuances, (2) none of the old investors were included in negotiations with the underwriter in setting the terms of the new public debt issuance and (3) the old investors had the opportunity to participate in the new issuance in the same manner as new investors (i.e., the old creditors did not receive preferential treatment in terms of access to the offering or participation at a predetermined principal amount).

The same concept may be applicable to a widely held private placement depending on the facts and circumstances, including whether the issuer can practically determine the identities of the old and new investors.

The accounting for modifications or exchanges of existing public debt issuances should be based on the individual facts and circumstances and requires professional judgment.

#### 2.6.2.11 Transactions between or among creditors

Transactions between or among creditors do not result in a modification or exchange of the original debt instrument between the debtor and creditor. Accordingly, those transactions do not affect the accounting by the debtor.

## 2.7 Classification and presentation

The ASC 210-10-20 Glossary defines current liabilities as "obligations whose liquidation is reasonably expected to require the use of existing resources properly classifiable as current assets, or the creation of other current liabilities." ASC 210-10-45 provides the principal guidance in determining the balance sheet classification of liabilities. Under that guidance, current liabilities include liabilities whose liquidation is expected to occur within 12 months (or operating cycle, if longer), such as:

- Current maturities of long-term debt
- Short-term debt with maturity of one year or less (or operating cycle, if longer)
- Due on demand loan agreements
- Long-term debt that becomes callable by the creditor[23] within 12 months (or operating cycle) or upon contingent events such as covenant violations or change of control events and those events have occurred at the reporting date
- Convertible or contingently convertible debt that requires the debtor to settle the accreted value in cash upon conversion and the contingency has been met at the reporting date

Certain short-term obligations that are expected to be refinanced on a long-term basis may not require the use of current assets and therefore may not be required to be included in current liabilities.

Liabilities that will be paid through the use of noncurrent assets or the incurrence of long-term obligations should not be classified as current pursuant to ASC 210-10-45-12.

[23] Debt callable by the creditor may also be referred to as puttable debt (i.e., the holder may require the issuer to repay the debt prior to its contractual maturity date).

## 2.7.1 Classification of debt with contractual maturity greater than one year

### 2.7.1.1 Due on demand loan arrangements

ASC 470-10-45-9 and 45-10 provide that debt that is due on demand or will be due on demand within one year from the balance sheet date should be classified as a current liability, even though the liability may not be expected to be paid within that period or the liability has scheduled repayment dates that extend beyond one year but nevertheless is callable by the creditor within one year. For example, debt that is due on demand or that is callable by the creditor but is otherwise scheduled for payment in 10 annual installments should be classified as a current liability.

### 2.7.1.2 Debt that becomes callable upon covenant violations

ASC 470-10-45 addresses the classification of long-term debt when there has been a covenant violation or other default at the balance sheet date and as a result of such violation or default the debt is callable by the creditor. It also addresses situations when such a violation or default is anticipated to occur within the next year.

The debt classification guidance in ASC 470-10-45 and more specifically in ASC 470-10-55-4 addresses both debt that is callable at the balance sheet date and debt that becomes callable after the balance sheet date but before the financial statements are issued (or available to be issued for private companies). We generally believe debt in default at the date the financial statements are issued (or available to be issued) should be viewed similarly to debt that is in default at the balance sheet date.

In evaluating the debt classification guidance in ASC 470-10-45, a debtor should consider the effect, if any, of the default on other debt instruments. Debt covenants may include cross-default provisions that automatically trigger an event of default if any of the issuer's other obligations are in default. In those cases, the other debt instruments would also be considered in default and should be evaluated under the guidance to determine the appropriate classification.

#### *2.7.1.2.1 Covenant violation at the balance sheet date (or prior to the issuance of financial statements)*

ASC 470-10-45-11 through 45-12 provide guidance on the classification of debt that is callable at the balance sheet date when there has been a violation of a debt covenant at the balance sheet date and as a result of such violation the debt is callable, either as a direct result of the violation or as a result of failure to cure the violation within a contractual grace period. The guidance requires callable debt to be classified as a current liability unless either of the following conditions is met:

(1) The creditor has waived or subsequently lost the right to demand repayment for more than one year (or operating cycle, if longer) from the balance sheet date.

(2) For long-term debt that contains a contractual grace period within which the borrower may cure the violation, it is probable that the violation will be cured within that period, thus preventing the debt from becoming callable.

Obligations that are callable by the creditor as of the balance sheet date or may become callable by the creditor as a result of a violation at the balance sheet date would not require current classification if the debtor has cured the violation after the balance sheet date within a contractual grace period and the obligation is not callable by the creditor at the time the financial statements are issued (or available to be issued).

For situations in which it is probable a violation will be cured within a contractual grace period that extends beyond the issuance date of the financial statements, the related debt may continue to be classified as noncurrent. Disclosure of the violation and courses of action to be taken to remedy the situation, together with a statement that management believes the action will cure the violation, may be appropriate.

Determining whether it is probable that the borrower will cure the debt covenant violation within the contractual grace period requires the use of professional judgment considering all of the relevant facts and circumstances, as illustrated in the following examples:

**Illustration 2-24: Debt covenant cure**

**Example 1 — Cure probable**

At the balance sheet date the borrower inadvertently violated a minimum compensating balance requirement, but has a contractual 90-day grace period in which to restore the balance. Sufficient cash is readily available in a separate money market account. Management intends to transfer funds from the money market account to cover the compensating balance requirement before the grace period expires. Forecasts and other evidence indicate that the cash will not be used for any other purpose.

**Example 2 — Cure remote**

The borrower has experienced three successive years of losses and is in violation of a minimum working capital provision at year end. Management's forecast for the coming year indicates it is unlikely the borrower will be able to cure the default within the contractual 90-day grace period. The lender has adopted a "wait-and-see" attitude, expressing its present intention not to call the loan.

In order for the debt to be classified as long-term in this example, a waiver of the lender's right to call the debt for more than a year from the balance sheet date should be obtained. Refer to section 2.7.1.2.1.1 for further discussion if the covenant compliance requirement is ongoing.

The seriousness of a covenant violation is not relevant for the purpose of balance sheet classification, but the nature of the violation might affect whether the debtor is able to obtain a satisfactory waiver or the probability of the debtor curing the default during any contractual grace period (refer to section 2.7.1.2.1.1 for further discussion on obtaining a satisfactory waiver).

#### *2.7.1.2.1.1 Covenant violation at balance sheet date (or prior to the issuance of financial statements) but a waiver has been obtained for a period greater than one year*

A loan covenant may be modified or eliminated prior to the balance sheet date, and absent that modification, the debtor would have been in violation of the covenant and as a result the debt would be callable. In other situations, covenant violations may have occurred at the balance sheet date but the creditor waives the current violation for a period greater than one year. In both of those scenarios, the creditor typically retains future debt covenant requirements at subsequent compliance measurement dates within the next year.

ASC 470-10-45-1 and the implementation guidance in ASC 470-10-55-4 (specifically, illustrations in scenarios (d) and (e)) provide guidance in determining whether such long-term debt obligations should be classified as current when future covenant requirements are retained. In those circumstances, the guidance provides that the debt should be classified as noncurrent unless it is probable that the borrower will not be able to cure the default (comply with the future covenant requirements) at measurement dates that are within the next 12 months.

A waiver's terms should be carefully evaluated because it may not be a valid waiver for classifying the callable debt as noncurrent, depending on the nature of the violation and the financial circumstances of the borrower. Generally, a lender's expression of no "present intention" to accelerate a callable debt's maturity, whether given orally or in writing, does not constitute a satisfactory waiver for callable debt under the debt classification guidance in ASC 470-10-45.

If the creditor waived its right to call the debt for more than one year for the current covenant violation, yet the creditor retains future debt covenant requirements at subsequent compliance measurement dates within the next year, the guidance in ASC 470-10-45-1 should be considered. The probability that a lender will waive or subsequently lose its right to call the debt or that a debt will be refinanced or renegotiated should not be considered.

In some cases, an event of default might be an isolated occurrence, such as the purchase of property in excess of a specified yearly maximum. A waiver of the lender's rights as a result of this type of violation is, in effect, an amendment to the loan agreement and will "cure" this specific event of default permanently. Other covenants may be based on the financial position or results of operations of the borrower. The terms of a waiver of a violated covenant should be carefully evaluated, considering the nature of the violation and the financial circumstances of the borrower, as the following examples illustrate.

**Illustration 2-25: Obtaining a satisfactory waiver**

**Example 1**

Entity A is required to maintain working capital of $1,500,000 throughout the year. The loss of a key customer resulted in a sales decline and a reduction of working capital below the $1,500,000 minimum during the months of June, July and August. By 31 December 20X1, the company has working capital of $1,500,000. In addition, Entity A expects that it is reasonably possible it will be able to maintain working capital in excess of the required minimum throughout the next year. That is, it is not probable the covenant will be violated in the next 12 months.

In this case, obtaining a letter from the lender waiving compliance with the working capital minimum for the periods during the year ended 31 December 20X1, would support continued classification of the debt as noncurrent because it is not probable the borrower will fail to maintain the minimum working capital requirements during the next year.

Entity A should consider whether to disclose in a financial statement footnote a description of the possible future violation and state that a waiver might have to be obtained from the lender if there is a violation in order for the debt not to become callable at a specified future date.

**Example 2**

Entity B is required to maintain working capital of $1,500,000 throughout the year. Entity B has incurred an operating loss for the year and, at 31 December 20X1, does not meet the working capital requirement. Prospects for a return to profitability and achievement of the working capital requirement for the coming year are uncertain.

The debt should be classified as current if the lender waives its rights to call the loan as a result of the company's noncompliance with the working capital minimum for the year ended 31 December 20X1. Although the lender waived its rights due to the violation for the year ended 31 December 20X1, a new violation occurs every day after year end as a result of the company not satisfying the required working capital minimum. That is, the covenant was immediately violated again on 1 January 20X2.

In order for the debt to be classified as long-term in this example, the lender should either (1) amend the loan agreement to reduce the working capital requirement at 31 December 20X1, and any subsequent interim measurement date within one year to levels that currently are achieved and are not probable of being violated by the borrower during the next year or (2) waive its rights to call the loan as a result of the company's noncompliance and expected future noncompliance with the working capital requirement for a period of more than one year from the balance sheet date.

#### *2.7.1.2.1.2 Covenant violation has not occurred at the balance sheet date (or prior to the issuance of financial statements) but violation probable within next year*

ASC 470-10-45-1 and the implementation guidance in ASC 470-10-55-4 (specifically, illustrations in scenarios (a), (b) and (c)) indicate that, unless facts and circumstances indicate otherwise, debt should be classified as noncurrent if there is no debt covenant violation at the balance sheet date but a violation is probable within the next year. This guidance generally indicates that these situations are more akin to non-recognized subsequent event (formerly Type II) situations and, accordingly, do not warrant adjustment to the noncurrent classification of the debt at the balance sheet date. However, we generally believe debt in default prior to the issuance of financial statements (i.e., a violation is known to have occurred or is certain to occur in the near future) should be viewed similarly to debt in default at the balance sheet date.

Individual facts and circumstances should be considered when evaluating violations occurring or expected to occur after the balance sheet date. For example, management may announce it will not make the next scheduled principal or interest payment, resulting in a debt covenant violation within the next year. ASC 470-10-55-5 requires borrowers to disclose the adverse consequences of its probable failure to satisfy future covenants.

The following examples illustrate how to apply the provisions of the debt classification guidance in ASC 470-10-45-1 and the related implementation guidance in ASC 470-10-55-4.

**Illustration 2-26: Classification of debt pursuant to ASC 470-10-45-1**

Assume the debtor's fiscal year end is 31 December, and it issues its financial statements 27 February.

**Example 1 — Debtor in compliance at balance sheet date, future violation reasonably possible**

Debtor is in compliance with its debt covenants at the balance sheet date, but it is reasonably possible that it will violate a financial covenant at 31 March.

The debt should be classified as noncurrent.

**Example 2 — Debtor in compliance at balance sheet date, future violation probable**

Debtor is in compliance with its debt covenants at the balance sheet date, but it is probable that it will violate a financial covenant at 31 March.

The debt generally should be classified as noncurrent, but facts and circumstances may indicate that the debt should be classified as current. For example, if the debtor concluded that it will not meet the 31 March financial covenant and publicly disclosed that fact, we believe the debt may be more appropriately classified as current.

**Example 3 — Debtor in compliance at balance sheet date because of modification, future violation probable**

Debtor is in compliance with its debt covenants at the balance sheet date only because, prior to the balance sheet date, the debtor negotiated a modification of the loan agreement that modified the covenant. Absent the modification, it would have been in violation of the covenant at the balance sheet date. A more restrictive covenant must be met on 31 March, and it is probable the borrower will fail to meet that requirement.

The debt should be classified as current.

### 2.7.1.3 Debt in default financial statement disclosure

Rule 4-08(c) of SEC Regulation S-X (codified in ASC 235-10-S99-1) specifies certain disclosures about debt in default. We generally believe nonpublic companies should follow those disclosure requirements as well.

- Lender waives or loses right to call loan — Rule 4-08(c) requires that "If a default or breach exists but acceleration of the obligation has been waived for a stated period of time beyond the date of the most recent balance sheet being filed, state the amount of the obligation and the period of the waiver."
- No waiver obtained or cure within a contractual grace period not probable — Rule 4-08(c) of SEC Regulation S-X requires that "the facts and amounts concerning any default in principal, interest, sinking fund, or redemption provisions with respect to any issue of securities or credit agreements, or any breach of covenant of a related indenture or agreement, which default or breach existed at the date of the most recent balance sheet being filed and which has not been subsequently cured, shall be stated in the notes to the financial statements."

### 2.7.1.4 Settlement of long-term debt shortly after the balance sheet date

The intention, prior to the balance sheet date, to voluntarily settle a long-term obligation (i.e., settlement not contractually required in the next 12 months) in the next operating cycle could affect the classification of the obligation as long-term at the balance sheet date. This determination depends on facts and circumstances.

While the Codification provides direct guidance for evaluating the intent and ability to refinance a short-term obligation as noncurrent (ASC 470-10-45) as of the balance sheet date there is no direct guidance on when a long-term obligation is intended to be repaid within the next operating cycle.

The Codification defines current liabilities as " … obligations whose liquidation is reasonably expected to require the use of existing resources properly classifiable as current assets, or the creation of other current liabilities." In contrast, long-term obligations are defined as " … those scheduled to mature beyond one year (or the operating cycle, if applicable) from the date of an entity's balance sheet." Further, ASC 210-10-45-4 notes that the classification of assets that would otherwise be considered current assets may be affected by how those funds will be used. ASC 210-10-45-4 excludes from current assets cash and claims to cash that "are segregated for the liquidation of long-term debt. Even though not actually set aside in special accounts, funds that are clearly to be used in the near future for the liquidation of long-term debts, payments to sinking funds, or for similar purposes shall also, under this concept, be excluded from current assets."

The definitions of current liabilities and long-term obligations as well as the requirements of ASC 210 require the use of judgment in determining what "reasonably expected," "scheduled" and "clearly to be used" mean. In addition, the definitions and requirements are themselves circular in that the classification for the obligation is based on the assets that will reasonably be expected to be used in satisfying the obligation, while the classification of the assets is also affected by the obligations they are used to satisfy. As a result of the differing interpretations of how the definitions should be applied, we generally believe there are two acceptable views and either view may be applied as an accounting policy election, as follows:

View A: This view focuses on the definition of a current liability and whether the entity is required to use current assets, properly classified as of the balance sheet date, to satisfy the obligation. Under this view, as long as the obligation is not contractually required to be satisfied within the next operating cycle, the obligation would be classified as noncurrent. Under this view, however, any funds that are clearly to be used in the near future for the liquidation of a long-term obligation would also be classified as noncurrent. The following example illustrates the application of this view:

> Company A has an outstanding debt ($1 million) that is required to be repaid on 31 December 20X5. In December 20X1, Company A decides that it will retire the debt in 20X2, although it is not required to do so. As of 31 December 20X1, Company A has accumulated sufficient funds to retire the debt

and Company A has designated those funds ($1 million out of a total of $5 million of available funds) to be used to retire the debt in 20X2. In assessing the balance sheet classification of the debt, Company A has concluded that at 31 December 20X1, its obligation under the debt agreement does not require the use of assets properly classified as current assets because Company A does not have a contractual requirement to retire the debt in 20X2. In fact, the debt is scheduled to mature beyond one year (20X5). However, because Company A has designated $1 million of funds to retire the long-term debt and has concluded they are clearly to be used for that purpose, the funds are required by ASC 210 to be classified as a long-term asset. As a result, in this example both the funds and the debt would be classified as long-term.

View B: An obligation is classified as current when (a) the obligation is reasonably expected to be retired and (b) such retirement will require the use of current assets (as opposed to a long-term refinancing or current assets that will be generated in a future period). Under this view, as long as the otherwise long-term obligation is classified as current based on the balance sheet date intention to retire the obligation, the current assets that will be used to fund the retirement remain properly classified as current assets. The following example illustrates the application of this view:

Company B has outstanding debt ($1 million) that is required to be repaid on 31 December 20X5. In December 20X1, Company B decides that it will retire the debt in 20X2, although it is not required to do so. As of 31 December 20X1, Company B has accumulated sufficient funds to retire the debt and Company B has designated those funds ($1 million out of a total of $5 million of available funds) to be used to retire the debt in 20X2. In assessing the balance sheet classification of the debt, Company B has concluded that at 31 December 20X1, the retirement of the debt in 20X2 is reasonably expected to require the use of existing resources properly classifiable as current assets. While Company B does not have a contractual requirement to do so, Company B reasonably expects to use $1 million of funds classified as current assets to retire the debt in 20X2. As a result, Company B classifies both the debt and the $1 million of funds to be used in its retirement as current liabilities and assets, respectively, in the 20X1 balance sheet.

An early settlement of a long-term obligation after the balance sheet date but prior to the issuance of the financial statements (or the date they are available to be issued) could also affect the classification of either the obligation or the settlement consideration in the year-end financial statements. For example, assume an issuer has long-term obligations outstanding that mature more than 12 months following the balance sheet date. Subsequent to the end of the year but prior to the issuance of the financial statements, the issuer voluntarily pays the long-term obligation using funds that were available as of the balance sheet date.

The debt classification in this example will depend on the facts and circumstances. The early settlement of a long-term obligation after the balance sheet date but prior to the issuance of the financial statements (or the date they are available to be issued) is not, in itself, determinative. Instead, it is evidence that should be considered in assessing the balance sheet date classification of the liability and related assets. We believe that the settlement of what would otherwise be considered a long-term obligation shortly after the balance sheet date may suggest that the issuer had the intention, at the balance sheet date, of settling the obligation (refer to the discussion above). The closer to the balance sheet date the settlement is, the more likely it is that such an action would be viewed as intended as of the balance sheet date and that the funds used to settle the obligation were already held at the balance sheet date (rather than generated subsequently). If it is determined that the intention existed as of the balance sheet date, the issuer would apply one of the two views discussed above.

The settlement of a long-term obligation after the balance sheet date may affect the issuer's evaluation of the classification of that obligation and any funds used to settle it as of the balance sheet date. However, the settlement does not affect the measurement or timing of any gain or loss recognized upon settlement.

## 2.7.2 Subjective acceleration clauses

A subjective acceleration clause (SAC) is a provision in a debt or financing agreement that allows the lender to accelerate the scheduled maturities of the debt or to cancel the financing agreement under conditions that are not objectively determinable, such as "if a material adverse change occurs" or for "failure to maintain satisfactory operations." In contrast, an objective acceleration clause can be independently verified and is not subject to the interpretation of the lender. Examples would include covenant violations that require compliance with specific ratios that can be calculated from objective information.

A debtor's (rather than the lender) requirement to determine whether there has been a "material adverse change" is not a subjective acceleration clause if it does not result in the lender being able to accelerate payment based on the lender's separate assessment of whether a "material adverse change" has occurred. In such a situation, a careful assessment of the terms of the agreement may be necessary, and it generally is appropriate to obtain input regarding the lender's rights from the company's legal counsel.

### 2.7.2.1 Long-term debt with subjective acceleration clauses

When otherwise long-term debt includes a SAC, judgment about the likelihood of acceleration of debt maturity caused by the creditor's exercise of the SAC is required to determine whether noncurrent classification is appropriate. ASC 470-10-45-2 indicates that in some situations, the circumstances (e.g., recurring losses or liquidity problems) would suggest that long-term debt subject to a SAC should be classified as a current liability. Other situations would indicate only disclosure of the existence of such clauses. ASC 470-10-45-2 also provides that neither reclassification nor disclosure would be required if the likelihood of the acceleration of the due date were remote.

Refer to section 2.7.3.2.3 for the consideration of SACs in refinancing arrangements and section 2.7.5 for consideration of SACs in lock-box arrangements.

## 2.7.3 Classification of short-term obligations expected to be refinanced on a long-term basis

Short-term obligations expected to be refinanced on a long-term basis are not expected to require the use of working capital during the ensuing fiscal year.

ASC 470-10-45-14 provides that short-term obligations should be excluded from current liabilities if the debtor has the intent to refinance the short-term obligation on a long-term basis and it can demonstrate the ability to refinance by (1) actually doing so after the balance sheet date by issuance of a long-term obligation or equity securities or (2) by entering into a long-term financing agreement with a party expected to be financially capable of honoring such agreement.

To demonstrate an entity has the intention to refinance short-term debt on a long-term basis, the entity must assert working capital will not be used during the ensuing fiscal year or operating cycle, if longer, to satisfy the obligation. ASC 470-10-45-15 indicates that payment of short-term debt, or any portion thereof, after the balance sheet date but prior to obtaining a long-term source of funds, would undermine any such assertion.

However, noncurrent classification may not be precluded if repayment of obligations subsequent to the balance sheet date but prior to the issuance of financial statements (or the date available for issuance as appropriate under ASC 855) is from funds other than working capital existing at the balance sheet date. For example, funds from the subsequent sale of noncurrent assets, the issuance of long-term debt, the sale of equity securities, or cash flows from subsequently profitable operation may provide evidence that the source of subsequent repayments was not a working capital existing at the balance sheet date. In the absence of evidence to the contrary, repayments of amounts outstanding at the end of the fiscal year that are made subsequent to the balance sheet date but prior to the issuance of the financial statements are classified as a current liability.

### 2.7.3.1 Demonstrating ability via actual refinancing

For the purposes of refinancing a short-term obligation on a long-term basis, an entity may issue a long-term obligation or equity securities after the date of the balance sheet but before the financial statements are issued (or the date they are available to be issued as appropriate under ASC 855). For example, a 31 January 20X6 refinancing may be considered in preparing the 31 December 20X5 balance sheet that is issued when available on 15 February 20X6.

If equity securities are issued in the refinancing of a short-term obligation prior to the issuance of the financial statements (or the date they are available to be issued as appropriate under ASC 855), the short-term obligation may be excluded from current liabilities. The equity securities should not be included in shareholders' equity at the balance sheet date, however.

Long-term debt actually issued for purposes of refinancing short-term obligations that contains a SAC should be evaluated under ASC 470-10-45-2 to determine whether noncurrent classification is appropriate (refer to section 2.7.2.1 for a discussion of the classification of a long-term obligation with SACs).

If a short-term obligation is repaid after the balance sheet date and long-term obligations or equity securities are subsequently issued whose proceeds are used to replenish current assets before the balance sheet is issued (or is available to be issued, as appropriate), ASC 470-10-45-15 states that the short-term obligation should be classified as current because the repayment of the short-term obligation required the use of current assets that existed at the balance sheet date.

### 2.7.3.2 Demonstrating ability via a financing agreement

As an alternative to actually refinancing short-term debt, an entity may enter into a financing agreement before the financial statements are issued (or available to be issued as appropriate under ASC 855) that clearly permits it to refinance the short-term debt on a long-term basis on terms that are readily determinable and meet the following conditions pursuant to ASC 470-10-45-14(b):

- The agreement does not expire within one year (or operating cycle) and any debt issued under the agreement is not callable within one year of the balance sheet date.
- The agreement must not be cancelable by the lender except for violation of a provision with which compliance may be readily and objectively determined or measured.
- There must be no violation of any provision of the agreement at the date of the balance sheet or prior to its issuance (or the date it is available to be issued as appropriate under ASC 855) for which a waiver has not been obtained.
- The other party to the agreement must be expected to be financially capable of honoring the agreement.

#### *2.7.3.2.1 Demonstrating ability via a standby credit agreement*

Entities that have short-term or maturing commercial paper frequently intend to replace that commercial paper with new commercial paper. In many instances, they obtain a standby credit agreement that would provide financing in the event the replacement commercial paper cannot be sold. For the short-term or maturing commercial paper to be excluded from current liabilities, (1) the entity must assert that working capital will not be used during the fiscal year (or operating cycle, if longer) to satisfy the obligation and (2) the standby credit agreement should meet the conditions provided by ASC 470-10-45-14(b).

#### *2.7.3.2.2 Demonstrating ability through potential alternative source of financing*

An entity may intend to seek an alternative (and perhaps more advantageous) source of financing rather than exercise its rights under an existing financing agreement. In those situations, provided that the existing financing agreement meets the conditions in ASC 470-10-45-14(b), the short-term debt may be classified as noncurrent only if the entity intends to exercise its rights under the existing agreement

when the alternative source does not become available. However, the intent to exercise may not be present if the existing financing agreement contains conditions (such as interest rates or collateral requirements) that are unreasonable to the entity.

#### *2.7.3.2.3 Refinancing agreement that contains subjective acceleration clause*

Because the debt being evaluated is already short-term and the issuer is attempting to justify a classification as noncurrent, the guidance has a higher standard for a financing agreement that supports the assertion that an enterprise can refinance a short-term obligation on a long-term basis than what is required for an existing long-term debt for which early repayment might be requested.

ASC 470-10-45-14(b)(1) requires that a financing agreement intended to be used to refinance short-term debt cannot be cancelable or callable by the creditor for at least a year, except for violation of an objectively determinable or measurable provision. This paragraph further states that "financing agreements cancelable for violation of a provision that can be evaluated differently by parties to the agreement (such as a material adverse change or failure to maintain satisfactory operations) do not comply with this condition."

Therefore, the existence of subjective acceleration clauses in a financing agreement intended to be used to refinance short-term debt precludes classification of the short-term debt as noncurrent under this guidance.

**Illustration 2-27: Classification of variable rate demand obligation supported by a liquidity facility**

Variable rate demand obligations (VRDOs) are debt instruments with interest rates that reset periodically (e.g., every seven days) to a market or indexed rate. VRDOs are typically issued by tax-exempt entities, such as health care entities, municipalities and educational institutions. Some VRDOs allow the holder to put the bonds (redeem the bonds) at any reset date directly to the issuer, in which case the VRDO would be classified as a current liability given its potential short-term nature.

In other cases, issuers may arrange for a liquidity facility to fund the purchase of the VRDO. Such a purchase facility can take several forms:

- The purchase facility may provide that a liquidity facility provider would draw on its own funds to purchase the VRDO, which remain outstanding from the perspective of the issuer. However, the liquidity facility provider may request the VRDO be modified subsequently into a term loan with the issuer if, after a certain period (for purposes of this example that period is assumed to be less than one year), the VRDO cannot be remarketed.
- In other cases, the liquidity provider may agree to purchase the VRDO from the investor under a standby letter of credit (LOC) and immediately modify the VRDO into a term loan with the issuer. In those cases, the VRDO is no longer outstanding and is replaced immediately by a term loan under the LOC.

Because the liquidity facility provides the issuer with the ability to refinance the otherwise short-term obligation (the VRDO), issuers should evaluate the terms of the liquidity facility pursuant to ASC 470-10-45-14 to determine the classification of VRDOs, including:

- The contractual expiration date of the liquidity facility (which is often shorter than the life of the VRDO) should be considered. For example, if a liquidity facility has a five-year term, once the fifth year begins, it would no longer support noncurrent classification of the VRDO (i.e., any term loan would become current when due within 12 months of the balance sheet date).
- The liquidity facility may contain a "subjective material adverse change" clause that allows the liquidity provider to terminate the arrangement at its discretion. A liquidity facility with SACs would not support the classification of the VRDO as a noncurrent liability because one of the conditions in ASC 470-10-45-14 requires the long-term financing agreement that is intended to be used to refinance the otherwise short-term debt not be cancelable or callable by the lender for at least a year, except for violation of an objectively determinable or measurable provision (e.g., a debt covenant).

#### 2.7.3.3 Amount to be excluded from current liabilities

Even though an entity may demonstrate its ability to consummate the refinancing of a short-term obligation, the amount to be excluded from current liabilities may be limited under certain circumstances.

If an actual refinancing occurs, the portion of the short-term obligation to be excluded from current liabilities may not exceed the proceeds from the new obligation or equity securities issued that are applied to retire the short-term obligation.

When a financing agreement is relied upon to demonstrate ability to consummate refinancing, the amount of the short-term debt to be excluded from current liabilities should be reduced, as appropriate, to the lesser of the following:

- The amount available for refinancing under the agreement
- The amount obtainable under the agreement after considering restrictions included in other agreements or restrictions as to transferability of funds
- A reasonable estimate of the minimum amount expected to be available for refinancing if the amounts that could be obtained fluctuate (e.g., in relation to the entity's needs, in proportion to the value of collateral, in accordance with other terms of the agreement)

If any of these amounts cannot be reasonably estimated, the entire amount of the short-term debt should be included in current liabilities.

**Illustration 2-28: Examples of limitations on amounts excluded from current liabilities**

**Example 1 — Amount excluded due to results of actual refinancing**

An entity with $5,000,000 of short-term debt issues 250,000 shares of common stock subsequent to the date of the balance sheet, but before the financial statements are issued, and intends to use the proceeds to liquidate the short-term debt when it matures. Assuming the net proceeds from the sale of the 250,000 shares totaled $4,000,000, only that amount of the short-term debt could be excluded from current liabilities. The $4,000,000 of debt is presented as part of long-term liabilities, but not included in equity because the shares were not yet issued on the balance sheet date.

**Example 2 — Amount excluded due to terms of financing agreement**

An entity enters into an agreement with a bank to borrow up to 75% of the amount of its trade receivables. The provisions of the agreement comply with the conditions for financing agreements under ASC 470-10-45-14(b). During the next fiscal year, the receivables are expected to range between a low of $2,000,000 in the first quarter and a high of $6,000,000 in the third quarter. The minimum amount expected to be available to refinance the short-term obligations that mature during the first quarter of the next year is $1,500,000 (75% of the expected low for receivables during the first quarter). Consequently, no more than $1,500,000 of short-term obligations may be excluded from current liabilities at the balance sheet date.

### 2.7.4 Revolving credit agreements

Entities often enter into revolving credit arrangements to meet their financing needs. Revolving credit arrangements can take various forms and have various terms. Some revolving arrangements are long-term in nature (e.g., 10 years) that allow the debtor to draw down and repay during the duration of the arrangement. Others are short-term (e.g., 90 days), but provide the debtor the ability to automatically renew the short-term debt for an uninterrupted period extending beyond one year. Generally, these arrangements permit a series of renewals or extensions that individually are for periods of less than one year. The renewal periods or extensions in such arrangements may aggregate several years, and some arrangements may provide that the outstanding obligation can be converted into term loans.

Determining the classification of obligations incurred under revolving credit agreements will depend on the form of the revolver.

### 2.7.4.1 Classification of long-term revolver

Borrowings that are contractually long-term under a long-term revolving credit agreement should generally be classified as noncurrent. The debtor should give the same considerations to call provisions that may exist in those revolving agreements as with long-term debt. Refer to section 2.7.1.2 for further details about classification of callable debt.

### 2.7.4.2 Classification of short-term revolver

A revolver that is short-term in nature allowing for automatic renewal or extension is essentially refinancing of the short-term debt via another short-term obligation. Under the debt classification guidance in ASC 470-10-45, the exclusion of such short-term debt from current liabilities can occur only when the debtor establishes its intent and ability to refinance the short-term obligation on a long-term basis. Specifically, the revolving credit agreement must meet all the conditions for financing agreements in ASC 470-10-45-14(b). Otherwise, the short-term debt should be classified as current.

Short-term revolving credit agreements may provide for either unrestricted or collateralized borrowing.

In an unrestricted borrowing, a debtor may borrow up to a stated amount or a maximum amount permitted under the arrangement. The borrowings may be continuously renewed at the option of the debtor (often for several years) at which time amounts outstanding may be converted to a term loan having a fixed repayment schedule. If an entity intends to renew its present short-term debt obligation under such an arrangement for an uninterrupted period extending beyond one year from the balance sheet date, that short-term debt amount may be classified as noncurrent, provided there are no subjective considerations that would allow the creditor to deny any such renewal.

Collateralized revolving credit agreements may limit the amount that can be borrowed based on financial statement tests, such as a percentage of receivables and inventories. In those cases, the amount to be excluded from current liabilities is limited to the lowest amount that is expected to remain outstanding in the coming year based on anticipated levels of those financial statement amounts. The following example illustrates this situation:

**Illustration 2-29: Collateralized revolving credit agreements**

An entity has a revolving credit agreement permitting it to borrow up to $20 million. So long as the entity complies with the provisions of the agreement (all of which are objectively determinable or measurable), the amounts borrowed are continuously renewable for 90-day periods at the company's option for three years. The agreement includes a provision that limits borrowing to 75% of total receivables and inventories at any date.

The entity intends to renew borrowings under the agreement for the full three years. Consequently, the short-term debt should be excluded from current liabilities to the extent that amounts expected to be borrowed do not exceed the limitation. For example, assume $15 million of short-term debt is outstanding at 31 December 20X0, and the lowest level of combined receivables and inventories expected at any time during 20X1 is $16 million. In that case, the amount of short-term debt to be excluded from current liabilities would be limited to $12 million ($16 million x 75%), and the remaining $3 million would continue to be classified as a current liability.

If the amount of borrowings otherwise may fluctuate based on the entity's needs, only the minimum amount expected to be outstanding during the next year is excluded from current liabilities.

## 2.7.5 Lock-box and 'springing lock-box' arrangements in revolving credit agreements

### 2.7.5.1 Lock-box arrangements

Borrowings outstanding under certain revolving credit agreements may require that the debtor maintain a lock-box arrangement. Under a lock-box arrangement, the debtor's customers remit directly to the bank and the amounts received are applied to reduce the debt outstanding under the revolving credit agreement. At the end of each day, the debtor may request additional borrowings under the revolving credit agreement and thus the balance outstanding could remain unchanged.

The flow of transactions under a revolving credit agreement results in a payment and a new borrowing, although the balance outstanding may remain unchanged. Because of the lock-box arrangement, the debt outstanding under the revolving credit agreement would be considered a short-term obligation and the guidance in ASC 470-10-45-14 should be applied in determining the debt classification. If the underlying revolving credit agreement satisfied the criteria of that guidance for financing arrangements, the debt outstanding could be classified as noncurrent. However, if the revolving credit agreement contained a subjective acceleration clause, the revolving credit agreement would not qualify under that guidance. Accordingly, a revolving credit agreement containing a subjective acceleration clause and a requirement to maintain a lock-box arrangement with the creditor should be classified as a current liability.

### 2.7.5.2 Springing lock-box arrangements

Under a springing lock-box arrangement, remittances from customers go directly to a lock-box maintained by the creditor but in the debtor's name, subject to a security interest in the favor of the creditor. The remittances from the customers are then forwarded to the debtor's general bank account. The debt is not reduced by those payments. The agreement may have a SAC which, if exercised, allows the creditor to immediately cause the cash in the lock-box at that moment, as well as all subsequent cash remittances by customers into the lock-box, to be redirected from the lock-box to the creditor's account and applied against the debt outstanding. Once the SAC is exercised, the cash is no longer transferred to the debtor's general account; it is transferred to reduce the outstanding debt.

The debt under a revolving credit agreement containing a SAC and a "springing lock box" arrangement is classified as noncurrent until the SAC is exercised (or probable of becoming exercised) because remittances do not automatically reduce the debt outstanding without another event occurring. The effect of the SAC is evaluated under the guidance in ASC 470-10-45-2 based on the likelihood of exercise.

## 2.7.6 Classification of convertible debt instruments

Frequently, convertible debt instruments permit conversion upon defined contingencies (e.g., a fundamental change event) and require that, on conversion, the principal amount be settled in cash and the conversion spread be settled in shares or cash at the issuer's option ("Instrument C" discussed in section 2.1.2.1). At different points in time, the instrument may also be puttable by the holder, either by the passage of time or upon a contingent event, or will mature.

Under the principle in ASC 210-10-45, current classification is required for the convertible debt if the settlement in cash is expected to occur within 12 months (or operating cycle, if longer), subject to the issuer's intent and ability to refinance the debt on a long-term basis pursuant to ASC 470-10-45. For example, debt would be classified as current if it is scheduled to mature within 12 months (or operating cycle, if longer) or if it could be put by the holder on any dates within that period.

With contingent conversion or put features, because contingencies must be met before the debt becomes convertible (thus requiring part of the conversion obligation to be satisfied in cash) or puttable by the holder, in those circumstances, noncurrent classification may still be appropriate as long as the contingencies have not been met and the holders cannot put or convert the debt. In the event contingencies have been met at the balance sheet date and the debt becomes convertible or puttable at the holder's option, current classification would be required.

For convertible instruments where the issuer has an option to settle the conversion value of the debt in cash, shares or any combination of shares and cash, the issuer's intended settlement method should be considered in determining the instrument's classification.

### 2.7.7 Classification of increasing-rate debt

Increasing-rate debt instruments are described in section 2.1.2.9. ASC 470-10-45-7 provides that the classification of increasing-rate debt as current or noncurrent should reflect the issuer's anticipated source of repayment (e.g., current assets, a new short-term borrowing versus a long-term refinancing agreement). An obligation whose liquidation is reasonably expected to require the use of existing resources that are classified as current assets or the creation of other current liabilities, would be classified as a current liability. In contrast, liabilities that will be paid through the use of noncurrent assets or the incurrence of long-term obligations should not be classified as current.

ASC 470-10-35-2 states that the periodic interest cost of increasing-rate debt is determined using the interest method based on the estimated outstanding term of the debt. However, pursuant to ASC 470-10-45-7, the classification of the increasing-rate debt need not be consistent with the time frame used to determine the periodic interest cost; rather, it should reflect the issuer's anticipated source of repayment.

# 3 Common shares, preferred shares and other equity-related topics

## 3.1 Overview

While the form of an equity interest may vary based on the type of entity (corporation, partnership, etc.), equity generally represents the residual interest in the assets of an entity after all liabilities have been satisfied. Equity may be divided among investors on a pro-rata basis based on their percentage ownership or based on preferential rights held by certain investors.

### 3.1.1 General description of common and preferred shares

Common shares represent the basic ownership interest in an entity and is the residual corporate interest that bears the ultimate risk of loss and receives the benefit of success. Common shareholders generally control the management of the entity by voting for a board of directors. Entities may offer different classes of shares, each with different rights or privileges. A liquidation preference is typically viewed as a key distinguishing characteristic between a common share and a preferred share. The terms of shares are commonly established in the corporate governance documents (e.g., articles of incorporation) at issuance and not subject to change without the approval of the shareholders.

Common shares are usually perpetual in nature with voting rights, dividend rights and a residual interest in liquidation. For some forms of organization, the basic ownership or residual interest may not be called a share, but have similar characteristics (e.g., a unit in a limited liability entity).

Preferred shares are usually characterized by (1) the life of the instrument (i.e., perpetual or redeemable) and (2) convertibility (i.e., convertible or nonconvertible).

The terms of preferred shares can vary significantly. Certain preferred shares function much like debt instruments (i.e., they have a stated dividend rate, like interest, and have a stated redemption date, like a maturity date). Other preferred shares are more akin to traditional common stock (i.e., they are perpetual in nature, have no stated dividend and share in the distributed earnings of the entity with the common share).

Although they may have some debt-like characteristics, preferred stock represents, in legal form, an ownership relationship with the issuer (as opposed to a creditor relationship). A preferred shareholder has priority over common shareholders in a bankruptcy proceeding, but would receive consideration only after all creditors had been paid. There may be various series of preferred shares (usually designated by letters, such as Series A, Series B, Series C, etc.).

### 3.1.2 Share terminology

Stock generally is characterized with the following terms:

- Issue price — The price at which the investor buys a share when it is first issued
- Par value — A minimum amount that a shareholder may be legally required to pay for a share on issuance (Stock may be issued as "no-par" depending on the laws of the state of incorporation.)
- Liquidation preference — A fixed or calculable amount that represents the legal amount of capital to which a share (typically a preferred share) has a right upon liquidation of the entity
- Voting rights — The ability to vote on certain corporate matters

- Dividends — The primary mechanism by which profits are distributed to shareholders. May be stated as a predefined rate (frequently with preferred shares), and may be cumulative in the circumstance that they are not paid based on a stated schedule (e.g., quarterly). Typically must be declared by the board of directors
- Authorized shares — The maximum number of shares that an entity can issue, typically outlined in the entity's articles of incorporation.

Depending on the nature of the stock, there may also be terms that address the contractual life of the share and whether it is convertible into another instrument or redeemable by either the issuer or the investor.

## 3.1.3 Common types of stock instruments

### 3.1.3.1 Par value stock

The par value of a share of stock is sometimes defined as the legal capital of a corporation. The par value of common stock is usually an insignificant amount that is sometimes required by law. In addition, the original purchaser or the current holder of the shares issued below par may be called on to contribute additional capital in the amount of the difference to prevent creditors from sustaining a loss upon liquidation of the corporation. The par value of a stock has no relationship to its fair value. Preferred stock is typically issued for proceeds equal to its par value (which likely also equals its initial liquidation value), and any dividends are generally calculated as a percentage of par. Refer to section 3.2.5 for further discussion of the recognition of stock issued with and without par value.

### 3.1.3.2 No par value stock

Many states permit the issuance of capital stock without a par value. No par value shares, like par value shares, are sold for whatever price they will bring, but unlike par value shares, the proceeds are not allocated to a par value. The amount received represents a credit in a single stock account. Some jurisdictions permit the issuance of no par stock and either require or permit that stock to have a stated value (i.e., a minimum value below which it cannot be issued).

### 3.1.3.3 Treasury stock

Treasury stock is stock that is repurchased by the issuing entity, reducing the amount of outstanding shares in the open market. When shares are repurchased, they may either be canceled or held for reissue. If not canceled, such shares are referred to as treasury shares. Treasury shares do not give the entity the right to vote, exercise preemptive rights as a shareholder, receive cash dividends or receive assets upon the liquidation of the entity. Treasury shares are essentially the same as unissued capital and reduce ordinary share capital. State laws may require the shares be retired rather than held in treasury. Refer to section 3.5.1.1 for a discussion of the accounting for treasury stock transactions.

### 3.1.3.4 Perpetual preferred stock

Perpetual preferred stock has no stated maturity date, but often may be convertible and/or redeemable (callable by the issuer or puttable by the investor) at any time, after a stated period or upon a contingent event.

### 3.1.3.5 Convertible stock

Convertible stock provides the investor the ability to convert the stock into other equity securities of the issuer (or of a subsidiary of the issuer or the issuer's parent), usually at some predetermined ratio (which may be adjusted in certain circumstances). The stock includes a conversion option (or forward in the case of mandatorily convertible stock), which is an embedded call option (or forward to sell) written on the underlying shares by the issuer to the investor. Convertible stock is considered to be a hybrid instrument that contains a host contract with an embedded feature. Conversion features are more likely to be found in preferred shares than common shares.

Convertible instruments contain the following elements related to the embedded conversion option:

- Conversion price — The price at which convertible shares can be converted into the underlying equity security (e.g., par or liquidation preference/conversion rate)
- Conversion rate (or conversion ratio) — The number of underlying equity securities to be received by investors at the time of conversion for each fixed dollar value of preferred stock (e.g., par or liquidation preference/conversion price)
- Parity value — The as-converted value of each share, which is equal to the current underlying equity security trading price multiplied by the number of shares into which the preferred is convertible
- Conversion spread — The amount by which the parity value of the convertible share exceeds the accreted value (sometimes also referred to as conversion premium)

There are many variations in the nature and terms of convertible stock instruments. The most common variations are discussed in section 3.2.8.

#### 3.1.3.6 Redeemable stock

Redemption is the repurchase of the stock instrument by the issuer. The ability to force redemption may be held by either the issuer (an embedded purchased call option) or the holder (an embedded written put option). An instrument is conditionally redeemable if it represents a conditional obligation that could require, or permit, the issuer to redeem the instrument at some point in the future or under specified conditions that are not certain to occur. Redemption rights are more frequently found in preferred shares than common shares.

#### 3.1.3.7 Mandatorily redeemable stock

Some redeemable shares are mandatorily redeemable and must be repurchased by the issuer on a specified date or on the occurrence of a specified event that is certain to occur, such as the death of an owner. Shares are considered mandatorily redeemable pursuant to ASC 480-10-25-4 through 25-7 if they are subject to an unconditional obligation to be redeemed by transferring assets (i.e., cash or other assets). That is, redemption is mandatory on both parties (the issuer must redeem and the holder must surrender), as opposed to mandatory on the issuer only if the holder decides to redeem. However, if the instruments are redeemable only upon the liquidation or termination of the reporting entity, those instruments are not considered mandatorily redeemable. Refer to section 3.2.1 for further discussion of those instruments.

#### 3.1.3.8 Increasing-rate preferred stock

Some types of preferred stock initially pay little or no dividends and later pay dividends at an increasing rate (often characterized as "increasing rate preferred stock"). Refer to section 3.4.5.9 for further discussion of those instruments.

#### 3.1.3.9 Restricted shares

Restricted shares are shares for which sale is contractually or legally (e.g., governmental regulations) restricted. A common type of restricted share is a form of compensation granted by an entity to employees or directors. ASC 718 defines restricted shares as fully vested and outstanding shares whose sale is contractually or governmentally prohibited for a specified period of time. However, most shares granted to employees and nonemployees under ASC 718 are better termed as nonvested shares because the limitation on sale stems solely from the forfeitability of the shares before the grantee has satisfied the necessary service or performance condition(s) to earn the rights to the shares. In some instances, a shareholder may be asked to put legally outstanding shares in an escrow account or otherwise subject those shares to a vesting requirement. These arrangements are presumed to be compensatory under

ASC 718; however, entities should consider the substance of the transaction. Refer to section 2.6 of our FRD publication, ***Share-based payment***, for a discussion of the accounting for shares when a vesting requirement has been added.

#### 3.1.3.10 Nominal stock issuances

Nominal issuances of stock, sometimes called "cheap stock," refers to stock issued for nominal consideration (i.e., a price significantly below its fair value or the price at which stock is subsequently sold in a public issuance of shares) to employees or others closely related to the issuer. Those types of transactions may occur prior to an IPO and raise a number of accounting issues, including share-based payment and EPS considerations. Refer to section 6.4.5 of our FRD publication, ***Share-based payment***, and section 6.6 of our FRD publication, ***Earnings per share***, for further discussion.

### 3.1.4 Additional paid in capital and retained earnings

APIC is generally the excess amount paid on capital stock over its par value. APIC may be created, increased or decreased due to a variety of transactions including:

- Treasury stock transactions (refer to section 3.5.1.1)
- Stock splits and stock dividends (refer to sections 3.4.4 and 3.4.5.4)
- Conversion of convertible securities (refer to sections 2.5.2 and 3.5.2)
- Liquidating dividends (refer to section 3.4.5.3)
- Issuance or settlement of equity contracts (refer to section 4)
- Termination of an S corporation election[24]
- Share-based payments accounted for under ASC 718
- Payments or settlements of obligations by shareholders on a company's behalf (ASC 220)

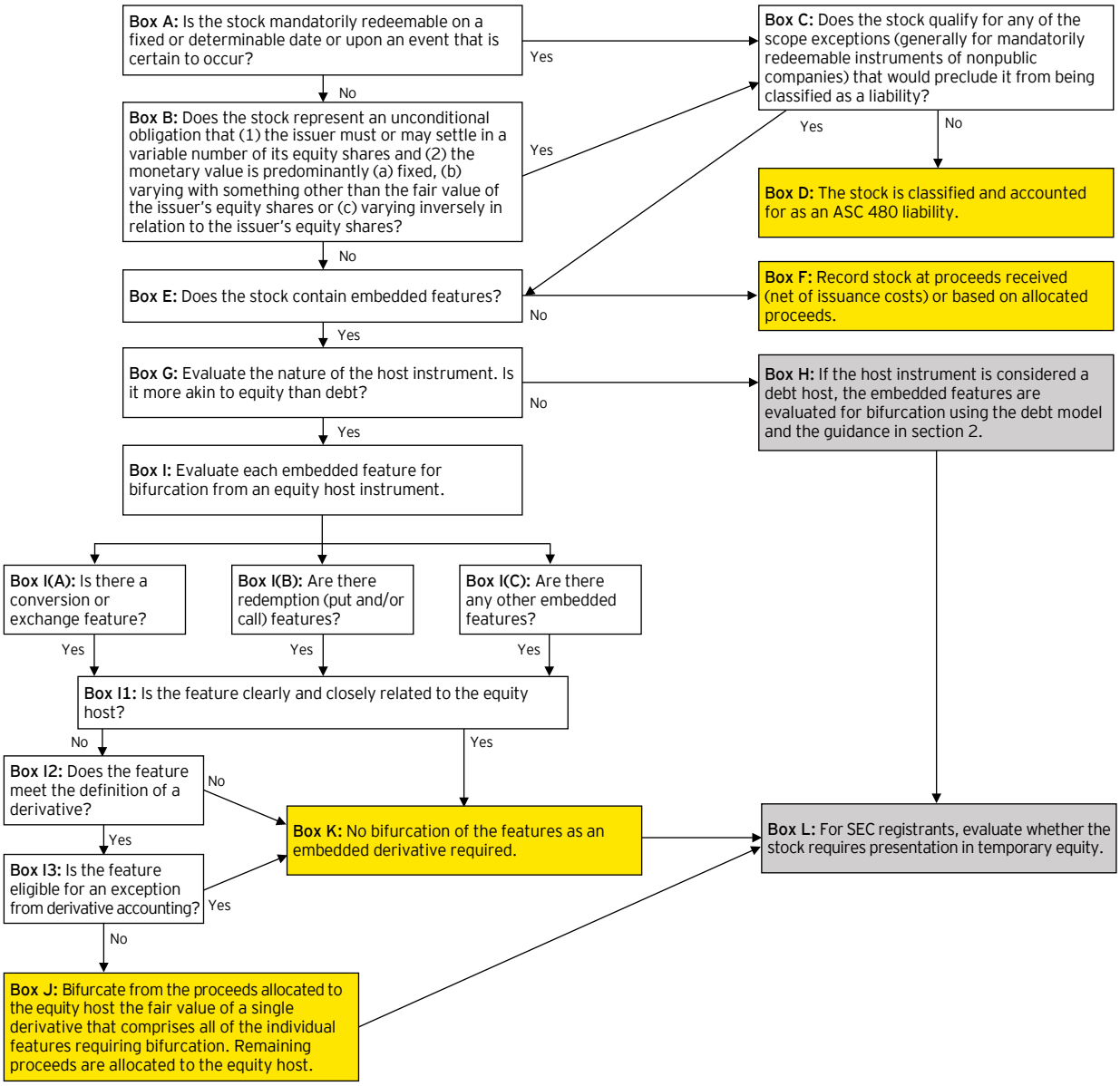
Retained earnings are profits generated by an entity that have not been distributed to shareholders. Companies may be legally or contractually required (or may elect) to appropriate retained earnings. In such cases, appropriated retained earnings are specifically identified within equity.

## 3.2 Issuer's initial accounting for stock instruments (including flowchart)

This section describes the steps generally necessary to determine the accounting for stock (including convertible stock) at issuance. In particular, this section provides detailed considerations related to the balance sheet classification, embedded conversion options, redemption features and other common embedded features.

[24] ASC 505-10-S99-3 indicates when an S corporation's election is terminated undistributed earnings should be reflected in the financial statements as APIC. This assumes a constructive distribution to owners followed by a contribution to the capital of the corporation.

The following flowchart summarizes the analysis at a conceptual level and should be used in conjunction with the related guidance throughout the rest of section 3.2.




Refer to section 5.10.2.1 for a flowchart that provides the road map for determining the classification of equity contracts over NCI.

## 3.2.1 Box A — Mandatorily redeemable stock

ASC 480-10-25-4 through 25-7 and related implementation guidance requires an instrument issued in the form of a share that is mandatorily redeemable to be classified as a liability. Shares are considered mandatorily redeemable if the issuer has an unconditional obligation to redeem them by transferring assets. That is, the issuer must redeem the shares, and the holder must surrender them. The shares wouldn't be mandatorily redeemable if the issuer had to redeem them only when the holder decided to do so.

However, if the shares are redeemable only upon the liquidation or termination of the reporting entity, those shares are not considered mandatorily redeemable. Additionally, ASC 480-10-15-7A through 15-7F provides a scope exception from liability classification for certain mandatorily redeemable shares issued by nonpublic entities (as defined in the guidance) and certain mandatorily redeemable NCIs. Shares that are subject to an unconditional obligation to be settled by issuing other shares are discussed in section 3.2.2.

Examples of mandatorily redeemable shares include stock (more frequently preferred stock) that is redeemable on a specified date or upon an event that is certain to occur (e.g., an instrument that must be redeemed upon the death of the holder). A mandatorily redeemable instrument that contains a provision to defer redemption to a future date, but not indefinitely, may change the timing of redemption but does not eliminate the obligation to redeem the instrument and, therefore, does not alter the requirement for liability classification.

The existence of a mechanism to fund the redemption of mandatorily redeemable shares does not affect their classification. For example, shares subject to mandatory repurchase upon the death of the holder for which the issuer has acquired insurance on the holder's life in an amount sufficient to fund the redemption are liabilities pursuant to ASC 480, notwithstanding the fact that the issuer is reasonably assured of having the funds necessary to satisfy the redemption obligation.

An instrument's terms should be carefully evaluated in determining whether it is mandatorily redeemable. If an otherwise mandatorily redeemable security is convertible into shares, the security is only contingently redeemable until the conversion feature expires, at which time the security becomes mandatorily redeemable. For example, if an instrument has a stated redemption date, but the instrument may be converted into another equity instrument, that instrument is not mandatorily redeemable until the conversion option expires. As long as the conversion option is considered substantive, the instrument is considered contingently or optionally redeemable as there is the possibility of conversion obviating redemption. However, if conversion requires settlement of the liquidation preference in cash and the remaining conversion spread in shares, then it is known that a settlement of the liquidation preference in cash will occur (either on redemption or on conversion) and that instrument would be classified as a liability and evaluated as a debt instrument.

Refer to section A.4 for further discussion of mandatorily redeemable instruments, including a discussion of certain deferred transition provisions for nonpublic companies.

### 3.2.2 Box B — Stock settled in a variable number of equity shares

ASC 480-10-25-14 requires liability accounting for certain financial instruments, including shares that embody an unconditional obligation to transfer a variable number of shares, provided that the monetary value[25] of the obligation is based solely or predominantly on one of the following three characteristics:

a. A fixed monetary amount known at inception (e.g., a preferred share that will be settled by issuing a variable number of common shares equal in value at that time to the liquidation preference of the preferred stock)

b. Variations in something other than the fair value of the issuer's equity shares (e.g., a preferred share that will be settled in a variable number of common shares with its monetary value tied to a commodity price)

c. Variations in the fair value of the issuer's equity shares, but the monetary value to the counterparty moves in the opposite direction as the value of the issuer's shares

Notwithstanding the fact that those instruments can be settled in shares, equity classification is not appropriate because instruments with those characteristics do not expose the counterparty to risks and rewards similar to those of an owner and, therefore, do not create a shareholder relationship.

[25] ASC 480 defines monetary value as the fair value of the cash, shares or other instruments that a financial instrument obligates the issuer to convey to the holder at the settlement under specified market conditions.

Shares with the characteristics described in (b) and (c) above are not as common as shares with the characteristics of (a). For example, some preferred shares require an exchange for a variable number of common shares equal to a fixed monetary amount, resulting in a fixed redemption value regardless of the share price. Pursuant to criterion (a), those shares would require liability classification if such an exchange feature is unconditional. Refer to section 3.2.8.3 for further discussion of those types of instruments.

Refer to section A.6 for further discussion of stock that may be settled in a variable number of shares.

## 3.2.3 Boxes C and D — Liability classification for stock

A share that is either (1) mandatorily redeemable (refer to Box A) or (2) unconditionally settled in a variable number of shares based on certain characteristics (refer to Box B) is classified as a liability unless it qualifies for one of the scope exceptions pursuant to ASC 480-10-15-7A through 15-7F for certain mandatorily redeemable shares of nonpublic entities or certain mandatorily redeemable NCIs.

When shares are classified as liabilities, the initial and subsequent measurement would be evaluated under the applicable guidance in Appendix A and the debt guidance in section 2.

### 3.2.3.1 Shares that represent legal form debt

Although uncommon, some shares represent legal form debt. An example is a preferred equity certificate (PEC) and related instruments (e.g., convertible PEC (CPEC)) issued by entities (often financing subsidiaries) domiciled in Luxembourg as part of various tax strategies. Refer to section 5.14 for a detailed discussion on those instruments.

## 3.2.4 Box E — Identifying embedded features

ASC 815-10-20 defines an embedded derivative as an implicit or explicit term that affects some or all of the cash flows or the value of other exchanges required by a contract in a manner similar to a derivative instrument. Those embedded features may or may not meet the definition of a derivative pursuant to ASC 815. Instruments that themselves are not derivatives may contain embedded features, and are referred to as hybrid instruments, which comprise a host contract (e.g., an equity host) and one or more embedded features.

ASC 815-15 requires an instrument that is not a derivative itself to be evaluated for embedded features that should be bifurcated and separately accounted for as freestanding derivatives. Bifurcated embedded derivatives are split from the hybrid instrument and recorded in the same manner as a freestanding derivative pursuant to ASC 815 (i.e., recorded at fair value with subsequent changes in fair value recognized in earnings each period).

Preferred stock instruments generally have embedded features more frequently than common shares and should be carefully reviewed to identify any terms that could result in a change (increase or decrease) in either the amount or timing (or both) of any cash or other value flows or settlement. Typical embedded features in preferred stock include conversion options, exchange options, redemption features (e.g., callable preferred or puttable preferred) and contingent dividends (additional dividends in certain circumstances). Similar features may be found in common shares, but they are atypical.

Refer to section 3.2.7 for evaluating whether an embedded feature meets the definition of a derivative.

## 3.2.5 Box F — Recognition at issuance

When stock with a par or stated value is issued for cash consideration, the proceeds (or amount allocated as discussed in section 1.2.7) should be credited to the applicable capital account in the amount of the aggregate par or stated value of the issued shares with any excess credited to APIC. Proceeds from the issuance of stock without a par or stated value should be credited entirely to the applicable capital account.

### 3.2.5.1 Stock subscription

If a public company enters into an agreement to sell its stock and issues the stock before it receives the proceeds in one or more scheduled payments (in what is commonly known as a stock subscription agreement), Rule 5-02.29 of SEC Regulation S-X requires the subscription receivable to be reflected as a reduction in stockholders' equity. Similar guidance is provided in ASC 310-10-S99-2 for capital stock that is issued to officers or other employees before cash payment is received.

For nonpublic companies, ASC 505-10-45-2 requires that notes receivable recognized in connection with the issuance of stock be reflected as a reduction of shareholders' equity in most cases (rather than as an asset) until paid. However, ASC 505-10-45-2 provides that, for nonpublic companies, subscription receivables may be recorded as an asset if they are collected in cash prior to the issuance of the financial statements. Additionally, ASC 505-10-45-2 indicates that under very limited circumstances, when there is substantial evidence of ability and intent to pay within a reasonably short period of time, nonpublic companies may record subscriptions receivables as assets. Although not carried forward into Codification, the guidance formerly in EITF 85-1[26] contained observations from Task Force members that they were aware of only a few cases where notes were reported as assets, and more specifically only when they (1) were secured by irrevocable letters of credit or other liquid collateral or were discountable at a bank and (2) included a stated maturity in a reasonably short period of time. The SEC staff has stated that, for registrants, exceptions to the general rule would be rare.

The treatment of consideration received under a stock subscription prior to the issuance of shares depends on the subscription arrangement. If the entity is obligated to refund consideration received in the event the subscription is canceled, amounts received should be accounted for as a liability until the underlying shares are issued. If consideration received is nonrefundable, payments received should generally be recorded as an addition to shareholders' equity.

Unlike stock subscriptions where stock is issued once all of the agreed upon consideration is received, when shares are issued prior to the receipt of all of the agreed upon consideration, the shares are frequently described as partially paid. The accounting for partially paid stock should be the same as that for stock subscriptions.

#### *3.2.5.1.1 Financing arrangements in SPAC transactions (added September 2024)*

A special purpose acquisition company (SPAC) is a blank-check company that raises capital from investors in an IPO to use in the future to acquire a private operating company (also referred to as the target company), which has not been identified at the time of the IPO, within a set timeframe (usually two years from the IPO). A SPAC typically issues units in its IPO, consisting of shares of common stock and warrants to purchase common stock. Substantially all of the proceeds from a SPAC IPO are placed into a trust account, where the cash is invested in highly liquid instruments and earns interest until an acquisition or business combination transaction, at which point the cash is released from the trust account to fund the transaction. Cash in the trust account may also be distributed to shareholders if the SPAC does not complete an acquisition or other business combination within the specified time period.

Public shareholders typically have the right to redeem their shares back to the SPAC in connection with the acquisition or business combination if they decide they no longer want to hold their shares. The redemption right is designed to protect shareholders, particularly those who do not vote for the proposed transaction. However, significant redemptions could reduce the number of shares outstanding and deplete the trust account, making it more difficult for the SPAC to complete the acquisition or business combination.

[26] EITF Issue No. 85-1, *Classifying Notes Received for Capital Stock* (EITF 85-1).

To reduce these risks, the SPAC may enter into a backstop arrangement with a financing entity, which would allow the shares of the SPAC to remain outstanding through the potential acquisition or business combination to make sure there are sufficient shares for the acquisition to close.

In a typical backstop arrangement, the financing entity agrees to purchase shares directly from the public shareholders of the SPAC, who decide to redeem their shares in connection with the transaction. Separately, the SPAC and the financing entity enter into a forward contract under which the SPAC (or its successor after the acquisition or business combination) is required to repurchase the shares acquired by the financing entity from the public shareholders within a defined period after the acquisition or business combination. The SPAC is required to pay upfront the redemption price for these shares, which is substantially equal to the cash paid by the financing entity to the public shareholders.

Under the terms of the agreement, the forward will be settled within the defined period in one of the following ways:

- If the financing entity sells any shares subject to the arrangement (i.e., shares acquired by the financing entity from the public shareholders) to third parties, the SPAC (or its successor) would receive the amount that the financing entity paid for those shares to the public shareholders. If the financing entity sells the shares at a price higher than the price it paid for those shares, it will be able to keep the excess amount of proceeds from the sales.
- Any shares that the financing entity is unable to sell by the end of the arrangement will be returned to the SPAC (or its successor). In certain arrangements, the financing entity may also receive a minimum return for each share it doesn't sell, which may require the SPAC (or its successor) to pay additional amounts.

Questions have been raised about whether the prepayment made by the SPAC at the inception of the forward contract should be accounted for as an asset under ASC 480 or as a subscription receivable under SEC Rule 5-02.29 of Regulation S-X (similar guidance is provided in ASC 505-10-45-2 for nonpublic companies). We generally believe that the SPAC (or its successor) should account for the upfront cash payment in a similar manner as a subscription receivable. That is, the subscription receivable is reflected as a reduction in stockholder's equity (refer to section 3.2.5.1 for a further discussion of stock subscriptions). In addition, the SPAC (or its successor) should evaluate the arrangement to determine whether any derivative accounting would be required under ASC 815.

At the 2023 AICPA & CIMA Conference on Current SEC and PCAOB Developments, a SEC staff member presented a SPAC backstop arrangement fact pattern and objected to an accounting view that the upfront payment by the SPAC under the backstop arrangement should be accounted for and presented as an asset under ASC 480. The SEC staff member noted that the prepayment was akin to a subscription receivable. The SEC staff also said the registrant would need to evaluate relevant guidance, including ASC 815, when considering the subsequent accounting for the arrangement.

### 3.2.5.2 Stock issued to nonemployees (including customers)

ASC 718 addresses the accounting for share-based payments issued to employees and nonemployees in exchange for goods or services to be used or consumed in the grantor's own operations as well as the measurement and classification of awards issued to customers in conjunction with a revenue arrangement that is not in exchange for a distinct good or service. For guidance on accounting for the issuance of equity instruments to nonemployees (including customers), refer to our FRD publication, ***Share-based payment***. Additionally, refer to section 5.7 of our FRD publication, ***Revenue from contracts with customers (ASC 606)***, for guidance on accounting for the issuance of equity instruments granted in conjunction with selling goods or services to customers.

## 3.2.6 Boxes G and H — Evaluate the nature of the host contract

A hybrid instrument consists of a host contract and an embedded feature. Pursuant to ASC 815-15-25-1(a), an embedded feature does not require bifurcation if the feature is clearly and closely related to the host contract. Therefore, the nature of the host contract must be determined in order to assess whether any embedded features are considered clearly and closely related.

Unlike the evaluation of most common stock (an equity host) or of a debt instrument (a debt host), the nature of the host contract in a hybrid instrument issued in the form of a preferred share may not be clear because the preferred share may contain both equity-like and debt-like features. A preferred share should be evaluated based on its terms and features to determine whether it is a debt host or an equity host. If an equity instrument is required to be classified as a liability pursuant to ASC 480, we generally believe it would be rare for an entity to conclude that the nature of the host instrument is equity.

While liability classification is indicative that the nature of the host instrument generally would be debt-like, the fact that the instrument is classified in equity does not indicate the host is equity-like. Rather, a comprehensive analysis of the factors in ASC 815-15-25-17C and 25-17D should be performed to reach a conclusion.

### 3.2.6.1 Defining the host contract

ASC 815-15-25-17A requires an issuer or investor to consider the economic characteristics and risks of a hybrid instrument issued in the form of a share, including all of its stated and implied substantive terms and features, to determine whether the nature of the host contract in the share is more akin to debt or to equity. This is commonly referred to as the whole instrument approach.

Under this approach, all stated and implied features, including the embedded feature being evaluated for bifurcation, must be considered. Each term and feature should be weighed based on the relevant facts and circumstances to determine the nature of the host contract. This approach results in a single, consistent determination of the nature of the host contract, which is then used to evaluate each embedded feature for bifurcation.

The guidance clarifies that the existence or omission of any single feature, including an investor-held, fixed-price, noncontingent redemption option, does not necessarily determine the economic characteristics and risks of the host contract. Instead, an entity must base that determination on an evaluation of the entire hybrid instrument, including all substantive terms and features.

However, an individual term or feature may be weighed more heavily in the evaluation on the basis of facts and circumstances. An entity should use judgment based on an evaluation of all of relevant terms and features, including the circumstances surrounding the issuance or acquisition of the equity share, as well as the likelihood that an issuer or investor is expected to exercise any options within the host contract, to determine the nature of the host contract.

#### *3.2.6.1.1 Weighing terms and features*

**Excerpt from Accounting Standards Codification**

**Derivatives and Hedging—Embedded Derivatives**

*Recognition*

*815-15-25-17C*

When applying the guidance in paragraph 815-15-25-17A, an entity shall determine the nature of the host contract by considering all stated and implied substantive terms and features of the hybrid financial instrument, determining whether those terms and features are debt-like versus equity-like, and weighing those terms and features on the basis of the relevant facts and circumstances. That is, an entity shall consider not only whether the relevant terms and features are debt-like versus equity-like, but also the substance of those terms and features (that is, the relative strength of the debt-like or equity-like terms and features given the facts and circumstances). In assessing the substance of the

relevant terms and features, each of the following may form part of the overall analysis and may inform an entity's overall consideration of the relative importance (and, therefore, weight) of each term and feature among other terms and features:

a. The characteristics of the relevant terms and features themselves (for example, contingent versus noncontingent, in-the-money versus out-of-the-money)

b. The circumstances under which the hybrid financial instrument was issued or acquired (for example, issuer-specific characteristics, such as whether the issuer is thinly capitalized or profitable and well-capitalized)

c. The potential outcomes of the hybrid financial instrument (for example, the instrument may be settled by the issuer issuing a fixed number of shares, the instrument may be settled by the issuer transferring a specified amount of cash, or the instrument may remain legal-form equity), as well as the likelihood of those potential outcomes. The assessment of the potential outcomes may be qualitative in nature.

*815-15-25-17D*

The following are examples (and not an exhaustive list) of common terms and features included within a hybrid financial instrument issued in the form of a share and the types of information and indicators that an entity (an issuer or an investor) may consider when assessing the substance of those terms and features in the context of determining the nature of the host contract, as discussed in paragraph 815-15-25-17C:

a. Redemption rights. The ability for an issuer or investor to redeem a hybrid financial instrument issued in the form of a share at a fixed or determinable price generally is viewed as a debt-like characteristic. However, not all redemption rights are of equal importance. For example, a noncontingent redemption option may be given more weight in the analysis than a contingent redemption option. The relative importance (and, therefore, weight) of redemption rights among other terms and features in a hybrid financial instrument may be evaluated on the basis of information about the following (among other relevant) facts and circumstances:

    1. Whether the redemption right is held by the issuer or investors

    2. Whether the redemption is mandatory

    3. Whether the redemption right is noncontingent or contingent

    4. Whether (and the degree to which) the redemption right is in-the-money or out-of-the-money

    5. Whether there are any laws that would restrict the issuer or investors from exercising the redemption right (for example, if redemption would make the issuer insolvent)

    6. Issuer-specific considerations (for example, whether the hybrid financial instrument is effectively the residual interest in the issuer [due to the issuer being thinly capitalized or the common equity of the issuer having already incurred losses] or whether the instrument was issued by a well-capitalized, profitable entity)

    7. If the hybrid financial instrument also contains a conversion right, the extent to which the redemption price (formula) is more or less favorable than the conversion price (formula), that is, a consideration of the economics of the redemption price (formula) and the conversion price (formula), not simply the form of the settlement upon redemption or conversion.

b. Conversion rights. The ability for an investor to convert, for example, a preferred share into a fixed number of common shares generally is viewed as an equity-like characteristic. However, not all conversion rights are of equal importance. For example, a conversion option that is noncontingent or deeply in-the-money may be given more weight in the analysis than a conversion option that is contingent on a remote event or deeply out-of-the-money. The relative importance (and,

therefore, weight) of conversion rights among other terms and features in a hybrid financial instrument may be evaluated on the basis of information about the following (among other relevant) facts and circumstances:

1. Whether the conversion right is held by the issuer or investors
2. Whether the conversion is mandatory
3. Whether the conversion right is noncontingent or contingent
4. Whether (and the degree to which) the conversion right is in-the-money or out-of-the-money
5. If the hybrid financial instrument also contains a redemption right held by the investors, whether conversion is more likely to occur before redemption (for example, because of an expected initial public offering or change-in-control event before the redemption right becoming exercisable).

c. Voting rights. The ability for a class of stock to exercise voting rights generally is viewed as an equity-like characteristic. However, not all voting rights are of equal importance. For example, voting rights that allow a class of stock to vote on all significant matters may be given more weight in the analysis than voting rights that are only protective in nature. The relative importance (and, therefore, weight) of voting rights among other terms and features in a hybrid financial instrument may be evaluated on the basis of information about the following (among other relevant) facts and circumstances:

1. On which matters the voting rights allow the investor's class of stock to vote (relative to common stock shareholders)
2. How much influence the investor's class of stock can exercise as a result of the voting rights.

d. Dividend rights. The nature of dividends can be viewed as a debt-like or equity-like characteristic. For example, mandatory fixed dividends generally are viewed as a debt-like characteristic, while discretionary dividends based on earnings generally are viewed as an equity-like characteristic. The relative importance (and, therefore, weight) of dividend terms among other terms and features in a hybrid financial instrument may be evaluated on the basis of information about the following (among other relevant) facts and circumstances:

1. Whether the dividends are mandatory or discretionary
2. The basis on which dividends are determined and whether the dividends are stated or participating
3. Whether the dividends are cumulative or noncumulative.

e. Protective covenants. Protective covenants generally are viewed as a debt-like characteristic. However, not all protective covenants are of equal importance. Covenants that provide substantive protective rights may be given more weight than covenants that provide only limited protective rights. The relative importance (and, therefore, weight) of protective covenants among other terms and features in a hybrid financial instrument may be evaluated on the basis of information about the following (among other relevant) facts and circumstances:

1. Whether there are any collateral requirements akin to collateralized debt
2. If the hybrid financial instrument contains a redemption option held by the investor, whether the issuer's performance upon redemption is guaranteed by the parent of the issuer
3. Whether the instrument provides the investor with certain rights akin to creditor rights (for example, the right to force bankruptcy or a preference in liquidation).

In determining the nature of a host contract, the guidance requires an entity to first identify all of the stated and implied substantive terms and features (e.g., a conversion option, a redemption option, voting rights, dividend rights, protective covenants) within the hybrid instrument and to determine whether those terms and features are debt-like or equity-like. The entity will then weigh each term and feature on the basis of the relevant facts and circumstances to determine the relative strength of the debt-like and equity-like terms and features. To assess the substance of relevant terms and features, it is important to determine not only which terms and features are debt-like or equity-like, but also the extent to which those terms and features are debt-like or equity-like.

When assessing the relative importance of the terms and features, an entity must consider their substance. In doing so, an entity may consider the following:

- The characteristics of the terms and features (e.g., contingent versus noncontingent, in-the-money versus out-of-the-money)
- The circumstances under which the hybrid instrument was issued or acquired (e.g., issuer-specific characteristics, such as whether the issuer is thinly capitalized or profitable and well-capitalized)
- The potential outcomes of the hybrid instrument and the likelihood of those potential outcomes (e.g., the instrument may be settled by the issuer issuing a fixed number of shares or by transferring a specified amount of cash, or the instrument may remain legal-form equity), as well as the likelihood of those potential outcomes

The potential outcomes may be assessed qualitatively. The entity's expectation of the potential outcomes as well as the investor's expectation of the nature of return (i.e., debt-like or equity-like) from the investment should be considered in the assessment.

The table below presents several key features that are common in preferred stock and whether those terms and features are, by their nature, debt-like or equity-like. Once a determination is made as to whether the feature is debt-like or equity-like, such feature should be weighted based on the relevant facts and circumstances to determine the nature of the host contract.

| **Feature** | Equity-like ⟷ Debt-like | | | |
|---|---|---|---|---|
| *Redemption* | Perpetual | Puttable (at holder's option) on contingent event | Puttable (at holder's option) with passage of time | Mandatorily redeemable |
| *Dividends* | Cumulative participating (and presumably noncumulative participating) | Noncumulative fixed rate (and presumably indexed variable rate) | Cumulative fixed rate (and presumably cumulative indexed variable rate) | |
| *Voting rights* | Votes with common on as-converted basis | Votes with common on as-converted basis on specific matters | Votes only on matters related to specific instrument | Nonvoting |
| *Covenants* | No provisions that are substantively protective covenants | | Includes provisions that are substantively protective covenants | |
| *Conversion rights* | Mandatorily convertible | Optionally convertible | Not convertible | |

## 3.2.7 Box I and Boxes I1, I2 and I3 — Evaluating embedded features for bifurcation

Embedded features should be evaluated as potential derivatives that should be bifurcated and accounted for separately. Box I(A) and Box I(B) represent two broad categories of features commonly found in stock: conversion options and put/call (i.e., redemption) features. Box I(C) captures any other features that meet the definition of an embedded derivative that could require bifurcation.

Boxes I1, I2 and I3 apply to any contractual feature requiring analysis as a potential embedded derivative. The questions in those boxes align closely with the criteria in ASC 815-15-25-1, which requires an embedded derivative to be bifurcated if all three of the following conditions are met:

a. The economic characteristics and risks of the embedded derivative are not clearly and closely related to the economic characteristics and risks of the host contract.

b. The hybrid instrument is not remeasured at fair value under otherwise applicable US GAAP with changes in fair value reported in earnings as they occur.

c. A separate instrument with the same terms as the embedded derivative would be considered a derivative instrument subject to derivative accounting (the initial net investment for the hybrid instrument should not be considered to be the initial net investment for the embedded derivative).

Under criterion (a), if an embedded feature being analyzed is clearly and closely related to the host, bifurcation is not required. To evaluate this criterion, the host contract should be properly identified. The evaluation of embedded features in this section is in the context of only an equity host contract. Preferred stock that is deemed a debt host is treated as a debt instrument in evaluating embedded features. Refer to the discussion in section 2.2.3 for evaluating embedded features for bifurcation when the host is determined to be a debt instrument.

Criterion (b) is not addressed because the fair value option cannot be elected for an equity-classified instrument, such as stock. Embedded features in stock classified as liabilities (refer to section 3.2.3) should be evaluated under the debt guidance in section 2.

Criterion (c) considers not only whether the embedded feature meets the definition of a derivative (evaluated as if it were a freestanding instrument with the same terms), but also whether it is eligible for an exception from derivative accounting. If the embedded feature would not be a derivative if freestanding, either because it does not meet the definition of a derivative or because it does meet the definition but receives an exception from derivative accounting pursuant to ASC 815, bifurcation is not required.

#### 3.2.7.1 Unit of analysis

The unit of analysis is important when evaluating potential derivatives because each embedded feature identified in a contract generally is evaluated for bifurcation. There are different approaches in practice in determining whether embedded features require bifurcation. Under one approach, each embedded feature is evaluated individually, while under another approach similar embedded features may be (or in some cases must be) combined. The approach followed for the unit of analysis (i.e., embedded features evaluated individually or in a group) may affect whether some or all of those embedded features should be bifurcated.

For example, consider a typical contingently convertible preferred stock instrument that may be converted in four different situations (e.g., based on the trading price, parity, a notice of redemption or a specified corporate transaction), with each situation representing the resolution of a contingency in the instrument. The contractual conversion features in a contingently convertible preferred share could be analyzed in two ways. Under one approach, the instrument would have a single conversion option with four separate triggers that permit conversion (e.g., based on the trading price of the common stock, parity, a notice of redemption or a specified corporate transaction). Under another approach, the instrument could be viewed to have four conversion options for bifurcation, each of which is exercisable only upon the occurrence of a certain event (e.g., the trading price of the common stock, parity, a notice of redemption or a specified corporate transaction).

If the instrument were viewed to have one option with multiple exercise triggers, the entire conversion option would be bifurcated if any individual trigger or related settlement met the requirements for bifurcation. Under the second approach (four options, each with its own exercise trigger), only each individual trigger or related settlement requiring separate accounting would be bifurcated. The valuation of that bifurcated derivative would be based on the value of a conversion option (or options, if several required bifurcation) that included an input for the probability of the trigger (or triggers) occurring. The remaining conversion options would not be bifurcated.

We generally believe either approach is acceptable in evaluating embedded derivatives. The approach followed should be consistently applied. However, the second approach may not be applied in all circumstances. For example, ASC 815-15-25-7 states that a single freestanding derivative may not be split into multiple derivatives. Therefore, a freestanding warrant that has four exercise contingencies should be viewed as a single equity contract.

Judgment will be required to determine when it is appropriate (or necessary) to combine terms into a single embedded feature to be evaluated for bifurcation. Factors to be considered include the commonality of the underlyings, a detailed analysis of the calculation of related settlement amounts, the situations in which settlements may be required and default provisions related to the terms. Once the appropriate unit of analysis is determined, each unit should be evaluated in accordance with the criteria in ASC 815-15-25-1 described below.

#### 3.2.7.2 Meaning of 'clearly and closely related'

The clearly and closely related evaluation generally refers to a comparison of the economic characteristics and risks of the embedded feature to those of the host instrument. The concept is not specifically defined in the guidance, but is illustrated throughout the examples in ASC 815-15-25-23 through 25-51. Generally, the underlying, which causes the value of the embedded feature to fluctuate, must be related to the inherent economic nature of the host instrument to be considered clearly and closely related to the host instrument.

If the economic characteristics and risks of the embedded feature are clearly and closely related to the economic characteristics and risks of the host contract, ASC 815 does not permit bifurcation of the feature.

For a share that has an equity host, the embedded feature's underlying must bear the economics and risks of the issuer's equity interest (i.e., be related to a residual interest) to be considered clearly and closely related. For example, a conversion option in a preferred stock that is deemed an equity host is generally considered clearly and closely related to the host instrument.

#### 3.2.7.3 Definition of a derivative instrument

To be a derivative pursuant to ASC 815, an instrument should have all of the following characteristics:

- A derivative's cash flows or fair value must fluctuate and vary based on the changes in one or more underlyings.
- The contract contains one or more notional amounts or payment provisions or both.
- The contract requires no initial net investment, or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors.
- The contract (a) provides for net settlement, (b) can be settled net through a market mechanism outside the contract or (c) provides for delivery of an asset that, because the delivered asset is readily convertible to cash, puts the recipient in a position not substantially different from net settlement (a gross settlement that is economically equivalent to a net settlement).

Refer to section 1.2.3 of this publication and section 2.4 of our FRD publication, ***Derivatives and hedging***, for additional information on the definition of a derivative.

### 3.2.8 Box I(A) and Boxes I1, I2 and I3 — Evaluating embedded conversion options

The conversion feature in convertible stock should be evaluated for potential bifurcation pursuant to the criteria in ASC 815-15-25-1, which includes the considerations described in section 3.2.7. If the option meets the definition of a derivative, the analysis should also consider whether the conversion feature, if freestanding, would receive an exception from derivative accounting.

The bifurcation analysis in this section addresses stock with an equity host. If convertible stock is determined to have a debt host, the evaluation of whether the conversion option requires bifurcation is performed as if the stock is a debt instrument. Refer to section 2.2.4 for guidance on evaluating embedded conversion options in debt instruments.

#### 3.2.8.1 Determining whether a conversion option is clearly and closely related to an equity host instrument

Most commonly, the economic characteristics and risks of a conversion option embedded in a stock instrument are considered clearly and closely related to an equity host as its value is influenced principally by the underlying equity security's fair value. Therefore, bifurcation would not be required.

However, if the host instrument and the embedded conversion feature are not clearly and closely related (e.g., the host is equity-like and it converts into debt or a debt-like security), an analysis pursuant to Box I2 is necessary to determine whether bifurcation of the embedded conversion feature is required.

#### 3.2.8.2 Contingently convertible stock

In a traditional convertible stock instrument, the holder may exercise its option to convert the stock into a number of underlying securities at any time. In contrast, a contingently convertible instrument entitles the holder to convert only after certain contingencies have been satisfied. The evaluation of a conversion feature in any stock hybrid instrument will depend on whether the host instrument is considered an equity host or a debt host (refer to section 3.2.6 for additional information regarding identifying the nature of the host). In an equity host, the conversion feature will usually be considered to be clearly and closely related to the equity host, even if it is contingently exercisable, and thus bifurcation would not be required.

#### 3.2.8.3 Share-settled stock

Convertible stock typically provides the investor the ability to convert the stock into a fixed number (only to be adjusted under certain events) of different shares of the issuer. As a result, the value the holder receives upon conversion is based entirely on the price of the other shares. However, some stock instruments may settle by providing the holder with a variable number of different shares with an aggregate fair value that equals the stock instrument's liquidation preference. In some cases, a slight fixed discount to the fair value of the other share price may be used to determine the number of other shares to be delivered, resulting in settlement in shares at a fixed premium.

Because the value that the holder receives at settlement does not vary with the value of the other shares, that settlement provision is not considered a conversion option and the stock instrument would not be considered convertible stock unless it also contained a conversion option (as discussed in section 3.1.3.5). Instead, this provision should first be evaluated pursuant to ASC 480-10-25-14 (refer to section A.6 for a discussion of the application of this guidance). If not subject to that guidance, the provision should be evaluated as a redemption feature as described in section 3.2.9.

### 3.2.9 Box I(B) and Boxes I1, I2 and I3 — Evaluating embedded redemption (put and/or call) features

A call option gives the issuer the right to repurchase the stock instrument, usually at par plus any cumulative dividends or stated increases in liquidation preference. A call feature is usually intended to enable the issuer to refinance an existing stock issuance with a lower cost alternative.

A put option gives the investor the right to sell the stock back to the issuer at an agreed upon or determinable amount. This enables the investor to obtain liquidity if the stock is not regularly traded as well as to exit an investment that is paying a below-market dividend rate.

Frequently, preferred stock instruments contain a put option that enables the investor to put the stock to the issuer upon the occurrence of a deemed liquidation event (as defined in the agreement). Although specific to each arrangement, common examples of deemed liquidation events include the following:

- A person or group becoming the direct or indirect ultimate beneficial owner of the issuer's common equity representing more than 50% of the voting power of the common equity
- Sale of all or substantially all of the issuer's net assets
- Consummation of any share exchange, consolidation or merger of the issuer into another entity
- Continuing directors cease to constitute at least a majority of board of directors
- Shareholders approve any plan or proposal for the liquidation or dissolution of the issuing entity
- The issuer's common stock ceases to be quoted or listed

If the redemption feature is triggered based on some kind of change in control, it is usually referred to as a change of control put.

Depending on the specific terms of the instrument, embedded put or call options may be exercisable at any time after issuance, after the passage of time (e.g., on or after the fifth anniversary) or upon the occurrence of specified contingent events. Puts and calls may be structured to coincide with each other.

Similar to the evaluation of the embedded conversion option, redemption features are also assessed in accordance with guidance provided in ASC 815-15-25-1.

The analysis of whether bifurcation is required changes based on whether the nature of the host stock instrument is equity-like or debt-like. If stock is determined to have an equity host as discussed at ASC 815-15-25-20, a redemption option is often not considered clearly and closely related to the equity host, and the redemption feature should be evaluated to determine whether it meets the definition of a derivative. If the redemption provision meets the definition of a derivative, the analysis then considers whether the redemption feature, if freestanding, would receive an exception from derivative accounting.

The bifurcation analysis in this section addresses only stock with an equity host. Refer to section 2.2.5 for guidance on evaluating embedded redemption (put and call) features in hosts determined to be debt instruments.

### 3.2.9.1 Determining whether put and call features are considered clearly and closely related to an equity host instrument

ASC 815-15-25-20 states that a put option that enables the holder to require the issuer of an equity instrument to reacquire that equity instrument for cash or other assets is not clearly and closely related to that equity instrument, and likewise a purchased call option by the issuer is not clearly and closely related. Puts and calls embedded in equity hosts are also not clearly and closely related as their economic characteristics and risks are unrelated to an equity interest, which is generally a residual interest that would reside with an investor until the issuing entity ceased to exist. The ability for the holder to redeem, or for the entity to force the holder to redeem, would not appear to be clearly and closely related to holding that residual interest.

Because the economic characteristics and risks of a holder's put and issuer's call option are generally not clearly and closely related to an equity host, any embedded put or call should be evaluated as to whether it (a) meets the definition of a derivative if it were freestanding (Box I2) and (b) if so, whether there is an exception from derivative accounting (Box I3).

### 3.2.9.2 Determining whether put and call features meet the definition of a derivative subject to derivative accounting

An embedded feature is a derivative pursuant to ASC 815 only if it meets the four characteristics of a derivative. A redemption feature would likely have the first three characteristics of a derivative in ASC 815-10-15-83, but may not have the fourth, based on the following:

- Underlying — The market price of the stock is the underlying in an equity-linked instrument.
- Notional amount — The number of shares of common or an amount of liquidation preference of preferred is the notional amount.
- No initial net investment — The fair value of the embedded redemption feature at inception (not the initial investment in the stock instrument) is generally substantially less than the fair value of the underlying stock.
- Net settlement — Redemption features generally require settlement via gross physical delivery (i.e., delivery of the stock to the issuer in exchange for delivery of cash to the investor). Gross settlement would not meet the net settlement requirement unless the stock is readily convertible to cash, as that phrase is interpreted in ASC 815, in which case the gross physical settlement qualifies as net settlement because it puts the recipient in a position not substantially different from net settlement.

  For example, a share of a publicly traded company is generally considered readily convertible to cash unless the market for the shares is not active and the number of shares to be exchanged (given the smallest increment available for conversion) is large relative to the daily trading volume of the underlying shares. However, if the underlying share is equity of a private company, the redemption feature would generally not meet the net settlement criteria in a physical settlement. However, active trading by a large enough group of the equity owners could result in a conclusion that a common share is readily convertible to cash and therefore a gross physical settlement meets the net settlement criterion.

Refer to section 2.4.4 of our FRD publication, ***Derivatives and hedging***, for further guidance on net settlement.

If the redemption feature does not meet all of the characteristics of a derivative pursuant to ASC 815-10-15-83, it should not be bifurcated from its equity host. If the redemption feature does meet all of the characteristics of a derivative pursuant to ASC 815-10-15-83, it should be analyzed to determine whether it is eligible for an exception from derivative accounting pursuant to ASC 815-10-15-13.

### 3.2.9.3 Exceptions from derivative accounting

Notwithstanding that an embedded feature, if freestanding, may meet all the characteristics of a derivative, an embedded feature should not be bifurcated if the feature is eligible for any of the scope exceptions provided by ASC 815. The most common exception for an equity redemption feature is provided by ASC 815-10-15-74(a), which states that contracts issued or held by that reporting entity that are both (1) indexed to its own stock and (2) classified in stockholders' equity in its statement of financial position are not considered derivative instruments in the scope of ASC 815. That analysis draws on the indexation and classification guidance in ASC 815-40 related to contracts in an entity's own stock.

Appendix B includes a comprehensive discussion of those concepts.

#### *3.2.9.3.1 Meaning of 'indexed to issuer's own stock'*

To determine whether an equity redemption feature is indexed to its own stock, it should be analyzed pursuant to ASC 815-40-15-5 through 15-8, including the related implementation guidance. The examples in ASC 815-40-55-26 through 55-48 should, in particular, be considered. This guidance is referred to throughout this publication as "the indexation guidance."

The indexation guidance requires a two-step evaluation of an instrument or feature. In the first step, any contingent exercise provisions are evaluated, and in the second step, an analysis of features that could change the instrument's settlement amount is conducted.

In the first step, an exercise contingency (as defined in the indexation guidance) does not preclude an instrument (or embedded feature) from being considered indexed to an entity's own stock provided that it is not based on either of the following:

a. An observable market, other than the market for the issuer's stock (if applicable)

b. An observable index, other than an index calculated or measured solely by reference to the issuer's own operations (e.g., sales revenue of the issuer, earnings before interest, taxes, depreciation and amortization of the issuer, net income of the issuer, total equity of the issuer)

In the second step, an instrument (or embedded feature) is considered indexed to an entity's own stock if its settlement amount equals the difference between (1) the fair value of a fixed number of the entity's equity shares and (2) a fixed monetary amount or a fixed amount of a debt instrument issued by the entity. While the second step appears to be a very strict fixed-for-fixed concept, an exception is provided such that if the instrument's strike price or the number of shares used to calculate the settlement amount is not fixed, the instrument (or embedded feature) could still be considered indexed to an entity's own stock if the only variables that could affect the settlement amount would be inputs to a fair value valuation model for a fixed-for-fixed forward or option on equity shares. Accordingly, any feature that adjusts the embedded redemption feature should be carefully analyzed.

Many redemption features (1) have either no contingencies or contingencies that are solely related to the issuer and (2) settle by delivering the shares (a fixed number of shares) to the issuer in exchange for a fixed amount of cash (the redemption price), and thus are considered indexed to the issuer's stock.

An equity redemption feature that is not considered indexed to the issuer's own stock would not qualify for the scope exception in ASC 815-10-15-74(a) and should be bifurcated.

#### *3.2.9.3.2 Meaning of 'classified in stockholders' equity'*

To determine whether an equity redemption feature would be classified in stockholders' equity if considered freestanding, ASC 815-40-25-1 through 25-43 should be considered, including the related implementation guidance (primarily codified in ASC 815-40-55-2 through 55-18). This guidance is referred to throughout this publication as "the equity classification guidance."

The equity classification guidance generally indicates that an equity redemption feature on a company's own stock, if freestanding, would be considered to be classified in equity under either of the following types of settlement:

- Required physical settlement or net share settlement
- Issuer has choice of net cash settlement or settlement in its own shares (physical settlement or net share settlement), regardless of the intent of the issuer

In contrast, an equity redemption feature would not be considered to be classified in equity if either of the following provisions is present:

- Required net cash settlement (including a requirement to net cash settle if an event occurs that is outside the control of the issuer)
- Holder has choice of net cash settlement or settlement in shares (physical settlement or net share settlement)

ASC 815-40-25-7 through 25-38 include additional conditions that must be met for equity classification. If any condition (as summarized below) is not met for a stock instrument, the equity redemption feature would not be considered to be classified in stockholders' equity and should be bifurcated:

- No explicit requirement to settle the contract in cash when registered shares are unavailable
- Entity has sufficient authorized and unissued shares
- Contract contains an explicit share limit
- No required cash payments (with the exception of penalty payments) if entity fails to timely file
- No cash settled top-off or make-whole provisions

An equity redemption feature typically requires the investor to deliver the underlying share in return for the consideration in a gross physical settlement. As the issuer does not typically deliver shares in settlement, and gross physical settlement meets the criteria to be classified in equity (even though the issuer must deliver cash), bifurcation is generally not required.

#### 3.2.9.4 Stock of a consolidated subsidiary that includes redemption rights

Refer to section 5.10.2.4 for guidance on redeemable NCI.

### 3.2.10 Box I(C) and Boxes I1, I2 and I3 — Evaluating other potential embedded features

A stock instrument may have a variety of features that can affect the timing and amount of future cash flows in a way similar to a derivative. Those features should be evaluated pursuant to the criteria in ASC 815 (discussed above in section 3.2.7) to determine if they require bifurcation. A careful analysis of the underlying agreements is necessary to identify all potential features to be evaluated.

While not all instruments have potential embedded derivatives, some of the more commonly observed features in practice are exchange features, rights offering features, indexed dividends and poison pill features.

#### 3.2.10.1 Exchange features

Exchangeable preferred stock or convertible exchangeable preferred stock is typically issued in a form that is identical to preferred stock or convertible preferred stock, except that it contains a provision that permits the issuer to call (or the investor to put) the preferred stock from the investor and, in consideration, the issuer issues debt to the investor with the same economics as the redeemed preferred stock.

As discussed in section 3.2.7, the exchange feature should be evaluated as to whether it is clearly and closely related to the host instrument and, if not, whether it meets the definition of a derivative pursuant to ASC 815. If the exchange option meets the definition of a derivative, it is unlikely that such a feature would qualify for any scope exceptions in ASC 815. In particular, the scope exception ASC 815-10-15-74(a) that is often available to conversion features generally should not be applied as those exchange features are not indexed to, and would not be classified in, the issuer's equity.

The exchange feature should also be considered in evaluating the preferred stock for temporary or permanent equity classification. If the exchange feature can be exercised only by the issuer at the issuer's option, permanent equity classification would be appropriate assuming no other features required temporary equity classification. However, if the exchange feature is exercisable by the investor or upon an event that is outside the control of the issuer, the exchange feature would require the preferred stock to be classified in temporary equity as the instrument would ultimately be settled in cash (with the maturity of the subsequent debt). Refer to section 3.2.13 and Appendix C for further guidance on temporary and permanent equity classification.

Another form of an exchangeable preferred share is a preferred share that may be, or is required to be, exchanged for common shares of another issuer (e.g., a PRIDES (preferred redeemable increased dividend equity security)). If the exchangeable preferred share is not required to be classified as a liability pursuant to ASC 480, the embedded exchange feature should be evaluated for bifurcation. If the exchange feature meets the net settlement requirements pursuant to ASC 815 (refer to section 3.2.7.3), the feature will likely require bifurcation. This bifurcation analysis is similar to that of debt exchangeable into the common stock of another issuer, which is discussed in section 5.1.

#### 3.2.10.2 Rights offering features

Rights offering features generally provide investors with the right to purchase additional shares of the issuer and may be freestanding instruments or embedded in shares. Embedded preemptive rights or privileges issued or granted to shareholders to purchase shares should be carefully evaluated as to whether they are clearly and closely related to an equity host, and if not, further analyzed pursuant to ASC 815-15-25-1, as discussed in section 3.2.7. In general, rights offering features that are embedded in a share are clearly and closely related to an equity host contract.

Rights offerings that are freestanding financial instruments should be evaluated pursuant to ASC 480 and ASC 815. Refer to section 4.2 for guidance on freestanding equity contracts.

#### 3.2.10.3 Indexed dividends

Some preferred shares may have a variable dividend rate that is tied to an external index, such as SOFR or US Treasury rates or a commodity price. External references for dividends, particularly such as a quoted interest rate or index, should be considered for bifurcation from an equity host contract.

One view is that an issuer can always choose how to calculate the amount of dividends distributed for instruments without a stated dividend, so selecting a method in advance (i.e., stating the use of an index) should not preclude the dividends from being considered clearly and closely related to its equity host, particularly for dividends that are a liability only when, if and as declared.

Under another view, the movement of an external index may be deemed unrelated to the equity host and, therefore, a dividend linked to such an index would not be considered clearly and closely related. The use of an index that bears some relation to the issuer, its operations or general financial concepts is more likely to be found clearly and closely related to an issuer's ability to generally set its dividend policy in an economically rational manner.

We generally believe judgment should be applied based on the individual facts and circumstances when determining whether indexed dividends are clearly and closely related to the equity host.

### 3.2.10.4 Shareholders' rights plans (Poison pills)

Shareholders' rights plans are arrangements, often in the form of a contingent rights offering, with current shareholders that permit companies to potentially defend against hostile takeovers by making such actions overly expensive through the immediate dilution of the acquirer's accumulated position. Those plans encourage direct negotiations with the target's board of directors and are typically activated by an acquisition of a large block of the target entity's shares. Those strategies are also known as poison pills. Those arrangements can take various forms and may include a combination of rights, the most common of which include:

- Flip-over or shareholders' rights plan — The most common type of arrangement. Under this plan, the holders of common stock of an entity receive certain rights for each share held, which allow them an option to buy or receive more shares in the entity, generally at a deeply discounted price, if anyone acquires more than a prescribed percentage of the entity's stock.
- Flip-in plan — A variation of the flip over is the flip-in plan. This plan allows the rights holder to purchase shares in the target entity at a discount in the event an acquiring entity were to merge or otherwise combine with the target entity.
- Voting poison pill plan — Under this plan, the target entity issues a dividend of securities, conferring special voting privileges to its stockholders. For example, the target entity might issue shares that do not have special voting privileges at the outset. When a potential hostile bid occurs, the stockholders, other than the acquiring party, receive super voting privileges.

While the specific facts and circumstances for each arrangement should be carefully evaluated, those protective plans are typically initiated by issuing certain rights to existing shareholders in the form of a dividend. Generally, those rights are not transferable separately from the underlying common stock and all further issuances of common stock (including stock issued in connection with the exercise of outstanding options) include those rights. Additionally, those rights are frequently cancelable or redeemable at the option of the issuing entity (e.g., on a vote of the board of directors) for a de minimis amount.

The original dividend of those rights to existing shareholders should be recorded at fair value, which may not be significant given the contingent nature of the rights as well as the de minimis call feature. Because those rights are typically considered embedded in the underlying shares after issuance, they should be evaluated pursuant to ASC 815. Many of those embedded rights will be considered clearly and closely related to the underlying equity host and, therefore, do not require separate accounting. If the plan is activated and the rights can transfer or trade separate from the share, then their classification should be reevaluated.

Careful consideration of the specific rights, including the terms of the instruments for which those rights may be exercisable into, is required to determine the appropriate accounting.

## 3.2.11 Box J — Bifurcation of a single embedded derivative

ASC 815-15-25-7 through 25-10 indicates that an entity should not account separately for more than one derivative feature embedded in a single hybrid instrument. As a result, after identifying, evaluating and concluding on which features of a share require bifurcation, a single derivative comprising all the features requiring bifurcation should be separated from the host instrument. This unit of account for bifurcation may be different than the unit of analysis for bifurcation as discussed in section 3.2.7.1.

ASC 815-15-30-2 requires the embedded derivative (whether a single feature derivative or a compound derivative) to be recorded at fair value. The difference, if any, between the proceeds allocated to the hybrid stock instrument (refer to section 1.2.3.3) and the fair value of the bifurcated derivative is assigned to the host stock instrument.

Refer to section 3 of our FRD publication, ***Derivatives and hedging***, for further guidance on embedded and compound derivatives, including defining option-based and forward-based embedded derivatives.

Stock that contains a potentially cash-settled embedded feature (e.g., redemption feature) should be evaluated in Box L to determine whether temporary equity classification is required, even if the embedded feature is bifurcated. Refer to section 3.2.13 and Appendix C for further guidance.

#### 3.2.11.1 Option-based embedded derivatives

ASC 815-15-30-6 states that the terms of an option-based embedded derivative should not be adjusted to result in the embedded derivative being at the money at the inception of the hybrid instrument. Rather, the option-based embedded derivative should be bifurcated based on the stated terms documented in the hybrid instrument whether the option is in the money, at the money or out of the money at inception.

#### 3.2.11.2 Forward-based embedded derivatives

ASC 815-15-30-4 states that in separating a non-option (forward-based) embedded derivative from the host contract, the terms of that non-option embedded derivative should be determined in a manner that results in its fair value generally being equal to zero at the inception of the hybrid instrument. This concept is illustrated at ASC 815-15-55-160.

#### 3.2.11.3 Financial statement classification

Bifurcated derivatives are presented as assets or liabilities. The individual facts and circumstances should be considered in classifying such an asset or liability as current or noncurrent in the balance sheet.

ASC 815 generally does not address the classification of changes in the fair value of derivatives (including bifurcated derivatives) but requires disclosure as to where the changes are reported in the statement of financial performance. The disclosures in ASC 815 are required for bifurcated embedded derivatives, as well as freestanding derivatives. Refer to section 8 of our FRD publication, ***Derivatives and hedging***, for further discussion of derivatives disclosures and financial statement presentation considerations.

### 3.2.12 Box K — Non-bifurcated features including conversion options and redemption features

If a feature is not bifurcated, and does not require further accounting under other guidance, it remains with the host instrument and no proceeds should be allocated to the embedded feature. However, there may be accounting consequences for subsequent measurement and presentation as discussed in section 3.4.3.2.

An embedded redemption feature that has not been bifurcated should be evaluated in Box L pursuant to the SEC staff's guidance on equity-classified instruments that may be redeemable outside the control of the issuer. This guidance may require temporary (mezzanine equity) classification for the entire share or a portion of the share. Refer to section 3.2.13 and Appendix C for further guidance.

### 3.2.13 Box L — Temporary equity classification

ASC 480-10-S99-3A provides guidance on the classification and measurement of redeemable securities. That guidance, issued by the SEC staff, requires classification in temporary equity of securities redeemable for cash or other assets if they are redeemable under any of the following conditions:

- At a fixed or determinable price on a fixed or determinable date
- At the option of the holder
- Upon the occurrence of an event that is not solely within the control of the issuer

A feature, whether or not bifurcated, that permits or requires the holder to exchange stock for cash or other assets (e.g., put option in stock) will likely cause the stock to be considered redeemable. Public entities should consider the redeemable equity guidance when classifying the stock. An item classified in temporary equity is classified after liabilities but before equity in the statement of financial position and cannot be included in any subtotal for equity, if one is presented.

Determining whether the redemption of an equity security is within the control of the issuer can be complex and all of the individual facts and circumstances should be considered. For instruments potentially settled in the issuer' shares (such that cash or assets may not be necessary), this includes evaluating whether there is any scenario in which the issuer may not be able to settle the redemption feature with its own stock pursuant to the equity classification guidance in ASC 815-40-25. In the absence of assurance that settlement in shares is within the control of the issuer, classification outside of permanent equity is required.

ASC 480-10-S99-3A states that stock classified in temporary equity should be initially measured at its fair value on the date of issuance. Such instruments will have ongoing measurement, disclosure and EPS considerations resulting from the conclusion that they are redeemable outside the control of the issuer.

Refer to Appendix C for further guidance on redeemable securities.

## 3.3 Share issuance costs

Stock issuances may be either classified in equity or as a liability. Issuance costs for stock requiring liability classification pursuant to ASC 480 should follow the accounting for debt issuance costs. Refer to section 2.3 for further guidance.

For stock that is classified in equity, direct and incremental costs related to its issuance such as legal fees, printing costs and bankers' or underwriters' fees, among others, should be accounted for as a reduction in the proceeds of the stock, and are considered a component of any premium or discount on preferred stock. Internal costs that meet the incremental and direct criteria (e.g., travel costs directly related to financing) may also be accounted for as a reduction in proceeds, but costs such as salaries, rent and other period costs may not be capitalizable as issuance costs. Costs related to financial statement preparation and audits are not directly attributable to a share issuance and, therefore, should not be capitalized.

For stock classified in equity, stock issuance costs are not amortized or accreted unless the stock is classified in temporary equity and the carrying amount is being accreted to its full redemption amount pursuant to ASC 480-10-S99-3A. Refer to section 3.2.13 for further guidance on temporary equity classification.

ASC 340-10-S99-1 states that, prior to the effective date of an offering of equity securities, specific incremental costs directly attributable to a proposed or actual offering of securities may be deferred and charged against the gross proceeds of the offering. In addition, ASC 340-10-S99-1 states that deferred costs of an aborted offering may not be deferred and charged against proceeds of a subsequent offering. A short postponement (up to 90 days) does not represent an aborted offering.

We believe cash payments for stock issuance costs should be classified in the statement of cash flows as a financing activity together with the proceeds from the issuance of the stock by analogy to debt issuance costs, which are specifically addressed in ASC 230-10-45-15(e).

## 3.4 Selected guidance on subsequent accounting and measurement

### 3.4.1 General

Depending on the terms of the stock instrument issued, there may be several subsequent accounting considerations.

## 3.4.2 Stock that is classified as a liability due to the provisions of ASC 480

Stock that is classified as a liability follows the subsequent measurement guidance specified in ASC 480. In general, a mandatorily redeemable instrument that has (1) a fixed redemption amount and (2) a fixed redemption date should be accreted to the redemption amount using the effective interest method. If the redemption amount varies (e.g., the redemption amount is based on a formula or is equal to the instrument's fair value) or the redemption date is unknown (e.g., must be redeemed upon the death of the holder), the instrument should be carried at the amount of cash that would be paid under the conditions specified in the contract if the shares were repurchased or redeemed at the reporting date. Refer to section A.4 for further guidance on mandatorily redeemable instruments.

A share that is classified as a liability because it represents an unconditional obligation to issue a variable number of shares whose monetary value is predominantly (1) fixed, (2) varies with something other than the fair value of the issuer's equity shares or (3) varies inversely related to changes in the fair value of the issuer's equity shares shall be classified as a liability, is subsequently remeasured pursuant to ASC 480. Refer to section A.6 for further guidance on those instruments.

Shares that are classified as liabilities are eligible to be measured at fair value pursuant to the fair value option provided no component of the share is classified in equity. If the fair value option is elected for an instrument at inception, fair value should be measured pursuant to the guidance in ASC 820 and all subsequent changes in fair value for that instrument are reported in earnings .[27] Refer to our FRD publication, ***Fair value measurement***, for further guidance on fair value measurement.

## 3.4.3 Stock that is classified in equity

If stock is not required to be classified as a liability pursuant to ASC 480, it is classified as either permanent or temporary equity. Regardless of the section in equity in which the stock is classified, there may be some features associated with the stock that require separate accounting and measurement, including the following:

- Premiums, discounts and issuance costs (section 3.4.3.1)
- Embedded features not bifurcated from an equity host instrument (section 3.4.3.2)
- Embedded features bifurcated from an equity host instrument as a derivative and classified as an asset or liability (section 3.4.3.3)

### 3.4.3.1 Premiums, discounts and issuance costs

Preferred stock may be issued either at par, a discount or a premium. Premiums or discounts (generally on preferred shares) may arise for several reasons, including the following:

- Allocating proceeds to multiple instruments upon issuance (e.g., when stock is issued with detachable warrants and the proceeds are allocated between the two elements)
- Bifurcating embedded derivatives in accordance with ASC 815 (e.g., certain put/call features or conversion options)
- Issuing a preferred share with a stated dividend rate that is higher or lower than the market rate

[27] For financial liabilities measured using the fair value option under ASC 825-10 or ASC 815-15, ASC 825-10-45-5 requires entities to recognize changes in the fair value of liabilities caused by changes in instrument-specific credit risk (own credit risk) in other comprehensive income.

Premiums or discounts on stock classified in permanent equity should generally not be accreted or amortized. Discounts on stock classified in temporary equity may require accretion depending on the application of the SEC staff's subsequent measurement guidance for redeemable equity.

Costs associated with equity-classified stock are considered an adjustment to the proceeds of the stock, and therefore reduce the carrying amount of the stock. For stock classified in permanent equity, stock issuance costs are not amortized. For stock classified in temporary equity, stock issuance costs may be required to be amortized in certain cases. However, issuance costs are considered part of the carrying amount of the stock in an extinguishment or conversion. Stock issuance costs are discussed in section 3.3.

Refer to sections 3.4.3.4 and 3.4.3.5 for further guidance on permanent equity classification and temporary equity classification, respectively.

### 3.4.3.2 Embedded features not bifurcated from an equity host instrument

The subsequent accounting for embedded features not bifurcated from their host instrument is based on the nature of the feature. The following are common examples:

- Call option — A non-bifurcated call feature in stock that is redeemable by the issuer generally is not accounted for until the stock is called, at which time the appropriate settlement accounting is applied. Refer to section 3.5.1 for further discussion.
- Put option — A non-bifurcated put feature in stock that is redeemable at par by the investor generally is not accounted for until the stock is redeemed, at which time the appropriate settlement accounting is applied. However, for SEC registrants, the put feature likely requires consideration of the redeemable equity guidance. Refer to section 3.4.3.5 for further discussion.
- Conversion option — A non-bifurcated or non-separated conversion feature in convertible stock is not accounted for until conversion. At that time, conversion accounting is applied as discussed in section 3.5.2.
- Increasing rate dividend — The non-bifurcated increasing rate dividend provision is accounted for in accordance with ASC 505-10-S99-7. Refer to an additional discussion in section 3.4.5.9.

If the embedded feature was not bifurcated from the instrument at issuance, it should be reassessed at each reporting date to determine that continued non-bifurcation is appropriate.

#### *3.4.3.2.1 Embedded features reassessment*

Embedded features that are not clearly and closely related to the equity host, yet not bifurcated on issuance either because the embedded feature (1) did not meet the definition of a derivative pursuant to ASC 815 or (2) met that definition but also qualified for an exception from derivative accounting (refer to section 3.2.7 for further discussion) should be reassessed at each reporting date. Such a feature may meet the definition of a derivative at some point in the future or lose its exception from derivative accounting and require bifurcation at that time.

In reassessing embedded features for bifurcation, the initial conclusion of whether that feature was clearly and closely related to the host instrument pursuant to ASC 815-15-25-1(a) is not reevaluated (by analogy to ASC 815-15-25-27). Accordingly, if initially deemed clearly and closely related (and therefore not bifurcated), that feature would not be bifurcated in the future. While not clear in the guidance, we generally believe that modifications of a stock instrument may require the embedded features be reevaluated, given that the modification results in a changed legal arrangement. This determination should be made based on the individual facts and circumstances.

In reassessing the definition of a derivative, the characteristics of having an underlying or an initial net investment generally will not change with time. However, the application of the net settlement criteria may change. A contract that was (or was not) net settleable by its contractual terms will likely remain as such through its life. However, a market mechanism to facilitate net settlement may emerge over time or an asset to be delivered in a physical settlement may become readily convertible to cash. ASC 815 requires the reconsideration of those elements (refer to ASC 815-10-15-118 and 15-139, respectively).

For example, a typical embedded feature (e.g., redemption feature) may not have met the definition of a derivative if gross settlement was required and the stock was not actively traded on an exchange (i.e., the underlying shares were not readily convertible to cash). If the issuer's stock were to actively trade on an exchange, the embedded derivative would meet the net settlement criterion on that date and should be further evaluated for bifurcation (i.e., evaluated for an exception from bifurcation).

As another example, a public issuer with limited transaction volume for its shares relative to the conversion shares may develop additional volume such that the conversion shares are now considered readily convertible to cash. Refer to ASC 815-10-55-101 through 55-108 for further guidance.

With respect to the reassessment of any scope exceptions, the most common exception from bifurcation for equity redemption features is pursuant to ASC 815-10-15-74(a), which requires an evaluation of whether the feature is indexed to the issuer's own stock and would be classified in stockholders' equity as follows:

- Reassessment of the indexation guidance — The conclusion under the indexation guidance generally would not be expected to change unless the contractual terms have changed.

  For an embedded equity-linked feature (e.g., redemption feature) that meets the definition of a derivative for the first time (e.g., preferred stock becomes actively traded making it readily convertible to cash), the embedded feature should be assessed at that time for the exception pursuant to ASC 815-10-15-74(a), if applicable. That assessment would be made under the then-current circumstances to determine if the feature is considered indexed to the issuer's shares.

- Reassessment of the equity classification guidance — In reassessing the criteria for equity classification related to settlement alternatives, a particular focus should be on the availability of shares to settle the instrument.

In accordance with ASC 815-40-35-8, this reassessment of the exception from derivative accounting under ASC 815-10-15-74(a) should be performed at each reporting date for both freestanding instruments and embedded features that meet the definition of a derivative.

#### *3.4.3.2.2 Subsequent bifurcation*

Pursuant to ASC 815-40-35-9, if an embedded feature no longer qualifies for the scope exception in ASC 815-10-15-74(a), it should be bifurcated from its host and accounted for as a derivative in accordance with ASC 815-10 and ASC 815-15, provided that all of the criteria in ASC 815-15-25-1 are met. While ASC 815 requires the reassessment of embedded features for potential bifurcation at each reporting date, it does not provide explicit guidance on how to bifurcate an embedded feature after the issuance date.

One approach, which is based on the literal application of ASC 815, would be to bifurcate the embedded derivative as of the date it was required to be bifurcated at its then-current fair value from the carrying amount of the host instrument and recognize it as an asset or liability. This accounting is the same as the initial issuance of the instrument. There may be other reasonably supportable methods of bifurcation. Subsequent changes in fair value should be recognized in earnings.

When determining the fair value of the feature to be bifurcated, an option-based feature would use the contractual terms (refer to section 3.2.11.1) and a forward-based feature would use the terms that would have implied a fair value equal to zero at the initial issuance of the instrument (refer to section 3.2.11.2).

### 3.4.3.3 Embedded features bifurcated from an equity host instrument as a derivative and classified as an asset or liability

Embedded features that were bifurcated from the equity host instrument upon issuance and are classified as an asset or a liability are measured at fair value at each reporting date with changes in fair value recognized in earnings. Refer to section 3 of our FRD publication, ***Derivatives and hedging***, for further discussion on embedded derivatives.

Bifurcated derivatives should be reassessed every reporting period to determine if they continue to require bifurcation. That is, they are reassessed to see if they still meet the definition of a derivative and still fail to qualify for any scope exception from derivative accounting. For example, an embedded feature may subsequently qualify for the exception from derivative accounting pursuant to ASC 815-10-15-74(a). This could result from the lapse of a noncompliant contractual term, or the authorization of additional shares (if there had been an insufficient number of shares to settle the feature). However, in reassessing embedded features for bifurcation, the initial conclusion of whether that feature was clearly and closely related to the host instrument pursuant to ASC 815-15-25-1(a) is not reevaluated (by reference to ASC 815-15-25-27).

An issuer may amend the terms of an agreement to qualify for the exception from derivative accounting. In those cases, the issuer should consider the accounting for the modification of the instrument.

If a bifurcated feature no longer requires bifurcation, it should be reclassified to equity at its then fair value. Gains and losses recognized to account for the feature at fair value during the period of bifurcation should not be reversed.

### 3.4.3.4 Stock that is classified in permanent equity

Stock that is classified in permanent equity is not subsequently remeasured. Equity issuance costs, premiums and discounts recognized for stock classified in permanent equity are generally not accreted or amortized.

ASC 480-10-S99-3A requires equity instruments to be evaluated on an ongoing basis for temporary equity classification. For example, a company with redeemable preferred securities settleable in the company's own stock that were initially classified in permanent equity may issue convertible debt resulting in the number of shares issuable under all outstanding instruments exceeding the number of authorized but unissued shares available for the preferred securities. As the settlement of the redeemable preferred stock in shares no longer would be within control of the company, temporary equity classification would be required.

ASC 480-10-S99-3A does not provide specific guidance on reclassifications of instruments from permanent into temporary classification. We believe one reasonable approach would be to reclassify the security at its fair value as of the date of the event that caused reclassification. By analogy to the guidance in ASC 815-40-35-9 on reclassifying contracts from permanent equity to assets or liabilities, any difference between the fair value of the security to be recorded in temporary equity and the previous carrying value of the security recorded in permanent equity would be accounted for as an adjustment to shareholder's equity (i.e., APIC). There may be other acceptable methods.

Refer to Appendix C for further guidance on these instruments.

### 3.4.3.5 Stock that is classified in temporary equity

ASC 480-10-S99-3A provides subsequent measurement guidance for situations where (1) the stock is currently redeemable, (2) the stock is not currently redeemable but probable of becoming redeemable and (3) the stock is not currently redeemable and not probable of becoming redeemable. ASC 480-10-S99-3A also provides guidance on reclassifications of instruments into permanent equity.

Refer to Appendix C for further guidance on those instruments.

#### 3.4.3.6 Stock classified in equity (temporary or permanent) that becomes mandatorily redeemable subsequent to issuance

While an instrument that must be redeemed upon or after the occurrence of an event that is not certain of occurrence is not required to be accounted for as a liability pursuant to ASC 480, once the event becomes certain of occurrence, that instrument should be reclassified to a liability. The term "certain of occurrence" should not be confused with "probable" or even "highly probable." Often, an event will not be certain of occurrence until it actually occurs. The assessment of whether a contingently or optionally redeemable instrument has become mandatorily redeemable pursuant to ASC 480 should be made throughout the life of the instrument.

For example, a common type of contingently redeemable shares is preferred stock the holder can put to the issuer for redemption at any time. This type of preferred stock becomes mandatorily redeemable when the holder notifies the issuer that it is exercising its put option. In some cases, the issuer is allowed a specified time period (e.g., 30 days) to satisfy the put. However, once the holder has notified the issuer of the exercise of the put option, the instrument becomes mandatorily redeemable and should be reclassified to a liability.

Preferred stock that becomes mandatorily redeemable pursuant to ASC 480 should be reclassified to a liability at fair value. For SEC registrants, that reclassification is considered the settlement of the equity instrument in consideration for the issuance of a liability pursuant to ASC 260-10-S99-2. The difference between the fair value and the carrying amount (whether classified as permanent or temporary equity) should be recognized in retained earnings as a deemed dividend. Refer to section 3.5.1.2 for further guidance on the extinguishment of preferred shares.

### 3.4.4 Capital restructuring

ASC 505-20-20 defines a stock split as follows:

> "an issuance by a corporation of its own common shares to its common shareholders without consideration and under conditions indicating that such action is prompted mainly by a desire to increase the number of outstanding shares for the purpose of effecting a reduction in their unit market price and, thereby, of obtaining wider distribution and improved marketability of the shares. Sometimes called a stock split-up."

The accounting for stock splits is primarily governed by ASC 505-20. Unless required under corporate law, no accounting is required for stock splits other than potentially recording the incremental par value of the newly issued shares. To the extent an incremental par value is required to be recorded, the amount should be offset against APIC.

Reverse stock splits are the cancellation of issued and outstanding shares on a pro-rata basis and are generally intended to decrease the number of outstanding shares and thus increase their unit market price. Similar to traditional stock splits, unless required under corporate law, no accounting is required for reverse stock splits other than potentially recording the decrease in par value for the canceled shares. To the extent a decrease in par value is required, the amount should be offset against APIC.

ASC 505-10-S99-4 indicates that for public companies, changes in the capital structure of a reporting entity due to a stock dividend, stock split or reverse split occurring after the date of the latest reported balance sheet but before the release of the financial statements (or the effective date of the registration statement, whichever is later) should be given retroactive effect in the balance sheet. In such cases, appropriate disclosure should be made of the retrospective treatment and the date the change became effective.

## 3.4.5 Accounting for dividends

Dividends are a distribution of an entity's retained earnings (or return of capital in the case of a liquidating dividend) to its owners. Dividends generally must be declared by the board and sometimes are subject to restrictions under state law based on historical earnings. Preferred shares often include a preference such that dividends are paid to preferred holders before common stockholders.

Dividends on preferred stock instruments are often cumulative, in which case the cumulative amount of any unpaid dividends on the preferred stock must be paid prior to the payment of any common stock dividends. For example, assume that a preferred stock is issued 1 January 20X1, and has a stated cumulative annual dividend of $5 that is payable on 31 December. If the entity elects not to distribute the dividend at the end of 20X1, the unpaid amount is added to the liquidation preference. Such amounts are usually required to be paid by the earlier of either (1) maturity, redemption, liquidation or conversion of the preferred stock or (2) the payment of any dividends on common stock. Preferred stock with cumulative dividends typically has a stated, nonparticipating dividend rate.

Dividend distributions typically involve the following key dates:

| | |
|---|---|
| Date of declaration | The date the board of directors declares the dividend to shareholders and it becomes a liability |
| Date of record | The date the board of directors specifies that shareholders of record on that date are entitled to the dividend payment |
| Date of payment | The date the dividend is actually paid by the entity |

Dividends should generally not be recognized as a liability (with an offset to retained earnings) until declared, even if the dividends are cumulative. As most dividends are paid within one year of the declaration date, dividends payable are typically current liabilities. ASC 505-10-50-5 requires entities to disclose either on the face of the statement of financial position or in the notes thereto the aggregate and per-share amounts of arrearages in cumulative preferred dividends.

With respect to EPS, ASC 260-10-45-11 states that income available to common shareholders (i.e., the numerator) is calculated by reducing income from continuing operations and net income by (1) the dividends declared in the period on preferred stock (whether or not paid) and (2) the dividends accumulated for the period on cumulative preferred stock (whether or not earned). If there is a loss from continuing operations or a net loss, the amount of the loss should be increased by those preferred dividends. Refer to section 3.2 of our FRD publication, ***Earnings per share***, for further guidance on the calculation of income available to common stockholders and related adjustments.

In addition, the AICPA's non-authoritative Technical Question and Answers section 4210.04, *Accrual of Preferred Dividends* (TQA 4210.04), states that if preferred dividends are cumulative only if earned, they should be deducted to arrive at income available to common shareholders only to the extent that they are earned. That guidance also states that in all cases, the effect that has been given to preferred dividends in arriving at income available to common stockholders in computing basic EPS should be disclosed for every period for which an income statement is presented. The guidance also emphasizes that cumulative dividends are not accrued until they become a corporate liability when declared.

The following types of dividends are addressed in this section:

- Cash dividends
- Noncash dividends
- Liquidating dividends

- Stock dividends
- Dividends on liability-classified stock instruments
- Dividends on temporary-equity classified stock
- Fixed-rate dividends
- Variable-rate dividends
- Increasing or decreasing-rate dividends
- PIK dividends
- Participating dividends

### 3.4.5.1 Cash dividends

A cash dividend becomes a liability once it is declared. Since payment is generally required within a short period of time, the dividend payable is usually classified as a current liability.

In some cases, the issuer or the shareholder has the ability to elect to receive the dividends in cash or shares of equivalent value. The accounting is essentially the same as for cash dividends but there may be EPS implications based on the guidance in ASC 505-20-15-3A.

### 3.4.5.2 Noncash dividends

Noncash dividends are payable in assets of a corporation other than cash and may include merchandise, real estate, investments or other assets, as designated by the board of directors. ASC 845-10-30-1 through 30-10 address the accounting for noncash dividends. Noncash dividends to owners of an entity that are **not** in the form of a spin-off, reorganization or liquidation, or in a plan that is in substance the rescission of a prior business combination should be recorded at the fair value of the property to be distributed, provided that the fair value is objectively measurable and would be clearly realizable to the distributing entity in an outright sale at or near the time of the distribution; otherwise, carrying values should be used in recording the dividend. Pursuant to ASC 845-10-30, differences between the fair value and carrying value of noncash assets distributed should be measured and recorded as a gain or loss. We believe that this should be recognized and measured on the date the noncash dividend is declared and becomes a liability of the entity.

When a subsidiary pays dividends in noncash assets, a gain or loss should be recognized in the consolidated financial statements of the parent only to the extent of dividends paid to NCI, if any, and any gain or loss recognized should be allocated entirely to NCI in the parent's consolidated income statement. Noncash dividends received by a parent or other companies under common control should be recorded at the historical cost of the parent of the entities under common control, pursuant to ASC 805-50-30-5. See Appendix C of our FRD publication, ***Business combinations***, for more guidance on the accounting for common control transactions.

A noncash dividend that is a pro rata nonreciprocal transfer of nonmonetary assets to owners in a spin-off or other form of reorganization or liquidation, or in a plan that is in substance the rescission of a prior business combination, is recognized at the carrying amount (after reduction for an indicated impairment, if necessary) of the nonmonetary assets transferred if the nonmonetary assets being distributed meet the definition of a business. Spin-offs are accounted for in accordance with ASC 505-60.

### 3.4.5.3 Liquidating dividends

Liquidating dividends are dividends based on something other than retained earnings, such as paid-in capital. Therefore, they are a return of the stockholders' investment rather than of profits and should not decrease retained earnings. AICPA TQA 4210.01, *Write-Off of Liquidating Dividends*, states the following:

> " … when liquidating dividends are declared, the charge is made to accounts such as "capital repayment," "capital returned," or "liquidating dividends" which appear on the balance sheet as offsets to paid-in capital … "

### 3.4.5.4 Stock dividends

ASC 505-20-20 defines a stock dividend as follows:

> "an issuance by a corporation of its own common shares to its common shareholders without consideration and under conditions indicating that such action is prompted mainly by a desire to give the recipient shareholders some ostensibly separate evidence of a part of their respective interests in accumulated corporate earnings without distribution of cash or other property that the board of directors deems necessary or desirable to retain in the business."

A stock dividend results in each stockholder having the same proportionate interest in the corporation and same total book value as before the dividend. The purpose of a stock dividend is to capitalize part of the earnings (i.e., reclassify amounts from retained earnings to contributed capital) and therefore retain the earnings on a permanent basis.

When the relative size of the stock dividend is so small that the issuance does not have any apparent effect on the share's market price, ASC 505-20-30 requires the fair value of the stock issued to be transferred from retained earnings. This is commonly referred to as a small or ordinary stock dividend. Although the point at which the relative size of the stock dividend becomes large enough to materially influence the unit market price of the stock will vary with individual companies and market conditions, ASC 505-20-25-4 through 25-6 indicates that stock dividends amounting to less than 20–25% of the common shares outstanding at the time of the dividend declaration are generally considered to be small or ordinary, requiring a transfer from retained earnings to capital surplus (APIC) based on the fair value of the stock issued. However, in closely held entities it is presumed that shareholders have significant knowledge of the corporation's affairs and there is no need to capitalize retained earnings other than to meet legal requirements.

When shareholders may elect to receive cash in lieu of a stock dividend or when stock of another class is distributed, the cash consideration or fair value of the shares issued should be used to determine the amount of capitalized retained earnings.

Pursuant to ASC 505-20-25-4 through 25-6, a stock dividend of more than 20–25% of the number of shares previously outstanding is generally considered a large stock dividend and should be treated similar to a stock split. The SEC staff has stated that distributions of 25% or more should be treated similar to a stock split. Stock splits generally do not result in the capitalization of earned surplus (retained earnings).

Occasionally, subsidiary enterprises capitalize retained earnings arising since acquisition/inception by means of a stock dividend or otherwise. ASC 810-10-45-9 states that this event does not require a transfer to retained earnings in consolidation, inasmuch as the retained earnings in the consolidated financial statements should reflect the accumulated earnings of the consolidated group not distributed to the shareholders of, or capitalized by, the parent entity.

### 3.4.5.5 Dividends on stock instruments classified as a liability

For stock instruments classified as liabilities pursuant to ASC 480 (refer to sections 3.2.1 and 3.2.2), any dividends are accounted for and presented as interest expense pursuant to that guidance.

### 3.4.5.6 Dividends on stock classified in temporary equity

Pursuant to the SEC staff's guidance in ASC 480-10-S99-2, the carrying amount of stock classified in temporary equity that is currently redeemable or probable of becoming redeemable should be increased by dividends not currently declared or paid, but that may be payable upon redemption. This accounting would apply irrespective of whether the stock may be voluntarily redeemed by the issuer or converted into another class of securities by the holder before the redemption date that is out of the registrant's control. The increase in the carrying amount of the stock should be treated in the same manner as dividends on non-redeemable stock, and would result in a charge against retained earnings or, in the absence of retained earnings, to APIC. The increase should also be considered when determining income available to common shareholders for EPS purposes. Refer to section 3.2.2 of our FRD publication, ***Earnings per share***, for further guidance on the effect of redeemable securities on income available to common stockholders.

### 3.4.5.7 Fixed-rate dividends

Fixed-rate dividends are calculated as a fixed percentage of the stock's par amount and generally become payable only when, and if, declared by the board of directors. A liability should be recognized once dividends are declared.

### 3.4.5.8 Variable-rate dividends

Variable-rate dividends are typically calculated based on an index such as an interest rate index (e.g., SOFR) or based on a specified formula. Other variable rate dividends are based on the issuer's financial performance. Particular consideration should be given to variable-rate dividends as to whether they represent an embedded derivative requiring bifurcation pursuant to ASC 815 (refer to section 3.2.10.3 for a discussion of indexed dividends). If bifurcation is not required, a liability should be recognized for the variable-rate dividends when they become payable, generally upon declaration by the board of directors.

### 3.4.5.9 Increasing or decreasing rate preferred stock

**Excerpt from Accounting Standards Codification**

**Equity**

*SEC Materials*

*505-10-S99-7*

The following is the text of SAB Topic 5.Q, Increasing Rate Preferred Stock.

> Facts: A registrant issues Class A and Class B nonredeemable preferred stock FN19 on 1/1/X1. Class A, by its terms, will pay no dividends during the years 20X1 through 20X3. Class B, by its terms, will pay dividends at annual rates of $2, $4 and $6 per share in the years 20X1, 20X2 and 20X3, respectively. Beginning in the year 20X4 and thereafter as long as they remain outstanding, each instrument will pay dividends at an annual rate of $8 per share. In all periods, the scheduled dividends are cumulative.
>
> > FN19 "Nonredeemable" preferred stock, as used in this SAB, refers to preferred stocks which are not redeemable or are redeemable only at the option of the issuer.
>
> At the time of issuance, eight percent per annum was considered to be a market rate for dividend yield on Class A, given its characteristics other than scheduled cash dividend entitlements (voting rights, liquidation preference, etc.), as well as the registrant's financial condition and future economic prospects. Thus, the registrant could have expected to receive proceeds of approximately $100 per share for Class A if the dividend rate of $8 per share (the "perpetual dividend") had been

in effect at date of issuance. In consideration of the dividend payment terms, however, Class A was issued for proceeds of $79 3/8 per share. The difference, $20 5/8, approximated the value of the absence of $8 per share dividends annually for three years, discounted at 8%.

The issuance price of Class B shares was determined by a similar approach, based on the terms and characteristics of the Class B shares.

Question 1: How should preferred stocks of this general type (referred to as "increasing rate preferred stocks") be reported in the balance sheet?

Interpretive Response: As is normally the case with other types of securities, increasing rate preferred stock should be recorded initially at its fair value on date of issuance. Thereafter, the carrying amount should be increased periodically as discussed in the Interpretive Response to Question 2.

Question 2: Is it acceptable to recognize the dividend costs of increasing rate preferred stocks according to their stated dividend schedules?

Interpretive Response: No. The staff believes that when consideration received for preferred stocks reflects expectations of future dividend streams, as is normally the case with cumulative preferred stocks, any discount due to an absence of dividends (as with Class A) or gradually increasing dividends (as with Class B) for an initial period represents prepaid, unstated dividend cost. FN20 Recognizing the dividend cost of these instruments according to their stated dividend schedules would report Class A as being cost-free, and would report the cost of Class B at less than its effective cost, from the standpoint of common stock interests (i. e., for purposes of computing income applicable to common stock and earnings per common share) during the years 20X1 through 20X3.

> FN20 As described in the "Facts" section of this issue, a registrant would receive less in proceeds for a preferred stock, if the stock were to pay less than its perpetual dividend for some initial period(s), than if it were to pay the perpetual dividend from date of issuance. The staff views the discount on increasing rate preferred stock as equivalent to a prepayment of dividends by the issuer, as though the issuer had concurrently (a) issued the stock with the perpetual dividend being payable from date of issuance, and (b) returned to the investor a portion of the proceeds representing the present value of certain future dividend entitlements which the investor agreed to forgo.

Accordingly, the staff believes that discounts on increasing rate preferred stock should be amortized over the period(s) preceding commencement of the perpetual dividend, by charging imputed dividend cost against retained earnings and increasing the carrying amount of the preferred stock by a corresponding amount. The discount at time of issuance should be computed as the present value of the difference between (a) dividends that will be payable, if any, in the period(s) preceding commencement of the perpetual dividend; and (b) the perpetual dividend amount for a corresponding number of periods; discounted at a market rate for dividend yield on preferred stocks that are comparable (other than with respect to dividend payment schedules) from an investment standpoint. The amortization in each period should be the amount which, together with any stated dividend for the period (ignoring fluctuations in stated dividend amounts that might result from variable rates, FN21 results in a constant rate of effective cost vis-a-vis the carrying amount of the preferred stock (the market rate that was used to compute the discount).

> FN21 See Question 3 regarding variable increasing rate preferred stocks.

Simplified (ignoring quarterly calculations) application of this accounting to the Class A preferred stock described in the "Facts" section of this bulletin would produce the following results on a per share basis:

Carrying amount of preferred stock

| | Beginning of Year (BOY) | Imputed Dividend (8% of carrying Amount at BOY) | End of year |
|---|---|---|---|
| | | | |
| Year 20X1 | $ 79.38 | 6.35 | 85.73 |
| Year 20X2 | 85.73 | 6.86 | 92.59 |
| Year 20X3 | 92.59 | 7.41 | 100.00 |

During 20X4 and thereafter, the stated dividend of $8 measured against the carrying amount of $100 FN22 would reflect dividend cost of 8%, the market rate at time of issuance.

FN22 It should be noted that the $100 per share amount used in this issue is for illustrative purposes, and is not intended to imply that application of this issue will necessarily result in the carrying amount of a nonredeemable preferred stock being accreted to its par value, stated value, voluntary redemption value or involuntary liquidation value.

The staff believes that existing authoritative literature, while not explicitly addressing increasing rate preferred stocks, implicitly calls for the accounting described in this bulletin.

The pervasive, fundamental principle of accrual accounting would, in the staff's view, preclude registrants from recognizing the dividend cost on the basis of whatever cash payment schedule might be arranged. Furthermore, recognition of the effective cost of unstated rights and privileges is well-established in accounting, and is specifically called for by FASB ASC Subtopic 835-30, Interest—Imputation of Interest, and Topic 3.C of this codification for unstated interest costs of debt capital and unstated dividend costs of redeemable preferred stock capital, respectively. The staff believes that the requirement to recognize the effective periodic cost of capital applies also to nonredeemable preferred stocks because, for that purpose, the distinction between debt capital and preferred equity capital (whether redeemable FN23 or nonredeemable) is irrelevant from the standpoint of common stock interests. ...

FN23 Application of the interest method with respect to redeemable preferred stocks pursuant to Topic 3.C results in accounting consistent with the provisions of this bulletin irrespective of whether the redeemable preferred stocks have constant or increasing stated dividend rates. The interest method, as described in FASB ASC Subtopic 835-30, produces a constant effective periodic rate of cost that is comprised of amortization of discount as well as the stated cost in each period.

ASC 505-10-S99-7 provides the SEC staff's view on nonredeemable preferred stock with increasing rate features that pay little or no dividends in the early years but then increase and usually level off to a fixed dividend rate, which is referred to as the "perpetual dividend amount." ASC 505-10-S99-7 indicates that such instruments are typically issued at a discount to compensate the holder for the lower amount of dividends in the early years of the instrument's life, and that this discount represents a prepaid unstated dividend that should be amortized to retained earnings using a discount rate equal to the market rate for comparable preferred stock without consideration of dividends.

The discount should be amortized over the period preceding the commencement of the perpetual dividend and the periodic amortization, when added to the stated dividend for the period, results in a constant rate of cost for the period preceding the commencement of the perpetual dividend that equals the perpetual dividend (which is the market dividend rate for the preferred stock at the time of issuance).

The subsequent accounting for the dividends paid for increasing rate preferred stock is consistent with the accounting for dividends paid on preferred stock without the increasing rate feature. That is, the dividends are recorded to retained earnings at each reporting date.

Some preferred stock instruments with increasing rate dividends may not be in the scope of the SEC staff's model. For example, consider preferred stock that has a dividend rate that will increase to 25% (which is considered significantly above market) beginning in year six and is callable by the issuer at any time. The preferred stock is issued at par (i.e., no discount to indicate an investor is being made whole for a low initial dividend). The dramatic increase in the dividend rate could suggest that the preferred stock is expected to be redeemed by the issuer at or prior to the dividend step-up date (i.e., it was intended as more of a penalty rate if the preferred stock was not redeemed timely). In this case, it may be appropriate to accrue dividends based on the stated rate.

### 3.4.5.10 Paid-in-kind dividends

Some preferred shares have dividends that are PIK (e.g., dividends paid in the form of additional shares of preferred stock) or permit the issuer to pay dividends in kind or in cash. If PIK, the issuer would typically issue stock with a liquidation preference amount equal to the dividends payable at the contractual rate. For example, an entity issues preferred stock that pays dividends quarterly at 2% of the liquidation preference ($1,000,000), when and if declared by the board of directors. To the extent dividends are declared, the issuer can pay the $20,000 quarterly dividends either in cash or by issuing shares with a total liquidation preference of $20,000 (e.g., 20 shares of $1,000 par amount preferred stock).

When determining the amount to accrue for the PIK dividend payable upon declaration, some entities analogize to the guidance for stock dividends in ASC 505-20, which defines a stock dividend, in part, as "An issuance by a corporation of its own common shares to its common shareholders[.]" As discussed in section 3.4.5.4, that guidance requires stock dividends (that are not treated as stock splits) to be capitalized out of retained earnings at the fair value of the shares on the declaration date. We generally believe the issuer may either (1) record the dividend payable based on the fair value of the instruments issued (the fair value of the $20,000 par amount of preferred stock in the example) or (2) record the contractual rate ($20,000 in the example). The approach followed should be consistently applied.

Other PIK dividends may be for a fixed (or predominantly fixed) monetary value, so the number of preferred shares distributed will vary between the declaration date and the payment date based on changes in the fair value of the underlying preferred shares, in which case the declared dividend represents a liability pursuant to ASC 480-10-25-14.

### 3.4.5.11 Participating dividends

Participating stock shares in dividends with common stock according to a predetermined formula (e.g., dollar for dollar, two for one) with, at times, an upper limit on the extent of participation (e.g., up to, but not beyond, a specified amount per share). The participating dividend feature should be analyzed to determine whether bifurcation is required under ASC 815. When a participating preferred share is considered to contain an equity host, the participating dividend feature would be considered clearly and closely related to the host. However, if the host contract is more akin to debt, the underlying (i.e., a dividend payment) is not considered clearly and closely related to the debt host instrument. The other criteria for bifurcation, including the definition of a derivative, should be further evaluated.

In addition, any security meeting the definition of a participating security pursuant to ASC 260-10-45-59A through 45-70 requires the use of the two-class method for calculating its impact on EPS. Refer to section 5 of our FRD publication, ***Earnings per share***, for further guidance on participating securities and the two-class method.

## 3.5 Share repurchase and conversions

Stock may be repurchased (i.e., redeemed if put or called or repurchased directly from the market) or converted (or exchanged). This section includes guidance for repurchases (section 3.5.1) and conversions (section 3.5.2) for stock that is classified in equity. Stock classified as a liability is accounted for as a debt instrument and would follow the appropriate debt guidance. Refer to section 2.5 for guidance on redemption and conversions of debt instruments. Stock terms also may be amended prior to redemption, retirement or conversion, and with that amendment, accounted for as either an extinguishment or a modification.

### 3.5.1 Repurchase of stock

The repurchase of common stock is generally referred to as the acquisition of treasury shares or as a retirement (or constructive retirement). Guidance on the accounting for repurchases of common stock is provided in ASC 505-30.

Repurchase of preferred stock upon the exercise of a call or put option is generally referred to as a redemption. Guidance on the redemption or repurchase of preferred stock for public companies is provided in ASC 260-10-S99-2. Although the scope of ASC 260-10-S99-2 addresses public entities, we generally believe that guidance is preferable for nonpublic entities.

#### 3.5.1.1 Treasury shares

It is not unusual for companies to buy back their own common shares. For example, corporations purchase their outstanding stock:

- To provide tax efficient distributions of excess cash to shareholders
- To increase future EPS and return on equity
- To provide stock for employee stock compensation contracts or to meet potential merger needs
- To discourage takeover attempts or to reduce the number of stockholders
- To make a market in the stock

Once shares are reacquired, they may either be retired or held in the treasury for reissue. If not retired, such shares are referred to as treasury shares or treasury stock. The laws in the state of incorporation and any future changes in those laws should be considered as they may require a particular accounting treatment for the reacquired shares.

If an enterprise acquires shares of its own capital stock, the cost of the acquired shares should generally be shown as a deduction from stockholders' equity. Dividends on such shares held in the entity's treasury should not be reflected as income and not shown as a reduction in equity. Gains and losses on sales of treasury stock should be accounted for as adjustments to stockholders' equity and not as part of income. Stock of a corporation held in its own treasury stock should not be presented as an asset. ASC 505-30-30-8 provides two methods of accounting for treasury shares depending on whether the stock is acquired for constructive retirement.

There is no authoritative guidance on the accounting for direct costs incurred to repurchase treasury stock. However, AICPA Technical Questions and Answers — *Costs Incurred to Acquire Treasury Stock* (TQA 4110.09) states that costs associated with the acquisition of treasury stock may be added to the cost of the treasury stock in a manner similar to stock issuance costs.

When stock is retired or purchased for constructive retirement, any excess purchase price over par value may be allocated between APIC and retained earnings or may be charged directly to retained earnings. When allocating any excess purchase price over par value between capital surplus and retained earnings, the portion of the excess allocated to capital surplus should be limited to the sum of both of the following:

(a) All capital surplus arising from previous retirements and net gains on sales of treasury stock of the same issue

(b) The pro rata portion of capital surplus paid in, voluntary transfers of retained earnings, capitalization of stock dividends, etc., on the same issue. For this purpose, any remaining capital surplus applicable to issues fully retired (formal or constructive) is deemed to be applicable pro rata to shares of common stock

Any excess par value over the purchase price should be credited to capital surplus.

When stock is acquired for purposes other than formal or constructive retirement or when ultimate disposition has not yet been decided, the accounting for constructive retirement may be followed. Another acceptable approach is to present the cost of the acquired stock separately as a deduction from the total of capital stock, capital surplus and retained earnings.

Gains on sales of treasury stock not previously accounted for as constructively retired should be credited to capital surplus; losses may be charged to capital surplus to the extent that previous net gains from sales or retirements of the same class of stock are included therein, otherwise to retained earnings.

Adequate recordkeeping of historical treasury transactions is required to properly apply the abovementioned accounting. Additionally, an acceptable inventory method, such as FIFO or average cost basis, should be used to track treasury transactions and determine the appropriate amount of gain or loss to be recorded upon the sale of treasury stock not previously accounted for as constructively retired.

Several states have enacted corporation laws that generally affect the legal status of dividends, redemptions, stock purchases and partial liquidations. An important feature of those laws provide that purchases of an entity's own stock immediately return the stock to the status of authorized and unissued, regardless of an entity's future intent to reissue the acquired stock. Companies incorporated in states with those laws would not report treasury stock as a separate line item within shareholders' equity in the financial statements.

Refer to section 2.7.1 of our FRD publication, ***Share-based payment***, for a discussion on the accounting for shares of a company's own stock held in a rabbi trust.

#### *3.5.1.1.1 Common stock purchased above fair value*

ASC 505-30-50-3 states that a repurchase of shares at a price significantly in excess of the current market price creates a presumption that the repurchase price includes amounts attributable to items other than the shares repurchased. For example, a selling shareholder may agree to abandon certain acquisition plans, forego other planned transactions, settle litigation, settle employment contracts or voluntarily restrict its purchase of shares of the entity or the entity's affiliates within a stated time period.

The SEC staff indicated that in applying ASC 505-30-30-2 through 30-4 (typically referred to as a "greenmail transaction"), the quoted market price of the common stock generally should be used for purposes of determining the fair value of the treasury shares purchased. The SEC staff generally has objected to the use of valuations that differ from prices existing in public markets.

If the purchase of treasury shares includes the receipt of stated or unstated rights, privileges or agreements in addition to the capital stock, only the amount representing the fair value of the treasury shares at the date the major terms of the agreement to purchase the shares are reached should be accounted for as the cost of the shares acquired. The price paid in excess of the amount accounted for as the cost of treasury shares should be attributed to the other elements of the transaction and accounted

for according to their substance (i.e., under other applicable US GAAP). If the fair value of those other elements of the transaction is more clearly evident, for example, because an entity's shares are not publicly traded, that amount should be assigned to those elements and the difference recorded as the cost of treasury shares. If no stated or unstated consideration in addition to the capital stock can be identified, the entire purchase price should be accounted for as the cost of treasury shares.

We generally believe circumstances that may provide a reasonable basis to recognize an amount paid in excess of fair value as the cost of treasury shares would be based on the facts and circumstances, but generally are limited to premiums paid in purchases to obtain:

(a) The desired number of shares in a tender offer to all or most shareholders

(b) A block of shares representing a controlling interest (i.e., a control premium)

#### *3.5.1.1.2 Shares escrowed in connection with an IPO*

In order to facilitate an IPO, underwriters may request that some or all shareholders (some or all of whom may be employees) of a privately held entity place a portion of their shares in an escrow account. The escrowed shares generally are legally outstanding and may continue to have voting and dividend rights. The shares are released from escrow based on the attainment of certain performance measures by the entity in subsequent periods, such as specified earnings or market price levels. If the targets are not achieved, the escrowed shares are returned to the entity and canceled. Escrow share arrangements in an IPO are often tied to employee service. Those arrangements are presumed to be compensatory, as discussed in section 2.6 of our FRD publication, ***Share-based payment***.

#### *3.5.1.1.3 Excise tax on stock repurchases (added August 2023)*

The Inflation Reduction Act of 2022 established a 1% excise tax provision on stock repurchases of more than $1 million by publicly traded US corporations. The amount of excise tax is calculated as 1% of the fair market value of the stock repurchased during the tax year, less the fair market value of stock issued during the tax year, including stock issued to employees of the corporation or its subsidiaries. The excise tax provision also applies to repurchases of stock of a publicly traded foreign corporation by the foreign corporation's domestic affiliate and applies to repurchases of stock made after 31 December 2022.[28]

The excise tax is not based on income and, therefore, is outside of the scope of the income tax accounting guidance in ASC 740. There is no other guidance that addresses the accounting for the excise tax. Because the excise tax is a cost associated with the repurchase of a reporting entity's stock, an entity may treat the excise tax as a cost of treasury stock repurchases if it determines that it is a direct cost associated with repurchasing its common stock. The accounting would follow the guidance in TQA 4110.09, which states that costs associated with the acquisition of treasury stock may be added to the cost of the treasury stock in a manner similar to stock issuance costs.

Additional considerations may be necessary to determine the appropriate accounting for excise taxes incurred to redeem preferred stock or stock classified outside of permanent equity.

### 3.5.1.2 Redemption of preferred stock

A redemption of preferred stock according to its original terms may be paid using cash, other instruments issued by the issuer or other assets (individually and collectively, the consideration) and may include a premium or discount. ASC 260-10-S99-2 provides the SEC staff's view that a premium (discount) on redemption represents a return to (from) the preferred stockholder that should be treated in a manner

[28] On 27 December 2022, the Internal Revenue Service (IRS) and the Department of the Treasury issued Notice 2023-2*, Initial Guidance Regarding the Application of the Excise Tax on Repurchases of Corporate Stock under Section 4501 of the Internal Revenue Code*, to address application of the excise tax. Refer to the IRS website at **https://www.irs.gov/pub/irs-drop/n-23-02.pdf.** Companies should continue to monitor developments in this area.

similar to a dividend to the preferred stockholder. Accordingly, the SEC staff requires that the difference between the fair value of the consideration paid upon redemption and the carrying value of the preferred stock be deducted from (if a premium) or added to (if a discount) net income to arrive at income available to common stockholders in the calculation of EPS. Additionally, this guidance requires that unamortized issuance costs be included in the carrying amount of the preferred stock when calculating the premium or discount upon redemption. See section 3.2.1 of our FRD publication, ***Earnings per share***, for further discussion of ASC 260-10-S99-2.

If the instrument being redeemed has embedded features that have been bifurcated and accounted for separately as a derivative, judgment is necessary to determine if there is any gain or loss to be recognized in earnings on the settlement. We generally believe one reasonable approach is to include the then-current fair value of the bifurcated derivative in the carrying value of the preferred stock in the calculation described above, as the bifurcated derivative is inherently being redeemed as part of the transaction.

Sometimes a company will make an offer to the preferred shareholders to repurchase or redeem an equity-classified preferred stock instrument (1) prior to the stated call date, (2) at an amount other than that prescribed in the instrument or (3) when there are no redemption features embedded in the instrument. In those instances, the accounting is the same as if the preferred stock were being redeemed according to a contractual feature of the contract.

If a preferred share becomes mandatorily redeemable pursuant to ASC 480, it is reclassified at fair value from equity to a liability. For SEC registrants, the difference between the carrying amount and fair value is treated as a deemed dividend and charged to income available to common stockholders under the SEC staff's belief that a liability instrument has been issued to extinguish an equity instrument.

### 3.5.1.3 Repurchase of redeemable shares issued by a subsidiary

The accounting for certain transactions for preferred shares issued by subsidiaries in consolidation is specified in ASC 810-10-40-1 through 40-2A. See section 18.1 of our FRD publication, ***Consolidation***, for more guidance on the scope of ASC 810.

Consistent with the accounting for purchases of additional ownership interests of a subsidiary pursuant to ASC 810-10-45-21A through 45-24, if a subsidiary's redeemable preferred stock is not accounted for as a liability, and the transaction is within the scope of ASC 810, the parent's acquisition of a subsidiary's redeemable preferred stock (i.e., purchase the subsidiary's preferred stock from a current third-party preferred shareholder) is accounted for as a capital stock transaction pursuant to ASC 810-10-40-2. Accordingly, the consolidated entity would not recognize in its income statement any gain or loss from the acquisition of the subsidiary's preferred stock.

If redeemable preferred stock is accounted for as a liability, any amounts paid or to be paid to holders of those contracts in excess of the initial measurement amount are reflected as interest cost and not as a capital stock transaction. ASC 405 specifies whether a liability has been extinguished and ASC 470-50 requires that the parent recognize a gain or loss upon extinguishment of the subsidiary's liability for redeemable preferred shares for any difference between the carrying amount and the redemption amount.

### 3.5.1.4 Purchases of parent's stock by a subsidiary

Accounting for shares of a parent purchased by a subsidiary in the consolidated financial statements is addressed in ASC 810-10-45-5. That paragraph states that shares of the parent held by a subsidiary should not be reflected as outstanding shares in the consolidated financial statements of the parent. Such outstanding shares should be reflected as treasury shares in the consolidated financial statements.

Refer to section 17.1.3 of our FRD publication, ***Consolidation***, for information regarding the treatment of a subsidiary's ownership interest in its parent in the consolidated financial statements and the subsidiary's separate financial statements.

## 3.5.2 Conversion of convertible stock instruments

The conversion of equity-classified stock generally does not result in a deemed dividend or a gain/loss upon conversion if the conversion is pursuant to the original terms of the agreement. Upon conversion, the issuer derecognizes the stock based on their current carrying values (including any discount or premium), and allocates that amount to common stock (including both par value and APIC, as appropriate).

### 3.5.2.1 Induced conversions of convertible stock (updated September 2024)

ASC 260-10-S99 provides the SEC staff's view on the accounting for induced conversions of convertible preferred stock and states that issuers should consider the guidance in ASC 470-20-40-13 through 40-17 to determine whether a conversion of preferred stock is pursuant to an inducement offer.

ASC 470-20-40-13 through 40-17 addresses the accounting for induced conversions of convertible debt that (1) occur pursuant to changed conversion privileges that are exercisable only for a limited period of time, (2) include the issuance of all of the equity securities issuable pursuant to conversion privileges included in the terms of the debt at issuance for each debt instrument that is converted and (3) involve any of the following:

- Reduction of the original conversion price (thereby resulting in the issuance of additional shares of stock)
- Issuance of warrants or other securities not provided for in the original conversion terms
- Payment of cash or other consideration (sometimes called a convertible stock sweetener) to those shareholders who convert during the specified time period. The additional consideration is usually offered to induce prompt conversion of the stock to another class of equity.

As the form is important to the application of this guidance, all equity shares issuable under the initial terms — meaning all or more — must be issued.

ASC 470-20-40-14 further explains that an induced conversion includes an exchange of a convertible debt instrument for equity securities or a combination of equity securities and other consideration, whether or not the exchange involves legal exercise of the contractual conversion privileges included in the terms of the debt.

The induced conversion guidance in ASC 470 applies regardless of the party that initiates the offer or whether the offer relates to all debt holders, as discussed at ASC 470-20-40-13(b). For example, even if a stockholder makes the offer to the issuer and only that holder's stock receives the right to convert at the sweetened conversion price, the accounting requirements of the induced conversion guidance in ASC 470-20 apply.

If a conversion of equity-classified preferred stock is an inducement offer pursuant to ASC 470-20, the fair value of the additional securities or other consideration issued to induce conversion should be subtracted from net income to arrive at income available to common stockholders in the calculation of EPS pursuant to ASC 260-10-S99-2. Refer to section 3.2.1 of our FRD publication, ***Earnings per share***, for further guidance on ASC 260-10-S99-2.

Refer to ASC 470-20-55-1A through 55-9 for illustrative examples of the application of this induced conversion guidance.

**FASB update**

In December 2023, the FASB issued a proposed ASU[29] that would clarify the requirements for determining whether to account for certain early settlements of convertible debt instruments as induced conversions or extinguishments.

The proposal would require an entity to account for a settlement as an induced conversion if the inducement offer includes the issuance of all of the consideration (in form and amount) issuable under the conversion privileges provided in the terms of the existing convertible debt instrument. The issuer would assess whether this criterion is satisfied as of the inducement offer acceptance date.

Under the proposal, induced conversion accounting would apply to all convertible debt instruments that have a substantive conversion feature at the time of issuance and are in the scope of ASC 470-20, regardless of whether the instrument is currently convertible. In addition, entities would be permitted to apply the guidance either prospectively to convertible debt instruments settled during the fiscal year beginning after the effective date or retrospectively, as of the beginning of the first comparative reporting period, to convertible debt instruments settled after the adoption of ASU 2020-06. See our To the Point publication, ***FASB proposes clarifying accounting for induced conversion of convertible debt instruments***, for more information.

During redeliberations, the Board tentatively decided that an entity would be required to assess whether a conversion feature is substantive as of both the issuance date and the offer acceptance date. The Board also decided that the guidance would be effective for fiscal years, including interim periods within fiscal years, beginning after 15 December 2025 for all entities. Early adoption would be permitted as of the beginning of the fiscal year for all entities that have adopted the amendments in ASU 2020-06.

At the time of this publication, the Board had completed its redeliberations and directed the staff to draft a final ASU. We encourage readers to monitor developments.

## 3.6 Modifications or exchanges of stock instruments

Significant modifications or exchanges of common stock instruments are infrequent. As the accounting for such transactions is not directly addressed in the accounting literature, the accounting considerations are heavily based on the individual facts and circumstances.

The accounting literature does, however, specifically address the extinguishment of equity-classified preferred shares, but does not address determining whether an amendment to an equity-classified preferred share is an extinguishment or a modification. Nor does it address the subsequent accounting for modifications. Common amendments include changes to, additions of, or deletions of redemption features, conversion rights, preference or seniority, voting or dividend rights. These changes may be executed through an exchange of preferred shares or by amending terms of existing preferred shares.

### 3.6.1 Modifications or exchanges of common stock instruments

In most instances common stock is modified or exchanged in connection with a capital restructuring, whereby by all common shareholders are receiving or giving up specified rights. Although all facts and circumstances should be considered, often no accounting is required, except where value is transferred from the common holders to the preferred holders, and that value represents a dividend to the preferred holders.

[29] Proposed Accounting Standards Update, *Debt — Debt with Conversion and Other Options (Subtopic 470-20) — Induced Conversions of Convertible Debt Instruments (a consensus of the Emerging Issues Task Force).*

In instances where only a subset of common stock is being modified or exchanged, consideration should be given as to whether that class of common stock is required to follow the two-class method of calculating EPS. Refer to section 5 of our FRD publication, ***Earnings per share***, for further guidance on the two-class method.

## 3.6.2 Modifications or exchanges of preferred stock instruments

Equity-classified preferred shares include those classified within equity and those within the "mezzanine" (i.e., both "permanent equity" and "temporary equity"). For SEC registrants, the effect of a redemption (i.e., an extinguishment) or induced conversion of equity-classified preferred stock on the calculation of EPS is addressed by SEC staff guidance at ASC 260-10-S99-2. Under that guidance, when equity-classified preferred shares are redeemed (i.e., extinguished), the difference between (1) the fair value of the consideration transferred to the holders of the preferred shares (i.e., the cash or the fair value of new instruments issued) and (2) the carrying amount of the preferred shares (net of issuance costs) are subtracted from (or added to) net income to arrive at income available to common stockholders in the calculation of EPS. Refer to section 3.2.1 of our FRD publication, ***Earnings per share***, for further discussion of ASC 260-10-S99-2. In addition to the effect on EPS, redemption (i.e., an extinguishment) or induced conversion of equity-classified preferred stock will result in adjustments within equity but will not result in recognition of any amounts in net income. The accounting guidance in ASC 260 does not, however, define an extinguishment, particularly in the context of whether amendments to an existing equity-classified preferred share constitute an extinguishment.

### 3.6.2.1 Determining whether an amendment of an equity-classified preferred share is an extinguishment or modification

ASC 470-50 addresses whether a debt instrument has been significantly modified such that extinguishment accounting is required. If extinguishment accounting is required for debt, the original debt is removed from the balance sheet, the new debt is recognized at its current fair value and the difference is recorded as a gain or loss on extinguishment. ASC 470-50 also applies to preferred shares that are classified as liabilities. However, comparable guidance for evaluating amendments to equity-classified preferred shares does not exist. The accounting literature does not address how to evaluate whether an amendment to an equity-classified preferred share should be accounted for as an extinguishment (with a corresponding effect on EPS and equity). Therefore, there may be certain reasonable accounting policies to apply in making this evaluation. The SEC staff updated the guidance in ASC 260-10-S99-2 in September 2009 through technical corrections in ASU 2009-08 and added a scope paragraph explicitly stating that a modification of preferred shares accounted for as an extinguishment is within its scope. We believe that implicitly acknowledged that there may be some modifications of preferred shares that do not require extinguishment accounting.

This was further clarified in comments made by the SEC staff at the 2014 AICPA National Conference on Current SEC and PCAOB Developments:[30]

> "The staff believes that an amendment to preferred stock can be of such significance that it represents an extinguishment of the existing preferred stock and the issuance of new preferred stock. On the other hand, the staff also believes that an amendment to preferred stock, while important to the parties, can lack the same level of significance and is more appropriately characterized as a modification. We believe current accounting literature supports this view. First, debt literature acknowledges that certain changes are merely modifications while other changes should be captured by extinguishment accounting. The staff believes it is appropriate to apply similar analysis to preferred stock. Second, in September 2009 when technical corrections were made to the scoping guidance to ASC 260-10-S99, the staff believed exchanges of preferred stock could be either extinguishments or modifications."

[30] T. Kirk Crews, 2014 — Refer to the SEC website at http://www.sec.gov/News/Speech/Detail/Speech/1370543665379.

The following are examples of accounting policies that were discussed by the SEC staff and that may be considered based on the prevailing facts and circumstances:

- Policy based on an evaluation of the changes in projected cash flows — For equity-classified preferred shares that have well-defined periodic contractual cash flows (especially those determined to have a debt-like host instrument), an amendment that results in a greater than 10% change in cash flows based on an analysis similar to ASC 470-50 is an extinguishment. An amendment that does not meet this criterion is a modification.
- Policy based on a change in fair value — If the fair value of the equity-classified preferred share immediately after the amendment is significantly different (e.g., by more than 10%) than the fair value of the instrument immediately before the amendment, the amendment is considered an extinguishment. An amendment that does not meet this criterion is a modification.
- Policy based on qualitative considerations — An amendment that adds, deletes or significantly changes a substantive contractual term (e.g., one that is at least reasonably possible of being exercised) or fundamentally changes the nature of the preferred shares is considered an extinguishment. That evaluation could include the consideration of both the expected economics, as well as the business purpose for the amendment. An amendment that does not meet these criteria is a modification.

The SEC staff also discussed what was referred to as a "legal form approach." Under this approach, any legal exchange resulting in the issuance of new preferred stock would be viewed as an extinguishment. Otherwise, any change in terms (regardless of significance) that does not result in the legal exchange of the preferred stock would be captured as a modification. However, the SEC staff cautioned that the legal form of the transaction is merely one data point to consider and should not be viewed as determinative with respect to this issue.

Other observations related to amendments to preferred shares include:

- Changes to the classification of the preferred shares from temporary (mezzanine) to permanent equity under the guidance in ASC 480-10-S99-3A may be considered an extinguishment under certain accounting policies whereas the accounting guidance specifically notes that an amendment resulting in reclassification of an equity instrument (permanent or temporary) to a liability is an extinguishment.
- A small incremental amendment to an equity-classified preferred share may not be an extinguishment (e.g., an amendment to preclude the issuance of senior equity without permission of preferred stock holders), yet cumulatively a series of small incremental amendments could result in an instrument that is very different than the original. Therefore, the issuer may need to consider the cumulative effect of any amendments over time. This would be similar to the guidance in ASC 470-50-40-12(f) which requires consideration of changes made within one year.
- In assessing whether an extinguishment has occurred, differences between the current fair value of equity-classified preferred shares and their current carrying amount we believe would not be considered.

If equity-classified preferred shares are amended and the amendment is viewed as an "extinguishment" based on the company's accounting policy and related analysis, the derecognition accounting model in ASC 260-10-S99-2 discussed above applies.

#### *3.6.2.1.1 Amendments to equity-classified preferred stock instruments due to reference rate transition*

ASC 848 provides temporary optional practical expedients to the US GAAP guidance on contract modifications and hedge accounting to ease the financial reporting burdens of the expected market transition from LIBOR and other interbank offered rates to alternative reference rates, such as the SOFR.

US GAAP, including ASC 848, does not specifically address the modification of equity-classified preferred stock. In practice, the accounting for such modification is generally based on the SEC staff remarks discussed in section 3.6.2.1.

At the 2019 AICPA National Conference on Current SEC and PCAOB Developments, an SEC staff member discussed a consultation on the accounting for amendments to equity-classified preferred stock instruments due to the cessation of LIBOR (e.g., amendments solely to designate SOFR as the replacement rate) when dividend payments were previously indexed to LIBOR.[31]

To evaluate the amendments, the issuer considered the business purpose of the amendment and whether the amendment may influence investors' decisions. The SEC staff member noted the staff has previously observed that there are various acceptable approaches for assessing whether preferred stock amendments are a modification or extinguishment. The SEC staff member further observed that the issuer had elected an accounting policy to apply a qualitative approach, which is one of the models that the staff has previously accepted. Since the issuer concluded that the changes were not considered significant on the basis of the business purpose for the changes and how the changes may influence the investor's economic decisions, the Office of the Chief Accountant (OCA) staff did not object to the issuer's conclusion that the amendments would be treated as a modification to the preferred stock rather than an extinguishment.

The SEC staff member also addressed whether the modification required accounting recognition. The SEC staff has previously accepted an analogy to the modification guidance in ASC 718-20, which requires recognition of the increase in fair value of the modified instrument as a result of the modification. Because there was no business purpose other than to designate the replacement rate for LIBOR, the SEC staff did not object to the issuer's conclusion that the modification is presumed to be negotiated at fair value, and, therefore, no accounting recognition is necessary.

The views expressed by the SEC staff member for preferred stock are consistent with the relief provided by the FASB in ASC 848 for other contract modifications due to reference rate transition.

For more information on reference rate reform, refer to ASC 848 and our Technical Line, ***A closer look at the FASB's accounting relief related to reference rate reform***.

### 3.6.2.2 Accounting for modifications of equity-classified preferred shares that are not extinguishments

When an equity-classified preferred share has been modified and extinguishment accounting is not considered appropriate, the issuer must evaluate the proper accounting for the modification. An issuer's policy for recognizing the effects of a modification should apply an appropriate methodology based on a careful consideration of the specific facts and circumstances.

There are two accounting models that may be useful when determining the accounting for modifications of an equity-classified preferred share and the corresponding EPS and equity effects, although the models focus on the income statement effects of a modification.

- The model for modified debt instruments that are not considered extinguished is discussed in ASC 470-50. It generally provides for prospective treatment of the modification of the contractual cash flows by establishing a new effective interest rate to equate the future contractual cash flows to the carrying amount of the debt. The debt model also specifies the accounting for a modification which increases the value of an embedded conversion feature.
- The model for a modified share-based payment award that is classified as equity and remains classified in equity after the modification is addressed in ASC 718-20-35. Under that model, the incremental fair value from the modification (the difference in the fair value of the instrument immediately before and immediately after the modification) is recognized as an expense in the income statement to the extent the modified instrument has a higher fair value. Modifications that result in a decrease in the fair value of an equity-classified share-based payment award are not recognized.

[31] Jamie N. Davis, 2019 — Refer to the SEC website at **https://www.sec.gov/news/speech/davis-speech-2019-aicpa-conference**.

The modified debt model in ASC 470-50 may be more appropriate when an issuer uses a discounted cash flow analysis when concluding that an amendment is a modification and not an extinguishment. That model results in accounting for the change in the equity-classified preferred share generally on a prospective basis (e.g., changing the amortization period and accretion or the dividend rate on a prospective basis). Accretion and dividends on equity-classified preferred shares are deducted from net income to arrive at net income available to common shareholders when calculating EPS.

For other modifications, the share-based payment model may be more appropriate, especially when there is a transfer of value from the common shareholders to the preferred shareholders. This may be the case in a "refinancing" with existing investors, or when preferred shareholders are demanding some form of compensation or fee for their consent to a company action. Under this model the value transferred from the common to preferred shareholders is reflected as a deemed dividend reconciling net income to net income available for common shareholders. If the carrying amount of the preferred share was also adjusted by the deemed dividend, rather than simply reflecting it as a reconciling item between net income and net income available for common shareholders (e.g., as is done with cumulative dividends that are not declared during a period), then the issuer would need to appropriately consider the change in the preferred share's carrying value on the subsequent measurement of the preferred share, for example under ASC 480-10-S99-3A. As noted previously, when analogizing to the share-based payment model, modifications that result in a decrease in the fair value of an equity-classified preferred share would not be recognized.

#### 3.6.2.3 Liability-classified preferred shares that are modified

For preferred stock instruments classified as liabilities under ASC 480 (refer to sections 3.2.1 and 3.2.2), the issuer should follow the accounting models for the modification or extinguishment of debt. Refer to section 2.6 for further details and discussion.

## 3.7 Equity-classified convertible preferred stock with a down round feature

Down round features reduce the exercise price of an issued financial instrument if the issuer sells shares of its stock for a lower price or issues an equity-linked instrument with a lower exercise price than the current exercise price of the issued financial instrument. They typically reduce the exercise price of the issued financial instrument to the new issuance or exercise price, a formulaic price or set a floor below which the exercise price cannot fall.

An entity that presents EPS in accordance with ASC 260[32] recognizes the value of the effect of a down round feature in an equity-classified convertible preferred stock (if that conversion feature has not been bifurcated in accordance with ASC 815) when the down round feature is triggered (i.e., when the exercise price is reduced). ASC 260 also provides guidance on how to measure the amount to be recognized. Refer to section 3.2.3A of our FRD publication, ***Earnings per share***, for further information.

See section B.3.4.1 for more information on the application of the definition of "down round" and section C.4.5 for subsequent measurement guidance for an equity classified convertible preferred with a down round feature that is classified in mezzanine equity in accordance with ASC 480-10-S99-3A.

## 3.8 Financial presentation and disclosure

ASC 505-10-50 outlines the general disclosures required for capital stock, which require that an entity explain the pertinent rights and privileges of the various securities outstanding, including the following:

- Dividend and liquidation preferences
- Participations rights

[32] See ASC 260-10-25-1.

- Call prices and dates
- Conversion or exercise prices or rates and pertinent dates
- Sinking-fund requirements
- Unusual voting rights
- Significant terms of agreements to issue additional shares

In addition, ASC 505-10-50 requires an entity to disclose the number of shares issued upon conversion, exercise or satisfaction of required conditions during at least the most recent annual fiscal period and any subsequent interim period presented.

Entities are required to disclose terms that may change the conversion or exercise prices of financial instruments, including those related to down round features, as well as actual changes to conversion or exercise prices that occur during a reporting period. These disclosures do not pertain to standard antidilution provisions. Further, when a down round feature is triggered and an entity has recognized its effect pursuant to ASC 260-10-25-1, the entity is required to disclose that fact and the value of the effect of the down round feature. Refer to section B.3.4.1 for further discussions on financial instruments with down round features.

ASC 505-10-50 also provides that companies that issue preferred stock (or other senior stock) that have a preference in involuntary liquidation considerably in excess of the par or stated value of the shares are required to disclose the liquidation preference of the stock in the equity section of the statement of financial position in the aggregate, either parenthetically or "in short," rather than on a per-share basis or through disclosure in the notes. In addition, companies are required to disclose within its financial statements, either on the face of the statement of financial position or in the notes thereto, the aggregate or per-share amounts at which preferred stock may be called or is subject to redemption through sinking-fund operations or otherwise, and the aggregate and per-share amounts of cumulative preferred dividends in arrears.

In addition, ASC 210-10-S99-1 requires certain presentation of capital stock on the face of the balance sheet or disclosures in the notes if more than one issue is outstanding, including information about the title of each issue, the dollar amount of each issue, the number of shares authorized and the number of shares issued or outstanding.

Stock may qualify as a liability (debt) in which case disclosure requirements applicable to debt instruments would apply to the stock. In addition to those general requirements, various pieces of authoritative literature provide disclosure requirements that may be applicable to stock transactions, based on the facts and circumstances.

# 4 Equity contracts

## 4.1 Overview and general description of equity contracts

An entity may issue a freestanding financial instrument (other than an outstanding equity share) whose value fluctuates with changes in an underlying based on the fair value of the company's own equity shares. Those underlying equity shares can include all forms of ownership interests, such as common and preferred shares, as well as partnership interests, and equity shares of a member of a consolidated group. This section refers to those freestanding financial instruments as equity contracts. Some equity contracts may also meet the definition of a derivative pursuant to ASC 815 and not receive an exception from derivative accounting. Those equity contracts are referred to as "equity derivatives" in this section.

Equity contracts are classified as either liabilities (or assets in some cases) or in equity. Contracts that do not involve the issuer's equity shares are subject to other guidance (e.g., ASC 815) and are outside the scope of this section.

Upon exercise, an equity contract may be settled in net shares or net cash or require physical settlement. The settlement method may significantly influence the classification of the equity contract. Those settlement methods are generally described as follows:

- Physical settlement — The party designated in the contract as the buyer delivers the full stated amount of cash to the seller, and the seller delivers the full stated number of shares to the buyer.
- Net share settlement — The party with a loss delivers to the party with a gain shares with a current fair value equal to the gain.
- Net cash settlement — The party with a loss delivers to the party with a gain a cash payment equal to the gain, and no shares are exchanged.

The most basic types of equity contracts are options and forwards. More complex equity contracts can be created from these basic contracts (e.g., by combing features or instruments).

### 4.1.1 Common types of equity contracts

There are many varieties of equity contracts. Basic equity options and basic forward contracts are described first, followed by a description of more complex structures that are constructed from the basic contracts.

#### 4.1.1.1 Equity option

An option is a contract between two parties that gives one party (the buyer, holder or purchaser of the option) the right, but not the obligation, to buy or sell an equity security at a reference price, while the other party (the seller or writer of the option) has the obligation to fulfill the transaction if requested by the buyer.

The most basic types of equity options are call and put options.

- Call options give the holder the right to buy the underlying equity securities on a certain date (or during a certain period of time) at a fixed or determinable price.
- Put options give the holder the right to sell the underlying equity securities on a certain date (or during a certain period of time) at a fixed or determinable price.

Options are also referred to as purchased options from the perspective of the option holder and written options from the perspective of the option seller. A single option contract is a purchased option to one party and a written option to the other party. For example, a purchased put option that entitles the holder to sell shares to the option seller is a written put option from the perspective of the option seller.

Equity options generally are characterized with the following terms:

- Strike price or exercise price — The price (e.g., fixed or formula-determined) at which the option buyer can buy (call) or sell (put) the underlying equity security
- Exercise date — The date on which an option holder exercises the right to buy or sell the underlying equity security
- Expiration date — The date after which an option is no longer valid and can no longer be exercised
- Notional — The number of underlying equity securities to be purchased or sold, which can be fixed or variable
- Premium — The cost that an option buyer pays to acquire the option. Generally, the premium at inception of an option contains only the time value of the option but can also include intrinsic value
- In-the-money option — A call option where the strike price is less than the then-current fair value of the underlying equity security or a put option in which the then-current equity security fair value is lower than the strike price (e.g., If the strike price of a call option is $10 and the current fair value of the share is $13, that call option is $3 in the money; or if the strike price of a put option is $15 and the current fair value of the share is $11, that put option is $4 in the money)
- At-the-money option — An option where the contractual strike price equals the then-current fair value of the underlying equity security
- Out-of-money option — A call option where the strike price is greater than the then-current fair value of the underlying equity security or a put option where the strike price is less than the then-current equity security's fair value
- Intrinsic value — The in-the-money portion of the option's current fair value (for call options, the intrinsic value is the excess of the underlying equity security's fair value over the strike price; for put options, it is the excess of the strike price over the underlying equity security's fair value.)
- Time value — The difference between the option's fair value and its intrinsic value (the time value generally represents the value of the instrument attributed to the volatility of the underlying share (i.e., the chance an option could go in the money or further in the money) and the length of time to exercise.)
- American option — An option that can be exercised at any time up to the expiration date
- European option — An option that can be exercised only on the expiration date itself
- Bermuda option — An option that can be exercised only on predetermined dates

Warrants are call options written by the issuer that permit the holder to purchase the issuer's equity shares at a specified price on a certain date or during a certain period of time. Similarly, rights offerings are also written call options by the issuer to provide investors the right to receive additional shares of the issuer.

In some cases, the exercise price of a warrant is set at a penny (often referred to as a penny warrant). While the payoff of a penny warrant is essentially the same as actually holding the underlying shares, it is viewed as an equity contract because the warrant contains all of the characteristics of an equity option as described above and usually lacks the other legal characteristics of a share (such as the ability to vote). Refer to section 5.13 for additional discussion of penny warrants.

#### 4.1.1.2 Equity forward

An equity forward is a contract between two parties under which one party must deliver (sell), at a future date (maturity or settlement date), an equity security in exchange for an agreed-upon price that the other party must pay. Unlike an option, both parties to a forward contract are required to perform in accordance with the agreed-upon terms. A contingent forward requires the parties to perform upon the occurrence of an event that is not certain to occur.

An equity forward differs from a spot purchase, in which the purchase or delivery of the equity security occurs on the transaction date at the current market price. Some forward contracts may have the forward price paid at inception and the shares delivered at a future date (prepaid forward).

The basic equity forwards on an issuer's own equity securities are:

- Forward purchase — A contract requiring the issuer to buy its own shares from the seller at a predetermined price at a future date.
- Forward sale — A contract requiring the issuer to sell its own shares to the buyer at a predetermined price at a future date.

Equity forwards generally are characterized with the following terms:

- Forward buyer — The party that agrees to buy the underlying equity security (also referred to as a long position).
- Forward seller — The party that agrees to sell the underlying equity security (also referred to as a short position).
- Notional — The number of underlying equity securities to be delivered, which can be fixed or variable.
- Forward price — The price (e.g., fixed or formula-determined) the buyer will pay upon maturity or settlement date to acquire the underlying equity security. Sometimes also referred to as the contract price.

The agreed-upon forward price is usually set at market, such that the fair value of the contract is zero at inception. The payoff of a forward at maturity depends on the relationship between the forward price and the underlying share price at that time. The contract results in a gain to one party and a loss to the other party as the underlying share price fluctuates.

#### 4.1.1.3 Variable share forward

A variable share forward is a forward contract that has a fixed forward price but the number of shares underlying the forward (i.e., the number of shares to be delivered in a physical settlement) varies. The number of shares is determined by dividing the contract price by some measure of share price (e.g., share price at period end, an average share price for some period). For example, if the forward price is $100,000 and the average share price is $10, the number of shares that the issuer repurchases would be 10,000; if the average share price is $15, the number of shares would be 6,667.

A range forward is a common variation of the basic variable share forward. The number of shares underlying a range forward varies based on the then-current fair value of the shares relative to preset price levels. If the share price is above an upper threshold, the seller delivers a fixed number of shares equal to the contract price divided by that upper threshold. If the share price is below a lower threshold, the seller delivers a fixed number of shares equal to the contract price divided by that lower threshold. If the share price is between the two thresholds, the seller delivers a variable number of shares equal to the contract price divided by the then-current share price.

#### 4.1.1.4 Prepaid forward purchase

A prepaid forward purchase contract requires the issuer (the forward purchaser) to prepay the counterparty a fixed amount up-front in exchange for the delivery of shares at a future date (the maturity date). That number of shares to be received can be either fixed or variable, such as the variable share forwards discussed in section 4.1.1.3.

#### 4.1.1.5 Accelerated share repurchase

An accelerated share repurchase (ASR) is an arrangement executed by a company with an investment bank to repurchase shares that generally results in an immediate effect to EPS but settles the economics of the share repurchase at a future date based on the subsequent stock price.

In a traditional ASR, the issuer makes an up-front payment and receives a specific number of shares from the bank in a contract typically documented as a forward purchase contract. Upon maturity (typically three to six months later), the ASR is settled based on the VWAP of the issuer's shares during the contract period. Through this settlement, changes in the stock price subsequent to the initial share purchase serve to increase or decrease the overall cost of the share repurchase by the issuer under the ASR.

There are many different ASR structures. The accounting depends on the specific terms of the arrangement. Refer to section 5.9 for a detailed discussion of certain ASR transactions.

#### 4.1.1.6 Equity collar

An equity collar is a combination of a purchased option and a written option on the issuer's own shares. It can be structured to consist of a purchased put option with a strike price at or below the current share price (lower strike) and a written call option with a strike price above the current market price (higher strike). The put option provides the issuer with the right to sell its own stock while the call option permits the counterparty to buy the issuer's stock at a specific price on or before a specific date. An equity collar may also be a combination of a lower strike written put option and higher strike purchased call option. When the premium received from sale of the written option completely offsets premium paid for the purchased option within the collar, the arrangement is referred to as a zero cost collar.

The accounting for an equity collar depends on whether it is issued as a single instrument with two features or as separate financial instruments. Refer to section 4.2.1.1 for a discussion on analyzing an instrument with more than one component.

Frequently, issuers use a collar strategy to limit their exposure to changes in the share price that arises from other outstanding equity contracts on their stock. For instance, a traditional ASR exposes the issuer to a potentially unlimited payment if the stock price rises during the forward period. To mitigate the potential payment, the issuer may incorporate a collar arrangement (which consists of a high strike purchased call option and a low strike written put option) in the ASR to limit the range of the settlement price.

Refer to section 5.9.3 for further discussion of collared ASR structures.

#### 4.1.1.7 Call spread transaction

One form of equity collar is a call spread. A call spread is a combination of a purchased call option at a specific strike price (referred to as the low strike call option) and a written call option at a higher strike price (referred to as the high strike call option). For example, a call spread permits the issuer to buy shares from the counterparty if the price is above $10 (a purchased call option) and permits the counterparty to purchase shares from the issuer if the strike price is above $14 (a written call option). The transaction can be documented as either a single combined option contract (a capped call option) or as two separate option contracts.

Call spreads are often entered into in conjunction with convertible debt issuances. In those transactions, the purchased call option (referred to in those cases as the "bond hedge") usually has a strike price equal to the conversion price of the convertible debt and economically offsets the payoff of the conversion option. The written call option partially finances the purchased call option. The combined economics of the convertible debt and the call spread is a synthetic increase of the strike price of the convertible debt.

Refer to section 5.16 for further discussion of convertible debt with a call spread structure.

#### 4.1.1.8 Prepaid written put option

A prepaid written put option is a written put option on the issuer's own shares in which the issuer has prepaid the strike price of the option at inception of the transaction. Some refer to this instrument by its original commercial product name of a "Dragon" (due to the shape of the payoff diagram) or CAESAR (cash enhanced share repurchase).

In a typical prepaid written put transaction, often executed in a form of a European option, the issuer (the option writer) makes an up-front payment to the counterparty (the option purchaser) in an amount equal the strike price of the put option (normally the spot price at inception) less the option premium the issuer is entitled to receive from the option purchaser for providing the put option.

At maturity, the written put option will be settled in one of two ways:

- If the stock price on the settlement date is below the strike price, the counterparty will deliver to the issuer the specified number of shares underlying the option. No cash is paid by the issuer as the strike was prepaid at inception.
- If the stock price on the settlement date is above the strike price, the issuer will receive from the counterparty a payment equal to the option strike price (i.e., a return of the prepaid strike price). The payment may also be in a form of variable number of the issuer's shares equal to the amount due, at the issuer's choice.

Companies often use a prepaid written put option to lower the overall cost of their share repurchase programs. Refer to section 5.17 for further discussion on prepaid written put options.

#### 4.1.1.9 Puttable warrant

A puttable warrant (sometimes called a put warrant) is a warrant with an embedded put option. The warrant will have terms that either permit the holder to require the issuer to pay cash to (1) repurchase the warrant itself or (2) purchase the shares obtained upon the holder's exercise of the warrant (i.e., put the shares) at a specified date for a fixed monetary amount.

A puttable warrant can be distinguished from a warrant where the underlying shares have a term that makes them redeemable. However, the accounting for a warrant for redeemable shares is similar to the accounting for a puttable warrant. Refer to section 5.7 for additional discussion of warrants for redeemable shares.

#### 4.1.1.10 Tranched preferred share financing

A tranched preferred share issuance, also referred to as a delayed issuance of preferred shares or a contingent issuance of preferred shares, consists of an initial issuance of preferred shares and a later or second tranche or delayed issuance. This later tranche (or in some cases tranches), while contractually agreed to at the initial closing date, results in preferred shares being issued at a specific future date or on the occurrence of a future event or milestone. The future issuance may be automatic, optional in the control of the issuer, optional in the control of the investor or entirely contingent on external factors.

Tranched preferred share transactions are commonly used by emerging biotech and technology entities to fund research and development and general operations. The later tranche(s) are often timed to coincide with a future expected need for capital to continue the entity's product development. Refer to section 5.8 for further discussion.

#### 4.1.1.11 Contracts settled in the stock of a consolidated subsidiary

A parent company may enter into freestanding equity contracts that are indexed to, and potentially settled in, the stock of a consolidated subsidiary. Those equity contracts can take the form of options or forwards. Refer to section 5.10 for a discussion of equity contracts on NCI.

#### 4.1.1.12 Share lending arrangement

An entity may enter into a share lending arrangement that is executed separately from, but in contemplation of, a convertible debt offering (or some other convertible financing transaction). Although the convertible debt instrument is ultimately sold to investors, the share lending arrangement is an agreement between the convertible debt issuer (share lender) and the investment bank (share borrower) and is intended to increase the availability of the issuer's shares in order to facilitate the ability of the investors to hedge the conversion option in the issuer's convertible debt. Companies often execute share lending arrangements to facilitate a convertible instrument offering or increase the attractiveness of an offering. Refer to section 5.5 for further discussion.

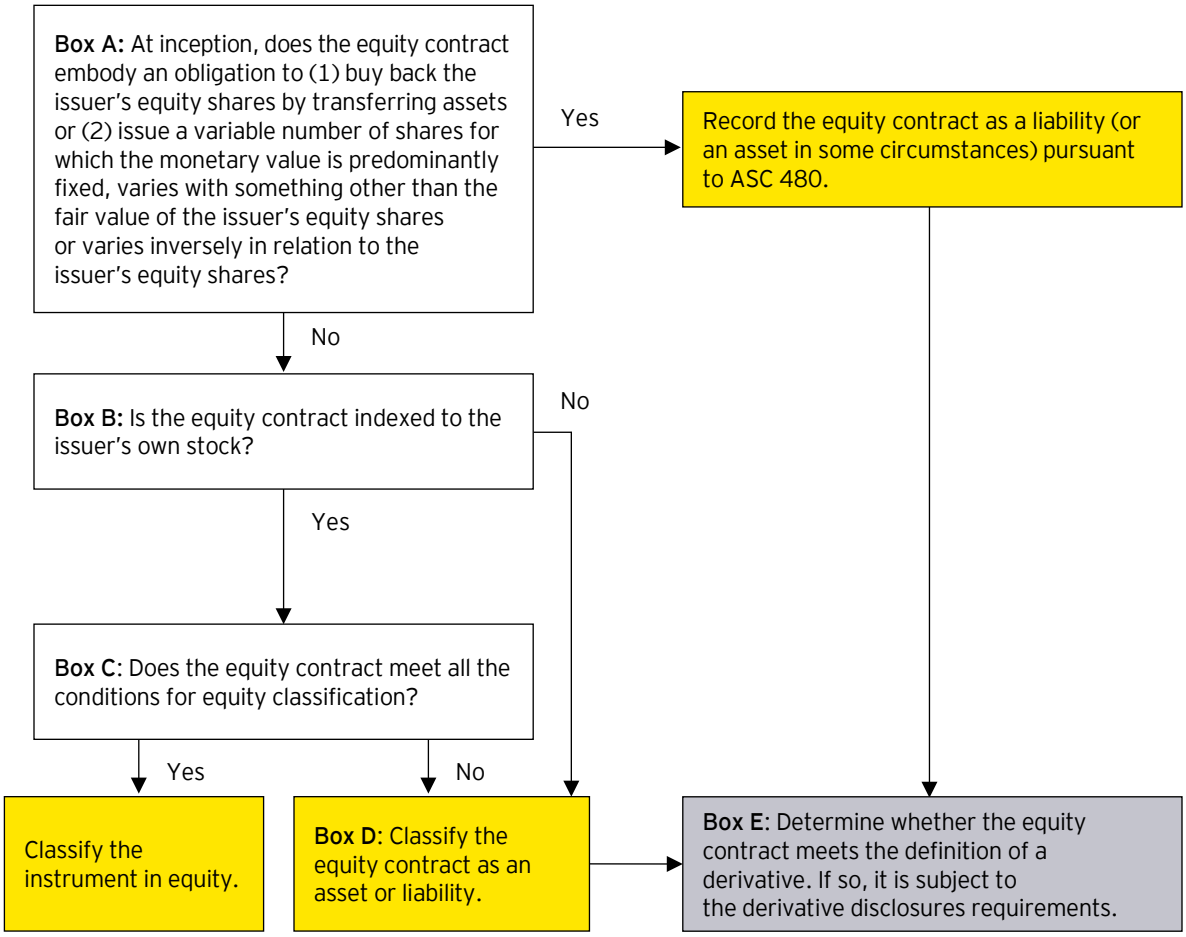
#### 4.1.1.13 Unit structures

Unit structures are a combination of (1) a debt or trust preferred security and (2) a warrant or a forward contract to purchase the issuer's common stock. The debt (or sometimes preferred stock) and equity contracts in a typical unit generally are deemed to be separate instruments as the holder may transfer or settle the equity contract separately from the debt instrument. The debt and equity contracts are detachable and, therefore, analyzed and accounted for separately. Refer to section 5.2 for further discussion.

## 4.2 Issuer's initial accounting for freestanding equity contracts (including flowchart)

This section describes the steps generally necessary to determine the accounting for equity contracts at issuance.

The following flowchart summarizes the analysis at a conceptual level and should be used in conjunction with the related guidance that begins after the flowchart.




### 4.2.1 Box A — Equity contracts within the scope of ASC 480

ASC 480 applies only to freestanding financial instruments that embody an obligation of the issuer. The guidance defines a freestanding financial instrument as a financial instrument that is entered into (1) separately and apart from any of the entity's other financial instruments or equity transactions or (2) in conjunction with some other transaction and is legally detachable and separately exercisable. Refer to section A.3.2.2 for further discussion on determining whether an instrument is freestanding.

The term "obligation" refers to either a conditional or unconditional obligation on the part of the issuer to transfer assets or issue equity shares. Equity contracts that do not embody any obligation to the issuer are not liabilities pursuant to ASC 480.

For example, options purchased by the issuer do not embody obligations of the issuer because they permit, but do not require, the issuer to buy or sell shares (whether on a gross or net basis). Therefore, purchased options are not subject to ASC 480. On the other hand, contracts that require or could require the issuer to purchase or issue its shares (e.g., forward purchase contracts, written put options, written call options on redeemable shares) are obligations and thus could be subject to ASC 480.

A prepaid forward purchase contract whereby the issuer prepays the forward price at inception (refer to section 4.1.1.4) is not an obligation if the issuer prepays the forward price at inception and has no further obligation to either transfer an asset or issue equity shares to the counterparty. Accordingly, such a prepaid forward is not a liability pursuant to ASC 480.

In addition to mandatorily redeemable shares, ASC 480 generally requires liability classification for the following broad classes of freestanding equity contracts:

- Instruments (other than an outstanding equity share) that, at inception, embody, or are indexed to, an obligation to buy back the issuer's equity shares that requires or could require transfer of assets (ASC 480-10-25-4 through 25-13). Examples are:
  - Forward contracts that require the issuer to purchase its own shares
  - Written options that permit the counterparty to require the issuer to buy back its own shares.

  Equity contracts in this category are not classified in equity because they usually represent an obligation in that the issuer knows it will, or can be forced to, settle an obligation or distribute assets, which is more akin to a liability.
- Instruments (other than an outstanding share) that embody an obligation, that the issuer must or may settle by issuing a variable number of its equity shares if, at inception, the monetary value of the obligation is based solely or predominantly on any one of the following conditions (ASC 480-10-25-14):
  - Has a fixed value known at inception (e.g., an obligation to deliver shares with a fair value at settlement equal to $1,000) (ASC 480-10-25-14(a))
  - Derives its value from an underlying other than the issuer's equity shares (e.g., an obligation to deliver shares with a fair value at settlement equal to the value of one ounce of gold) (ASC 480-10-25-14(b))
  - Has a value to the counterparty that moves in the opposite direction to changes in fair value of the issuer's shares (e.g., net share settled written put options) (ASC 480-10-25-14(c))

  ASC 480 defines "monetary value" as the fair value of the cash, shares or other instruments that a financial instrument obligates the issuer to convey to the holder at the settlement under specified market conditions.

  Equity contracts in this category are classified as liability (or an asset) because they do not expose the counterparty to risks and rewards similar to those of an owner and therefore, do not create a shareholder relationship.

The following table lists certain common equity contracts and whether they are in the scope of ASC 480.

| Equity contract (single contract) | In scope of ASC 480 | Outside scope of ASC 480 |
|---|---|---|
| Forward purchase contract (contract to purchase issuer's own shares) | X | |
| Forward sale contract (contract to sell issuer's own shares) | | X[33] |
| Equity collar with lower strike purchased put option and higher strike written call option (issuer holds the collar)[34] | | X[33] |
| Equity collar with lower strike written put option and higher strike purchased call option (issuer provides the collar)[35] | X | |
| Purchased call option | | X |
| Purchased put option | | X |
| Written call option | | X[33] |
| Written put option | X | |
| Warrant on puttable shares or puttable warrants | X | |

An equity contract determined to be a liability (or an asset in some circumstances) pursuant to ASC 480 should follow the initial and subsequent measurement and disclosure requirements of that guidance. In addition, if the instrument also meets the definition of a derivative under ASC 815 (including consideration of all scope exceptions), the disclosures in that guidance are also required.

Refer to section A.3 for further discussion of financial instruments in the scope of ASC 480.

#### 4.2.1.1 Equity contracts with more than one component

ASC 480 also provides specific guidance on freestanding financial instruments that are composed of more than one option or forward contract embodying obligations that may require settlement by transfer of assets or delivery of a variable number of shares. Various scenarios are described in ASC 480-10-55-29 through 55-52.

Examples of those instruments include puttable warrants (or forwards) and equity collars. A puttable warrant has a written call option that entitles the holder to buy the issuer's shares and a written put option that entitles the holder to put the warrants back to the issuer at a specified price. Similarly, a forward sale contract on puttable shares obligates the holder to buy and the issuer to sell a number of shares at a specified price and contains a written put option that entitles the holder to put the shares obtained upon the settlement of the forward back to the issuer at a specified price. An equity collar is a combination of a purchased option and a written option. Although containing two options, an equity collar is legally one freestanding instrument because the two option components are not legally detachable and separately exercisable.

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[33] Provided the underlying shares are not puttable.

[34] The contract also does not embody, nor is it indexed to, an obligation to repurchase the issuer's equity shares that could require settlement by transferring assets. Also, while this equity contract embodies an obligation that may require the issuer to issue a variable number of its equity shares, the obligation is not based on any of the three types under ASC 480-10-25-14.

[35] This freestanding equity collar is subject to the provisions of ASC 480 due to the written put component. If required to be physically settled or net cash settled, the contract is a liability pursuant to ASC 480-10-25-8 through 25-13 because it embodies an obligation that may require repurchase of the issuer's equity shares and settlement by a transfer of assets. If net share settlement is required, the equity collar could also be a liability pursuant to ASC 480-10-55-43 (refer to section 4.2.1.1.2 for further discussion).

#### *4.2.1.1.1 Component requires or may require transfer of assets (ASC 480-10-25-8 through 25-13)*

Generally, if a financial instrument is composed of more than one component and any component obligates the issuer to repurchase shares (or is indexed to such an obligation) and may require a transfer of assets, the presence of this obligation would require the entire financial instrument be classified as a liability (or an asset in some circumstances). For example, a puttable warrant is a liability pursuant to ASC 480-10-25-8 through 25-13 because the put option component embodies an obligation that is indexed to repurchasing the issuer's shares and may require a transfer of assets. The same is true for a warrant for shares that are puttable for cash. Both instruments embody an obligation that may require a transfer of assets.

#### *4.2.1.1.2 Component requires delivery of a variable number of shares (ASC 480-10-25-14)*

ASC 480-10-55-43 summarizes a two-step approach to evaluating instruments where one component requires or may require the delivery of a variable number of shares. The approach is different than that for the contract that requires or may require a transfer of assets.

An issuer should first identify all component obligations. Each component obligation should be evaluated to determine whether that component potentially requires the delivery of a variable number of shares and, if freestanding, would be a liability pursuant to the three conditions outlined in ASC 480-10-25-14, as discussed in section 4.2.1.

If any component(s) potentially requiring delivery of a variable number of shares meets one of the conditions in ASC 480-10-25-14, the issuer should next determine whether the monetary value of that component obligation(s), is (collectively) predominant over the collective monetary value of all other component obligation(s) identified. If so, the entire instrument would be classified as a liability (or an asset in some circumstances). Otherwise, the equity contract is not in the scope of ASC 480 and other guidance should be considered.

While not defined in ASC 480, the concept of predominance is discussed briefly in ASC 480-10-55-44 and is illustrated in several examples in ASC 480. We generally believe the determination of whether a component(s) is predominant is based on the likelihood the equity contract will settle in accordance with that particular component(s), compared to the likelihood of settling under the other component obligation(s). The issuer should analyze an equity contract at inception and consider all possible outcomes to evaluate which component obligation(s) is predominant. The information to be considered includes the issuer's current stock price and volatility, the strike price of the instrument and other factors.

Consider a collar arrangement that is comprised of a higher strike purchased call option and a lower strike written put option that requires net share settlement. The written put option component, if freestanding, would be within the scope of ASC 480 because its value moves in the opposite direction as the fair value of the issuer's shares, pursuant to ASC 480-10-25-14(c). Once identified, the monetary value of this component obligation is assessed to determine whether it is predominant over the monetary value of the other component obligation. In this case, because the collar does not contain any other obligations (the purchased call option does not embody any obligation and therefore does not affect the classification of the entire instrument), the net settled written put component obligation governs the classification of the instrument (i.e., it is predominant). As such, the collar in its entirety should be classified as a liability (or asset) and recognized at fair value with changes in fair value recognized in earnings.

Even though the value of the purchased call option may exceed the value of the written put option at inception (i.e., a net purchased option), the instrument is within the scope of ASC 480 because the written put option component, if freestanding, would be a liability pursuant to ASC 480-10-25-14(c) as the monetary value of the issuer's obligation to deliver a variable number of shares under the written put option varies inversely in relation to changes in the fair value of the issuer's share price. The fair value would represent an asset if the fair value of the purchased option component exceeds the fair value of the written option component, and would represent a liability if the opposite were true.

Refer to sections A.5.1.1 and A.6.1.4 for further discussion of compound financial instruments.

#### 4.2.1.2 Puttable warrants and warrants on redeemable shares

Puttable warrants (refer to section 4.1.1.9) and warrants on redeemable shares are generally required to be classified as a liability pursuant to ASC 480 because they embody an obligation or are indexed to such an obligation to repurchase the issuer's shares and may require a transfer of assets by the issuer to settle the obligation.

Refer to section 5.7 for additional discussion of warrants on redeemable shares.

#### 4.2.1.3 Forward purchase contract

A freestanding forward contract for the issuer to purchase its equity shares that requires physical or net cash settlement is generally classified as a liability (or asset) because that instrument embodies an obligation that requires settlement by the issuer transferring assets (ASC 480-10-25-8 through 25-13).

If net share settlement is required, the forward purchase contract is classified as a liability pursuant to ASC 480-10-25-14(c) because that instrument embodies an obligation by the issuer to deliver a variable number of shares and the monetary value of that obligation to the holder moves inversely in relation to changes in the fair value of the issuer's equity shares. ASC 480-10-25-14(c) requires instruments with such characteristics to be classified as liabilities because they do not establish a shareholder relationship with the counterparty, as the payoff to the counterparty has an inverse relationship to changes in the fair value of the underlying equity shares.

As a result, regardless of the form of settlement, all forward purchase contracts are liabilities pursuant to ASC 480. However, the measurement attributes may be different based on the form of settlement.

Refer to sections A.5.1.1 and A.6.1.3 for additional discussion.

#### 4.2.1.4 Variable share forward

A variable share forward contract (refer to section 4.1.1.3) is an equity contract that requires the issuer to settle the contract by issuing a variable number of its equity shares (this can be in the form of a forward to sell or a net share settled forward to purchase). Because it embodies an obligation of the issuer to deliver a variable number of shares, the instrument should be evaluated pursuant to ASC 480-10-25-14. That paragraph states that financial instruments, other than an outstanding share, that embody obligations that can be settled by issuing a variable number of shares are classified as a liability (or an asset in some circumstances) if, at inception, the monetary value of the obligation is based solely or predominantly on one of several conditions, one of which is that the settlement amount has a fixed value (ASC 480-10-25-14(a)).

In a variable share forward contract, the number of shares deliverable upon settlement is determined based on the market price of the shares at the settlement date. That is, the number of shares delivered is obtained by dividing the contract price (agreed to at inception) by the fair value of the shares at settlement. In some cases, an average market price over a period of time (e.g., the last 30 days) may be used in the calculation.

Although the number of shares will be variable (based on the fair value of the issuer's shares), the holder will receive a fixed monetary value equal to the fixed contract price. In a situation where the variable number of shares to be issued is based on an average market price (e.g., an average market price for the shares over the last 30 days) instead of the share price on the date of settlement, ASC 480-10-55-22 indicates that while the monetary value of the obligation is not entirely fixed at inception and is based, in small part, on variations in the fair value of the issuer's equity instruments, the monetary value of the obligation is predominantly based on a fixed monetary amount known at inception.

Overall, the forward contract embodies an obligation for which the issuer must issue a variable number of its equity shares upon settlement. Because at inception the final settlement amount that the issuer is obligated to deliver represents a fixed monetary amount (regardless of the share price at delivery), the variable share forward should be classified as a liability pursuant to ASC 480-10-25-14(a).

Refer to section A.6.1.1 for further discussion of this concept.

#### 4.2.1.5 Range forward

The settlement of a range forward sale contract (refer to section 4.1.1.3) depends on where the share price on the settlement date falls within the ranges defined in the agreement. Because the forward seller (i.e., the issuer) may be required to deliver a variable number of its own shares, consideration of ASC 480-10-25-14 is required.

Consider the following example:

**Illustration 4-1: Range forward sale contract**

A range forward sale contract provides that, at the end of one year, the counterparty will purchase and the issuer will sell for $25 a variable number of shares of the issuer's common stock based on the average price for a period of 30 days ending on the settlement date as follows:

- If the common stock price at the settlement date is at or above $30, the counterparty will receive 0.83 shares of stock upon settlement of the contract.
- If the price of a share of the issuer's common stock at the settlement date is at or below $25, the counterparty will receive one share of stock upon settlement of the contract.
- If the price of a share of the issuer's common stock at the settlement date is between $25 and $30, the counterparty will receive a variable number of shares of the issuer's stock equal to $25 in value. For example, if the stock price is $26, the counterparty will receive approximately 0.962 ($25/$26) shares of stock upon settlement of the contract. If the stock price is $29, the counterparty will receive approximately 0.862 ($25/$29) shares on settlement.

ASC 480-10-25-14 requires liability accounting for equity contracts that embody an obligation to transfer a variable number of shares provided that the monetary value of the obligation is based solely or predominantly on: (1) a fixed monetary amount, (2) variations in something other than the fair value of the issuer's shares or (3) variations inversely related to changes in the fair value of the issuer's equity shares.

The analysis of the range forward sale contract pursuant to the three conditions in ASC 480-10-25-14 follows:

- A fixed monetary amount — The issuer is required to deliver a variable number of shares with a fixed value ($25) when the price of the issuer's stock is between $25 and $30. However, if the stock price is outside of that range, the issuer will deliver a fixed number of shares. Because the forward includes a range in which the number of shares to be delivered is variable, but the monetary value of the shares to be delivered is fixed, the instrument should be evaluated pursuant to ASC 480-10-25-14(a) to determine whether liability classification is required. Specifically, the issuer should determine whether such a fixed monetary amount is predominant with respect to the entire settlement obligation that also includes obligations to issue (1) a fixed number of shares associated with the downside range (price less than $25) and (2) a fixed number of shares associated with the upside range (price greater than $30).

Because the counterparty bears much of the potential the risks of a decreasing price for a share (if the stock declines below $25) and much of the potential benefits from an increasing price for a share (if the stock appreciates above $30), the probability of the share price at settlement being outside the range, where a fixed number of shares with a variable settlement amount is delivered, may be sufficient enough that such settlement obligation would not be considered predominant. The determination of whether the fixed monetary amount settlement is predominant should consider standard valuation theory, volatility and length to expiration, etc. Generally, the narrower the price range requiring delivery of a variable number of shares equal to a fixed monetary amount, the less likely this type of forward would be a liability pursuant to ASC 480-10-25-14(a).

- Variations in something other than the fair value of the issuer's shares — The monetary value of the obligation is based solely on the number of shares to be delivered and the share price of the issuer's common stock at settlement. Therefore, this instrument would not be classified as a liability pursuant to ASC 480-10-25-14(b).
- Variations inversely related to changes in the fair value of the issuer's equity shares — The payoff to the counterparty of the forward sale contract fluctuates positively in relation to changes in the fair value of the issuer's common stock. Although there is a range within which the monetary value does not change, outside that range they do move in a direction consistent with changes in share price. Therefore, this instrument would not be a liability pursuant to ASC 480-10-25-14(c).

Based on the analysis above, if the range equity forward would not be a liability under ASC 480, further analysis under the equity contract road map using the guidance in ASC 815-40 is necessary to determine the instrument's classification and measurement.

### 4.2.2 Box B — Equity contracts indexed to the issuer's own stock

A contract that is not in the scope of ASC 480 is evaluated under the guidance in ASC 815-40. ASC 815-40 applies to both (1) instruments that meet the definition of a derivative and are evaluated for the exception from derivative accounting pursuant to ASC 815-10-15-74(a) and (2) instruments that do not meet the definition of a derivative and are evaluated for the appropriate classification. The guidance in ASC 815-40 states that contracts should be classified as equity instruments (and not as an asset or liability) if they are both (1) indexed to the issuer's own stock and (2) classified in stockholders' equity in the issuer's statement of financial position.

To determine whether an equity contract is indexed to the issuer's own stock, it should be analyzed pursuant to the indexation guidance in ASC 815-40-15-5 through 15-8, including the related implementation guidance. There are two steps in evaluating an instrument. The first step evaluates any contingent exercise provisions and the second step requires an analysis of provisions that could change the instrument's settlement amount.

In the first step, an exercise contingency (as defined in the indexation guidance) does not preclude an instrument from being considered indexed to an entity's own stock provided that it is not based on either of the following:

a. An observable market, other than the market for the issuer's stock (if applicable)

b. An observable index, other than an index calculated or measured solely by reference to the issuer's own operations (e.g., sales revenue of the issuer, earnings before interest, taxes, depreciation and amortization of the issuer, net income of the issuer, or total equity of the issuer)

In the second step, an instrument is considered indexed to an entity's own stock if its settlement amount equals the difference between (1) the fair value of a fixed number of the entity's equity shares and (2) a fixed monetary amount or a fixed amount of a debt instrument issued by the entity. While the second step appears to be a strict fixed-for-fixed concept, an exception is provided such that if the instrument's strike price or the number of shares used to calculate the settlement amount is not fixed, the instrument could still be considered indexed to an entity's own stock if the only variables that could affect the settlement amount would be inputs to a fair value valuation model for a fixed-for-fixed forward or option on equity shares. Accordingly, any feature that adjusts the settlement amount of an equity contract should be carefully analyzed.

If based on the indexation guidance the equity contract is not considered indexed to the issuer's own stock, it would be precluded from equity classification (i.e., asset or liability classification is required).

Refer to section B.3 for further discussion of the indexation guidance.

#### 4.2.2.1 Adjustments affecting an equity contract's settlement amount, including antidilution and down round provisions

Equity contracts frequently contain provisions that adjust the instrument's terms to protect the investor (and sometimes the issuer) from a loss of value due to events that were not expected to occur or events in the control of the issuer that could be detrimental to the holder, such as merger, tender offer, nationalization, insolvency or delisting. In addition, certain other events such as a hedging disruption, increased cost of hedging, inability to borrow stock and increased cost of stock borrowing could also trigger adjustments. The basic equity instrument pricing models do not incorporate an expectation of these events, and thus the possibility of these events occurring is usually excluded from the pricing. To protect the parties from the impact of these events, the contractual agreement frequently provides that if those identified events occur, the contract terms will be adjusted. If such a provision is triggered, usually the strike price or the number of shares covered by the contract is adjusted such that the settlement amount would change to protect one party to the contract.

ASC 815-40-15-7G clarifies that certain adjustments to the fixed-for-fixed notion that were designed to compensate one of the parties to the instrument for changes in value that could not be incorporated into a pricing model should not preclude a conclusion that an instrument is indexed to the issuer's stock. It states that:

> "Standard pricing models for equity-linked financial instruments contain certain implicit assumptions. One such assumption is that the stock price exposure inherent in those instruments can be hedged by entering into an offsetting position in the underlying equity shares. For example, the Black-Scholes-Merton option-pricing model assumes that the underlying shares can be sold short without transaction costs and that stock price changes will be continuous. Accordingly, for purposes of applying Step 2, fair value inputs include adjustments to neutralize the effects of events that can cause stock price discontinuities. For example, a merger announcement may cause an immediate jump (up or down) in the price of shares underlying an equity-linked option contract. A holder of that instrument would not be able to continuously adjust its hedge position in the underlying shares due to the discontinuous stock price change. As a result, changes in the fair value of an equity-linked instrument and changes in the fair value of an offsetting hedge position in the underlying shares will differ, creating a gain or loss for the instrument holder as a result of the merger announcement. Therefore, inclusion of provisions that adjust the terms of the instrument to offset the net gain or loss resulting from a merger announcement or similar event do not preclude an equity-linked instrument (or embedded feature) from being considered indexed to an entity's own stock."

Example 17 in ASC 815-40-55-42 and 55-43 illustrates that adjustments to the terms of an instrument to offset the dilution caused by certain events would not preclude the contract from being considered indexed to the issuer's own equity. The variables (i.e., triggers) that affect the settlement amount in that example are inputs (or underlying assumptions) to the fair value of a fixed-for-fixed option on equity shares. It points out that an implicit assumption in standard pricing models for equity-linked financial instruments is that such events that could dilute the counterparty will not occur or that the strike price of the instrument will be adjusted to offset the dilution caused by such events.

For example, if the issuer were to issue shares for less than their then-current fair value, the current investors are economically diluted (because the proceeds of the sale are less than the fair value of the shares issued, the fair value per share outstanding after the issuance is reduced). Likewise, if the entity purchased shares for more than their then-current fair value, existing shareholders are diluted (the entity gives up assets with a fair value in excess of the shares repurchased, thereby reducing the fair value per remaining share).

A down round feature adjusts the settlement amount of the instrument if the issuer subsequently sells equity at a price lower than the strike price of the equity contract. Importantly, this adjustment provides protection to a particular investor in promising to give the investor the lowest pricing available to any other investors, rather than protecting against true economic dilution. The provision has been relatively common in transactions between hedge funds, private equity funds, and venture capitalists and their investees, as well as in many privately negotiated transactions by public companies (such as transactions involving privately issued convertible debt and warrants). A down round provision by itself does not preclude instruments from being considered indexed to a company's own stock. Refer to section B.3.4.1 for additional discussion of the application of the indexation guidance to instruments with down round provisions.

Refer to sections B.3.3.2, B.3.4.1 and related FAQs in Appendix B for additional discussion of adjustments to a fixed-for-fixed contract.

#### 4.2.2.2 Equity contracts executed in ISDA forms

Equity contracts that are executed using standard ISDA documentation should be carefully reviewed because they frequently contain provisions that adjust the instrument's terms, including the strike price or the number of shares upon specified events such that the settlement amount would change. Those adjustments are typically triggered upon the occurrence of antidilution or extraordinary events (e.g., merger, tender offer, nationalization, insolvency, delisting). In addition, certain other events such as hedging disruption, increased cost of hedging, loss of stock borrowing and increased cost of borrowing could also trigger adjustments, depending on what the ISDA contract defines as the adjustment events. By adjusting the terms (and thus the settlement amount) of the equity contract (or perhaps terminate the instrument in some cases), the counterparty's exposure to the risks embodied in those events is mitigated.

The second step of the indexation guidance, and the related examples, was in large part created to address certain adjustment and termination provisions found in the standard ISDA forms. Upon triggering events, the indexation guidance requires the calculation of the resulting adjustment to be commercially reasonable. The ISDA agreements stipulate that the calculation agent (as named in the ISDA confirmation) is responsible for making certain determinations, adjustments and calculations when required. The calculation agent pursuant to the ISDA Equity Definitions must act or exercise judgment in good faith and in a commercially reasonable manner. Additionally, the ISDA confirmation frequently explicitly states that whenever an adjustment or determination is made, it should be made in a commercially reasonable manner. Generally, these provisions comply with the indexation guidance but should be carefully analyzed. Entities may enter into side letters with their counterparties to override and modify provisions in the standard ISDA agreements used to execute equity contracts. These side letters should be evaluated, together with the ISDA agreements in determining the accounting for the equity contracts.

Refer to section B.3.3.2 and related FAQs in Appendix B for additional discussion of adjustments to a fixed-for-fixed contract.

### 4.2.3 Box C — Equity contracts classified in equity

If an equity contract is considered indexed to the issuer's own stock, it is next evaluated under the equity classification guidance. To determine whether a freestanding equity contract would be classified in stockholders' equity, the equity classification guidance in ASC 815-40-25-1 through 25-43 should be considered, including the related implementation guidance (primarily codified in ASC 815-40-55-2 through 55-18).

The equity classification guidance contains detailed criteria for an equity contract to be classified in equity. That determination is heavily dependent on how the instrument settles and whether an acceptable form of settlement is entirely within the control of the issuer.

The equity classification guidance generally indicates that an equity contract on a company's own stock would be considered to be classified in equity under either of the following types of settlement:

- Required physical settlement or net share settlement
- Issuer has a choice of net cash settlement or settlement in its own shares (physical settlement or net share settlement), regardless of the intent of the issuer

However, an equity contract would not be considered classified in equity if either of the following provisions is present:

- Required net cash settlement (including a requirement to net cash settle if an event occurs that is outside the control of the issuer)
- Holder has choice of net cash settlement or settlement in shares (physical settlement or net share settlement)

ASC 815-40-25-7 through 25-38 include additional conditions that should be met for equity classification. These conditions are considered to test whether the issuer will have the ability, in all cases, to effect the settlement in shares. Otherwise, net cash settlement is presumed (even if not contractually stated) and equity classification is not appropriate. Each criterion (as summarized below) should be met, and the failure to meet a single condition results in asset or liability classification:

- No explicit requirement to settle the contract in cash when registered shares are unavailable
- Entity has sufficient authorized and unissued shares
- Contract contains an explicit share limit
- No required cash payments (with the exception of penalty payments) if entity fails to timely file
- No cash-settled top-off or make-whole provisions

These criteria should be applied based on a theoretically possible standard (i.e., if it is theoretically possible that the criteria could not be met outside of the issuer's control, net cash settlement is presumed). Issuers should also evaluate the implementation guidance in ASC 815-40-55-2 through 55-6 that discusses circumstances where equity classification is appropriate despite the possibility of a cash settlement if holders of the same class of underlying shares also would receive cash in exchange for their shares.

Equity-classified contracts are initially measured at fair value (or allocated value). Subsequent changes in fair value are not recognized as long as the contracts continue to be classified in equity. In contrast, if an equity contract that was indexed to the issuer's own stock fails the requirements for equity classification, it should be classified as an asset or liability at fair value with subsequent changes in fair value recorded in earnings.

Refer to section B.4 for a comprehensive discussion of the equity classification guidance.

#### 4.2.3.1 Equity contracts executed in ISDA forms

Equity contracts executed using ISDA documentation usually contain provisions that could trigger an early termination of the instrument. For example, in an event of default, extraordinary event (e.g., merger or tender offer, etc.) or other market disruption events, one of the parties could terminate and request a settlement of the contract. In those circumstances the standard ISDA terms often specify the default settlement method.

When evaluating settlement provisions under early termination, the issuer should consider whether it has the choice to select an equity-qualified settlement method in all situations, regardless of probability of the situation occurring. Some of the standard provisions in the ISDA contract (either the Master Agreement or the Equity Definitions) invoke a net cash settlement when early termination events have occurred.

For example, the contract may stipulate cancellation and payment as the settlement method upon a tender offer. In practice, issuers may address this automatic trigger of net cash settlement by including in the ISDA confirmation language that states, notwithstanding any other terms or settlement provisions in the associated ISDA Master Agreement or Equity Definitions, that in all cases the issuer can override those provisions and choose the form of settlement. The effect of these provisions should be carefully considered in determining if conditions for equity classification are met.

#### 4.2.3.2 Equity contracts issued in registered form

Companies may issue equity contracts using a registration statement. The most common type of equity contract offered through a registration statement is a registered warrant.

Under existing securities law, the issuance of a warrant is an offer to sell the underlying share, and the exercise and settlement of the warrant is the completion of the sale of the share. This construct for registered warrants in the securities law has a significant effect on how they are analyzed under the accounting guidance because, as a general rule under the securities law, a sale that "starts public" and requires current financial information with its offer must "stay public" with similar current financial information available at its completion. In other words, if a warrant is offered in a registered form (starts public), settlement in registered shares is likely required under the securities laws (stays public).

In contrast, for a registered forward contract, the concept is slightly different. Because both parties agree to buy and sell the shares at inception and are not required to make any subsequent decision regarding the sale, the settlement of the forward is viewed as a delayed delivery of what was already agreed to at inception rather than the completion of the sale. No additional funds are being placed at risk and therefore current information in the form of timely filings is usually not necessary.

When evaluating whether an equity contract may require net cash settlement, entities are not required to consider whether settlement is required in registered shares unless the contract explicitly states that an entity must settle in cash if registered shares are unavailable. That is, an entity is not required to look beyond the contract terms to evaluate whether there is an implicit requirement to cash settle for accounting purposes. A requirement to deliver registered shares does not, in and of itself, require a contract that otherwise qualifies as equity to be classified as a liability.

Contracts that permit settlement in unregistered shares or are silent about how they will be settled when registered shares are unavailable are not precluded from being classified as equity if all other equity classification criteria in ASC 815-40 are met.

However, pursuant to ASC 815-40-25-10A, when a contract requires settlement in registered shares and explicitly states that an entity must settle in cash if registered shares are unavailable, that entity must consider its ability to deliver the registered shares.

Determining whether an entity has the ability to settle a warrant in registered shares involves consideration of both the terms of the instrument (especially the settlement methods) and securities law. Securities counsel may need to be consulted to confirm the proper application of the securities laws to the specific facts and circumstances.

#### 4.2.3.3 Warrants issued in a PIPE transaction

A private issuance of public equity (PIPE) transaction is a form of equity offering under an exemption in the securities law for qualifying private placements by issuers of publicly traded equity securities. These issuances often include both common shares and warrants issued as a separable unit, and neither instrument is registered when issued. The warrant in a PIPE transaction is subject to all of the relevant guidance for equity contracts.

Because the investor may be receiving unregistered shares on settlement, a PIPE transaction typically includes a registration rights agreement that requires the issuer to file a registration statement covering the resale of the shares initially issued and the shares to be issued under the warrant (and perhaps even the warrant itself). The purpose of a registration rights agreement is to provide the investor with liquidity for its investment.

This subsequent registration process should not be confused with a transaction where the securities are offered initially pursuant to an effective registration statement. In the case of registration at inception, the issuance takes on a public characteristic and will have to be settled publicly. In the case of the filing of a registration subsequent to initial issuance (e.g., to comply with a registration rights agreement), it is the future resale transaction of the underlying shares, rather than the existing securities being offered, that is registered. Therefore, a subsequent registration that is executed as required under a registration rights agreement generally does not flip the initial private transaction to a public transaction. Securities counsel may be needed to interpret the securities laws.

A registration rights agreement frequently includes a penalty provision if the registration is not achieved on a timely basis. That penalty provision is not relevant in assessing whether there are cash payments required if an entity fails to timely file, provided the registration rights agreement meets all the criteria in ASC 825-20, *Financial Instruments — Registration Payment Arrangements*. Refer to section 5.11 for a discussion of registration rights agreements.

### 4.2.4 Boxes D and E — Equity contracts not meeting equity classification guidance

Equity contracts (regardless of whether they meet the definition of a derivative) that (1) are not indexed to the issuer's shares or (2) are indexed to the issuer's shares but do not meet the equity classification guidance are classified as assets or liabilities and measured at fair value with changes in fair value recorded in earnings.

If these contracts meet the definition of a derivative and do not receive any scope exceptions under ASC 815, they are subject to the provisions of that guidance as a derivative, including its disclosure requirements.

To be a derivative pursuant to ASC 815, an equity contract should have all of the following characteristics:

- A derivative's cash flows or fair value must fluctuate and vary based on the changes in one or more underlyings.
- The contract contains one or more notional amounts or payment provisions, or both.
- The contract requires no initial net investment or requires an initial net investment that is smaller than would be required for other types of contracts expected to have a similar response to changes in market factors.
- The contract (1) provides for net settlement, (2) can be settled net through a market mechanism outside the contract or (3) provides for delivery of an asset that, because the delivered asset is readily convertible to cash, puts the recipient in a position not substantially different from net settlement (a gross settlement that is economically equivalent to a net settlement).

Refer to section 1.2.3 of this publication and section 2.4 of our FRD publication, ***Derivatives and hedging***, for additional guidance on the definition of a derivative.

## 4.3 Issuance costs

Companies often incur costs in connection with the issuance of equity contracts (e.g., underwriting fees, legal costs). ASC 340-10-S99-1 states that specific incremental costs directly attributable to a proposed or actual offering of equity securities may properly be deferred and charged against the gross proceeds of the offering.

Analogizing to that guidance, specific incremental costs directly attributable to the issuance of an equity contract to be classified in equity should generally be recorded as a reduction in equity. However, issuance costs for equity contracts that are classified as assets and liabilities should be expensed immediately.

## 4.4 Subsequent accounting and measurement

The subsequent accounting and measurement of an equity contract depends on the instrument's classification. An equity contract is classified in one of the following ways:

- As an ASC 480 liability (or an asset in certain circumstances) if the contract met the conditions pursuant to ASC 480-10-25-8 through 25-13 or ASC 480-10-25-14 (refer to section 4.4.1)
- As an equity instrument if the contract (regardless of whether it met the definition of a derivative pursuant to ASC 815) met the requirements of the indexation and equity classification guidance in ASC 815-40 (refer to section 4.4.2)
- As an asset or liability if the contract (regardless of whether it met the definition of a derivative pursuant to ASC 815) did not meet the requirements of the indexation or equity classification guidance in ASC 815-40 (refer to section 4.4.3)

Equity contracts may require reclassification between equity and an asset or liability subsequent to issuance. Additionally, from time to time, equity contracts may be modified or settled prior to maturity.

### 4.4.1 Equity contracts subject to ASC 480 liability classification

ASC 480 provides specific subsequent measurement guidance for forward contracts that require physical settlement by repurchase of a fixed number of the issuer's equity shares in exchange for cash. All other equity contracts within the scope of ASC 480 are measured subsequently at fair value with changes in fair value recognized in earnings, unless other accounting guidance specifies another measurement attribute.

#### 4.4.1.1 Measurement of a physically settled forward contract

A physically settled forward contract to purchase a fixed number of the issuer's shares for cash should be measured initially at the fair value of the shares at inception, adjusted for any consideration or unstated rights or privileges, with an offset to shareholder's equity. This amount would generally be expected to equal the present value of the amount to be paid at settlement.

If the settlement date and amount are both fixed, the forward should be measured subsequently at the present value of the settlement amount (i.e., forward price), accruing interest cost using the implicit rate in the forward contract. Accretion on the liability is treated as interest expense. We generally believe any dividend paid on the underlying shares prior to actual settlement should also be expensed consistent with its classification as a liability.

If a physically settled forward contract is subject to a variable redemption amount or the settlement date varies, the contract subsequently should be recognized at the amount of cash that would be paid under the specified conditions if the exchange occurred at the reporting date. The change in that amount from the previous reporting date should be recognized as interest expense.

Refer to section A.5.2 for further discussion on the measurement of contracts within the scope of ASC 480.

### 4.4.2 Equity contracts classified as equity pursuant to ASC 815-40

For equity contracts classified in equity, the instrument is not subsequently remeasured, unless it requires reclassification from equity to an asset or liability (refer to section 4.4.4).

Refer to section B.3.4.1 for discussions on the recognition and measurement of down round features in equity contracts classified in equity.

### 4.4.3 Equity contracts classified as an asset or liability pursuant to ASC 815-40

Equity contracts (whether they meet the definition of a derivative) that (1) are not indexed to the issuer's shares or (2) are indexed to the issuer's shares but do not meet the equity classification guidance are classified as assets or liabilities and measured at fair value with changes in fair value recorded in earnings.

### 4.4.4 Reclassification of equity contracts

ASC 815-40-35-8 through 35-9 require an issuer to reassess the classification of both freestanding equity contracts and embedded equity features at each balance sheet date. If the classification changes because of events occurring during the reporting period, the instrument is reclassified as of the date of the event that caused the reclassification.

The classification conclusion could change due to changes in the issuer's capital structure or other transactions (e.g., issuance of new equity contracts, issuance of shares in another transaction) that would affect whether there are a sufficient number of authorized and unissued shares for settlement of the instrument. In addition, equity contracts that provide the issuer with the choice to elect net cash settlement or settlement in its own shares may require reclassification upon the issuer's irrevocable election of net cash settlement during the settlement period. These equity contracts often have extended settlement periods (e.g., 45 days) and require the issuer to make an irrevocable settlement election at the beginning of the settlement period.

Equity contracts that do not initially meet the definition of a derivative pursuant to ASC 815 may subsequently satisfy all the characteristics of a derivative and thus, should be evaluated pursuant to ASC 815-40. For example, an equity contract may not have met the definition of a derivative if gross settlement were required and the issuer was not a public company (i.e., the underlying shares were not readily convertible to cash). That condition could change if the issuer underwent an IPO and its shares now were readily convertible to cash. In that case, the equity contract would now meet the definition of a derivative.

If reclassification from equity to an asset or liability is required, the contract is reclassified at its then-current fair value. The change in fair value of the contract during the period the contract was classified as equity should be accounted for as an adjustment to stockholders' equity. If a contract is reclassified from an asset or a liability to equity, it is measured at fair value one last time through earnings and any previous gains or losses recognized during the period that the contract was classified as an asset or a liability are not reversed.

In some cases, partial reclassification may be required for an equity contract. Refer to section B.6 for further discussion about reclassification.

### 4.4.5 Modification of equity contracts

An issuing entity may modify the terms of an equity contract from time to time. Among other potential changes, modifications may involve an increase in the number of underlying shares or a reduction in the exercise price of the equity contract (e.g., a warrant's exercise price) to induce exercise and thus raise new capital. Others may be made in connection with modifications to the issuer's other capital transactions (e.g., preferred stock).

The accounting for a modification to an equity contract depends primarily on whether the contract is classified in equity or as an asset or liability.

### 4.4.5.1 Modification of equity-classified contracts

There is no specific guidance that addresses a modification of an equity-classified contract. We generally believe the accounting for such a modification depends on the nature of, and reason for, the modification, with measurement for the modification based on analogy to the share-based compensation guidance.

The model for a modified share-based payment award that is classified as equity and remains classified in equity after the modification is addressed in ASC 718-20-35-3. Under that model, the incremental fair value from the modification (the change in the fair value of the instrument immediately before and immediately after the modification) is recognized as an expense in the income statement to the extent the modified instrument has a higher fair value. Modifications that result in a decrease in the fair value of an equity-classified share-based payment award are not recognized.

A similar model may be appropriate for measuring the effects of a modification to equity-classified contracts. However, the charge may not always be recorded in the income statement. In some cases, it may be more appropriate to record the charge in retained earnings (e.g., dividends to a particular class of equity holders). In some limited cases, the effect of the modification could be capitalized, such as when a company modifies a warrant with a third-party holder because that holder's permission is needed in order for the company to issue debt.

The accounting for modifications of equity-classified contracts requires professional judgment and should be based on the individual facts and circumstances.

#### *4.4.5.1.1 Modification or exchange of certain equity-classified written call options (after the adoption of ASU 2021-04)* [36]

Issuers should account for modifications or exchanges of freestanding equity-classified written call options (e.g., warrants) that remain equity classified after the modification or exchange based on the economic substance of the modification or exchange. For modifications or exchanges of written call options in the scope of another ASC topic, such as ASC 718, issuers should follow the guidance in those topics to account for these transactions.

The guidance in ASC 815-40-35-14 through 35-18 requires an issuer to consider the facts and circumstances of a modification or exchange of an equity-classified freestanding written call option and applies the following guidance to account for the resulting change in fair value of the written call option (measured as the difference between the fair value of the modified or exchanged written call option and the fair value of the original written call option immediately before it is modified or exchanged), based on the reason for the modification or exchange:

- To issue equity: Any increase in fair value is accounted for as an equity issuance cost that reduces additional paid-in capital under ASC 340-10-S99-1.
- To issue debt: Any increase in fair value is accounted for as a debt issuance cost or a discount under ASC 835.

[36] ASU 2021-04, *Earnings Per Share (Topic 260), Debt — Modifications and Extinguishments (Subtopic 470-50), Compensation — Stock Compensation (Topic 718), and Derivatives and Hedging — Contracts in Entity's Own Equity (Subtopic 815-40): Issuer's Accounting for Certain Modifications or Exchanges of Freestanding Equity-Classified Written Call Options (a consensus of the Emerging Issues Task Force).* The ASU is applied prospectively to all modifications or exchanges that occur on or after the date of adoption. It is effective for all entities for fiscal years beginning after 15 December 2021, and interim periods within those fiscal years. Early adoption is permitted, but entities need to apply the guidance as of the beginning of the fiscal year that includes the interim period in which they choose to early adopt the guidance.

- To modify an existing debt instrument: If the written call option is held by a creditor, any change (increase or decrease) in fair value is (1) included in the 10% cash flow test in ASC 470-50 used to determine whether to account for a modification or exchange of an existing debt instrument held by that same creditor as an extinguishment and (2) considered a fee between the debtor and the creditor when applying the guidance in ASC 470-50 on accounting for fees between a debtor and a creditor as part of a modification or an exchange of a debt instrument and in 470-60 on troubled debt restructurings. If the written call option is held by a third party that is directly involved with the debt modification or exchange, an increase (but not a decrease) in the fair value of the modified or exchanged written call option should be accounted for in the same manner as a third-party cost that is directly related to the modification or exchange of a debt instrument under ASC 470-50.
- For other reasons: Any increase in fair value is accounted for as a deemed dividend that reduces retained earnings and EPS, if the modification is not in the scope of any other US GAAP guidance.

  Refer to section 3.2.4 of our FRD publication, ***Earnings per share***, for further discussion on the effect of modifications or exchanges of equity-classified freestanding written call options on income available to common stockholders.

If a modification or exchange falls into more than one of the categories listed above (e.g., equity issuance and debt modification), the issuer must allocate any change in fair value among those aspects of the transaction and account for the amounts as described above.

#### 4.4.5.2 Modification of equity contracts classified as assets or liabilities

When an equity contract that is classified as an asset or liability and measured at fair value is subsequently modified, the effect of the changed terms will be reflected in the subsequent measurement and thus will generally be recognized in earnings. Similar to the discussion in section 4.4.5.1, depending on the facts and circumstances, the change in fair value due to the modification may be classified differently from the rest of the change in the fair value, and the classification may vary based on the nature of, and reason for, the modification.

#### 4.4.5.3 Modification of equity contracts resulting in a reclassification

Judgment should be applied in determining the appropriate accounting for a modification to an equity contract that results in its reclassification between equity and assets or liabilities. Generally, if a contract is modified such that it is reclassified to equity, an analogy to the guidance for reclassifications in ASC 815-40 would suggest that the contract be measured at fair value one last time and then reclassified. However, if an equity-classified contract was modified to result in classification as an asset or liability, analogy to the reclassification guidance in ASC 815-40 may not be appropriate. Rather, other guidance (ASC 718-20-35-3 or ASC 260-10-S99-2) might suggest recognition of some amount (for example, the difference between the fair value before and after the modification) as an expense or deemed dividend.

## 4.5 Settlement/termination

Upon settlement or termination, if an equity contract is classified as an asset or liability at fair value, the instrument is marked to its fair value at the settlement date and then the asset is realized or liability settled.

- If cash is received or paid in the settlement, it is recorded as a debit or credit for the amounts transferred.
- Any shares received or delivered are recorded at that balance in equity as treasury stock (if shares are received) or as shares issued (if shares are delivered) with appropriate allocation to common stock at par and the remainder to APIC related to common shares. If the treasury shares are considered retired, separate accounting is performed.

For certain contracts accounted for at an accreted value or settlement value (e.g., forward purchase contracts pursuant to ASC 480), a debt extinguishment model is followed, with the consideration transferred recognized at fair value, the liability relieved and any resulting difference resulting in a gain or loss.

If the instrument is classified as equity, any cash received or paid in the settlement is recorded as a debit or credit for the amounts transferred with offset to APIC. If any shares are received or delivered they are generally recorded in equity as treasury stock (if shares are received) or as shares issued (if shares are delivered) with appropriate allocation to common stock at par and APIC. If the treasury shares are considered retired, separate accounting is performed.

If an equity contract that is classified as equity is settled at an amount that is different from the contractual settlement value, the issuer should consider whether there are stated or unstated rights or privileges that should be given separate accounting consideration (similar to the treasury stock transactions described in ASC 505-30).

# 5 Selected transactions

## 5.1 Debt (or preferred share) exchangeable into common stock of another issuer

### 5.1.1 Overview and background

Debt (or preferred shares) that is exchangeable into common stock (exchangeable debt or exchangeable preferred shares) of another issuer is a security that is structured to lock in the appreciation in the fair value of the issuer's investment in another entity's common stock. These instruments have a variety of trademarked names such as DECS (debt exchangeable into common stock) and PRIDES (preferred redeemable increased dividend equity security). These instruments exclude debt (or preferred shares) exchangeable into the common stock of a consolidated subsidiary that is a substantive entity, which should be analyzed similar to convertible debt (or preferred shares). This section focuses on accounting considerations for exchangeable debt. The accounting is similar for an exchangeable preferred share.

Exchangeable debt is in many ways similar to traditional debt (e.g., a stated interest rate, par value, maturity date), except that at maturity the holders will receive either the common stock of another entity (the referenced shares) based on a formula (driven by the fair value of the referenced shares) or a cash payment in an amount equal to the fair value of the referenced shares. Therefore, the settlement amount of the debt is generally different from the par or carrying amount of the exchangeable debt.

Typically, the issuer owns the referenced shares (which generally are publicly traded) and accounts for them as equity investments measured at fair value, with changes in fair value recognized in net income (FV-NI) pursuant to ASC 321. The proceeds from the issuance often approximate the fair value of the referenced shares at issuance. The exchangeable debt permits the issuer to substantially reduce the risk of a decline in the value of its investments in the referenced shares, while retaining some of the potential appreciation through the settlement of the debt.

The following example summarizes the terms of a typical exchangeable debt transaction:

**Illustration 5-1: Exchangeable debt**

**Assumptions:**

- Company XYZ owns MNO stock, which are equity securities accounted for at FV-NI pursuant to ASC 321. At the time of acquisition, Company XYZ paid $5 for each share of MNO stock. At the date the exchangeable debt was issued, the fair value of MNO stock was $20.
- Company XYZ issues exchangeable debt with a $20 principal amount (per bond), which matures in three years and bears interest at 6%. The interest is payable on a quarterly basis.
- At maturity, Company XYZ will settle the debt at its option either by (1) delivering a number of shares of MNO stock based on the following formula or (2) paying cash equal to the fair value of the shares determined in (1):
  - If the market price of MNO stock is less than $20, Company XYZ will deliver one share of MNO stock to debt holders. Company XYZ does not bear any risk of loss in the event of a decline in MNO stock below $20 because the loss in the investment in MNO stock is offset by the decrease in the settlement obligation in the debt. This provision represents an embedded purchased put option on MNO stock at $20 per share.

- If the market price of MNO stock is between $20 and $25, Company XYZ will deliver a fractional share of MNO stock equal to $20 to debt holders. For example, if Company MNO stock is trading at $22 per share, the exchangeable debt holder would receive 0.91 shares, worth $20 ($22 x 0.91 shares). Company XYZ retains all appreciation between $20 and $25 of its investment in MNO stock.
- If the market price of MNO stock is greater than $25, Company XYZ will deliver 0.8 shares of MNO stock to debt holders. For example, if MNO stock is trading at $30 per share, the exchangeable debt holder would receive stock worth $24 in settlement of the debt. On a net basis, the company would retain 0.2 shares of MNO stock worth $6 ($30 x 0.2 shares). Thus, Company XYZ retains 20% of the MNO appreciation of MNO stock over $25. This provision is considered to be an embedded written call option on 0.8 shares of MNO stock at a strike price of $25 per share.

- In essence, the exchangeable debt holders incur the risk of loss when the market price of MNO stock falls below $20 and receive 80% of any appreciation in the stock above $25 per share.
- The exchange feature comprises two derivatives: a purchased put option (i.e., Company XYZ sells the MNO stock to the exchangeable debt holders at $20 per share if the share price is below $20) and a written call option (i.e., Company XYZ sells the MNO stock to the exchangeable debt holders at 80% of the then current fair value if the share price is above $25).
- The fair value of the embedded derivatives is determined to be $5 for the purchased put option (an asset) and $5 for the written call option (a liability) at issuance.

The accounting discussion below uses the assumptions from the above example.[37]

## 5.1.2 Analysis

### 5.1.2.1 At issuance

The exchange feature (viewed as two embedded options) is an equity-linked derivative embedded in a debt instrument. It is not clearly and closely related to the host debt instrument because it is indexed to another entity's stock (and thus does not qualify for the scope exception in ASC 815-10-15-74(a)). The issuer should bifurcate the exchange feature, unless the issuer elects the fair value option for the exchangeable debt pursuant to the guidance in ASC 815-15-25-4, which would require the hybrid instrument to be measured at fair value with any changes in fair value recognized in earnings.

ASC 815-15-25-7 through 25-10 requires separate embedded derivatives to be bundled together as a single, compound derivative instrument that would be bifurcated from the host contract. For illustration purposes, the journal entries below separately present the components of the embedded derivatives (the purchased put option and the written call option) and changes in their fair value.

[37] The transaction could potentially be decomposed differently. For example, the same economics could be expressed as the combination of (1) a prepaid physically settled forward sale contract on one share of MNO for $20 plus (2) a net share settled purchased call option with a $20 strike on one share of MNO plus (3) a net share settled written call option with a $25 strike price on 0.8 shares of MNO. The prepaid physically settled forward would consist of a debt host contract and an embedded forward contract. Thus, in this decomposition, there would be a debt host and a compound embedded derivative consisting of three components (two call options and the forward).

Pursuant to ASC 815-15, the derivative should be bifurcated at its fair value, with the residual recorded as the carrying amount of the exchangeable debt instrument.

**Illustration 5-2: Exchangeable debt — initial accounting**

The issuer would record the exchangeable debt instrument at the proceeds from issuance ($20). Pursuant to ASC 815, the embedded derivative would be bifurcated from the host instrument and accounted for separately at fair value.[38]

| | | |
|---|---|---|
| Cash | $ 20 | |
| Purchased put option | 5 | |
| Debt | | $ 20 |
| Written call option | | 5 |

### 5.1.2.2 Subsequent accounting

Assume that as of the next balance sheet date, the fair value of MNO stock has increased to $30.

#### *5.1.2.2.1 Exchangeable debt*

Interest expense (including amortization of any issuance costs, premiums or discounts, etc.) would be recognized using the effective interest method pursuant to ASC 835-30-35-2 through 35-5.

#### *5.1.2.2.2 Bifurcated derivative*

As the fair value of the MNO stock increases above $25, the liability for the written call option increases in value while the asset for the purchased put option decreases in value.

**Illustration 5-3: Exchangeable debt — subsequent accounting**

Assume the fair value of the purchased put option decreased by $2 for time value decay (with no change in intrinsic value) and the fair value of the written call option liability increased by $3, consisting of a $1 decrease in time value and a $4 increase in intrinsic value (as the shares increased to $30, the increase in the intrinsic value of the written call option is calculated as 80% of the $5 gain in excess of $25).[39]

| | | |
|---|---|---|
| Expense[40] | $ 5 | |
| Purchased put option | | $ 2 |
| Written call option | | 3 |

[38] Only for illustration purposes, the journal entry separately presents the components of the embedded derivatives (the purchased put option and the written call option) and changes in their fair value. Under US GAAP, they should be bifurcated and separately accounted for from the host debt instrument as one compound derivative.

[39] Only for illustration purposes, the journal entry separately presents the components of the embedded derivatives (the purchased put option and the written call option) and changes in their fair value. Under US GAAP, they should be bifurcated and separately accounted for from the host debt instrument as one compound derivative.

[40] ASC 815 does not specify the classification of changes in the fair value of derivatives, but requires disclosure of where the changes are reported in the statement of financial performance.

#### *5.1.2.2.3 Investment in MNO*

Consistent with ASC 321, the MNO shares would continue to be accounted for as equity investments measured at FV-NI.

**Illustration 5-4: Exchangeable debt — subsequent accounting (continued)**

Company XYZ would mark its investment in MNO stock to $30 per share and the incremental unrealized gain of $10 ($30 current market price less the $20 market price at issuance of the exchangeable debt) would be reflected in net income.

| | | |
|---|---|---|
| Investment in MNO | $ 10 | |
| Other income (expense) | | $ 10 |

### 5.1.2.3 At maturity

At maturity, the exchangeable debt obligation would be extinguished. The time value of the options would have declined to zero. The exchange feature would be settled. Any delivery of shares of MNO stock in satisfaction of the obligation would be recognized as a sale of equity investments. Because the changes in fair value of MNO stock are reported in earnings as they occur, there is no gain or loss recognized when these investments are sold.

**Illustration 5-5: Exchangeable debt — accounting at maturity**

Continuing with the example, assume the value of MNO stock remained at $30 per share.

As the remaining time value in the purchased put option decreased $3 to zero and the remaining time value in the written call option liability decreased $4 to zero, with no further change in intrinsic value as the fair value of MNO stock remained at $30, the embedded features would be adjusted through income as follows[41]:

| | | |
|---|---|---|
| Written call option | $ 4 | |
| Purchased put option | | $ 3 |
| Income | | 1 |

The ending balance of the written call option is a $4 liability before settlement.

The settlement of the debt, exchangeable feature and the sale of investment in MNO stock would be recorded as follows:

| | | |
|---|---|---|
| Debt | $ 20 | |
| Written call option | 4 | |
| Investment in MNO (80% x $30) | | $ 24 |

## 5.1.3 Exchangeable preferred shares

Typically, an exchangeable preferred share would likely be classified as a liability pursuant to ASC 480-10-25-4 because the share is mandatorily convertible into another entity's shares or settled in cash and, therefore, embodies an unconditional obligation to settle the preferred stock by transferring assets (i.e., either the issuer's investments in another entity's stock or cash) at maturity. An exchangeable preferred share should generally be analyzed similar to exchangeable debt.

[41] Only for illustration purposes, the journal entry separately presents the components of the embedded derivatives (the purchased put option and the written call option) and changes in their fair value. Under US GAAP, they should be bifurcated and separately accounted for from the host debt instrument as one compound derivative.

## 5.2 Unit structures

### 5.2.1 Overview and background

Unit structures are a combination of (1) debt or preferred stock and (2) a warrant or a forward contract to purchase the issuer's common stock. When viewed on a combined basis, the instruments provide the holder with the economics of a convertible instrument. Some recent structures have used convertible preferred stock and a forward contract.

Below are examples of typical unit structures, each of which include a summary of the significant terms of the unit structure and the related accounting analysis. For EPS considerations, refer to section 6.5 of our FRD publication, ***Earnings per share***.

#### 5.2.1.1 Unit structure — Debt instrument

**Illustration 5-6: Unit structure with a senior unsecured note**

Company A (the issuer) issues 1 million units to investors in a public offering at $100 per unit. Each unit comprises (1) a three-year variable-share forward purchase contract (the forward contract) and (2) a five-year senior unsecured note with a principal amount of $100. Key terms of the securities are as follows:

- The note will pay interest at a fixed rate of 1% and mature in five years. At the end of three years, the note will be remarketed. Company A has the option to remarket the notes beginning after two years and nine months. Upon the remarketing, the interest rate of the note will be reset such that the proceeds from the remarketing are equal to or greater than the $100 principal amount.
- The forward contract provides that, at the end of three years (the stock purchase date), investors will purchase and the issuer will sell for $100 a number of shares of the issuer's common stock as follows:

| Common stock price* | Number of common shares delivered at settlement |
|---|---|
| Greater than or equal to $120 | 0.83 shares |
| Greater than $100 and less than $120 | Variable number of shares equal to $100 in value |
| Equal to or less than $100 | 1 share |

* Generally based on the weighted average common share price for a period immediately preceding the stock purchase date.

- The forward contract requires the issuer to make quarterly payments to the investors at an annual rate of 6% during the term of the forward contract (the contract adjustment payments). The issuer has the right to defer all or part of these payments until the stock purchase date. Any deferred contract adjustment payments would accrue additional amounts at the rate of 7% (i.e., the rate of total distributions on the units that includes the interest on the note of 1% plus the contract adjustment payment of 6%) until paid, compounded quarterly to, but excluding, the stock purchase date. The issuer can elect to settle these payments in cash, shares or a combination of both.
- The interest rate of 1% is the market rate for the issuer based on its credit rating and the terms of the notes at issuance. Therefore, the fair value and par value of each note equals $100 (i.e., there is no premium or discount). The forward contract has an assumed fair value of $16 per unit, which equals the present value of the contract adjustment payments.
- Holders of the units will initially pledge their ownership interests in the notes to secure their obligations to purchase common shares under the forward contracts. If a holder wants to participate in the remarketing of the notes, they must substitute their ownership interests in the notes with US Treasury securities.

#### 5.2.1.1.1 *Analysis*

The first step is the unit of account evaluation. The issuer should determine whether the debt and the forward contract should be accounted for as freestanding financial instruments. ASC 480 defines a freestanding financial instrument as one that is entered into (1) separately and apart from any of the entity's other financial instruments or equity transactions or (2) in conjunction with some other transaction and is legally detachable and separately exercisable.

The debt and equity-linked instrument (warrant or forward) in a typical unit structure generally are considered freestanding financial instruments because the holder can transfer and settle the equity-linked instrument separately from the debt. However, in some circumstances, the economic substance of multiple freestanding financial instruments issued in a single transaction may suggest that accounting for them on a combined basis is more appropriate. ASC 815-10-15-9 provides a list of indicators that an issuer should consider in determining whether two or more freestanding financial instruments should be combined and accounted for as one unit. Furthermore, the non-authoritative guidance in pre-Codification Emerging Issues Task Force (EITF) 02-2, *When Certain Contracts That Meet the Definition of Financial Instruments Should Be Combined for Accounting Purposes*, discusses a similar concept related to combination. Judgment is required given the facts and circumstances to determine whether freestanding contracts should be combined for accounting purposes. Refer to section 1.2.1 for further discussion on evaluating the unit of account when multiple instruments are issued in a single transaction.

In the unit structure described in Illustration 5-6, the debt and the forward contract do not share the same risk because the debt does not include any embedded equity-linked features (e.g., conversion option). Practice has developed that they are generally accounted for separately even though (1) the unit holder may in certain circumstances use the proceeds received from the remarketing of the debt (or if the remarketing is unsuccessful, the debt itself) to satisfy the exercise price of the forward contract and (2) the unit holder typically will be required to post collateral to secure its obligation under the forward purchase contract if the unit is separated and the debt transferred.

Once the unit of account is determined, the issuer should consider the allocation of proceeds and the accounting for each instrument. Because there are two freestanding financial instruments issued in the transaction, the proceeds should be allocated between them. The allocation method should be determined after considering the instruments' classification and measurement bases. In a unit structure, the relative fair value method is normally applied to allocate proceeds because the equity-linked instrument is generally classified in equity and the note is carried at amortized cost.

Next, the forward contract is analyzed as a freestanding equity-linked instrument. The guidance in ASC 480 related to determining whether certain contracts settled in shares are classified as a liability should be evaluated.

In this example, the issuer is required to deliver a variable number of shares with a fixed value of $100 when the price of the company's stock is between $100 and $120 at the end of three years (the stock purchase date). However, if the stock price is outside of that range, the issuer will deliver a fixed number of shares. Because the forward includes a range in which the number of shares to be delivered is variable, but the monetary amount of the shares to be delivered is fixed, the instrument should be evaluated pursuant to ASC 480-10-25-14 to determine whether liability classification is required. Specifically, the issuer should determine whether the fixed monetary amount (when the share price is between $100 and $120) is predominant with respect to the entire settlement obligation that also includes obligations associated with the downside (share price equal to or less than $100) and upside (share price greater than or equal to $120) ranges.

Because the unit holder bears the risks of owning a share of stock if the stock declines below $100 and much of the potential rewards of owning the stock if the stock appreciates above $120, the probability of the share price at settlement being in the outer ranges may be sufficient such that the settlement obligation would not be considered predominantly based on a fixed monetary amount known at inception. The determination of whether the stock price falling in the fixed monetary amount settlement range is predominant should consider all possible outcomes and information, such as the current stock price,

volatility, strike price and equity growth assumptions. Company A performs an assessment and determines that the settlement outcome between $100 and $120 would not be the predominant outcome, and the forward would not be classified as a liability under ASC 480.

The forward contract should be further analyzed pursuant to ASC 815-40 to determine its appropriate classification and measurement. Generally, the forward contract can be structured to meet the criteria for equity classification and would not require subsequent remeasurement at fair value as an asset or liability. Terms of the forward should be carefully considered in light of the indexation and equity classification guidance in ASC 815-40 to ensure the appropriate classification of the forward.

The contract adjustment payments are accounted for as a liability as it embodies an obligation of the issuer to make payments during the three-year contract period. As the present value of the contractual adjustment payments essentially represents a financing of the premium that the issuer was required to pay to enter into the forward contract, it typically approximates the initial fair value of the forward contract. The accounting for the contract adjustment payments is in accordance with ASC 835-30, *Interest — Imputation of Interest*. Accordingly, the present value of the contract adjustment payments is recorded as a liability (with an offset in equity as it is a premium paid for the forward contract) and subsequently accretes and settles periodically over the term of the forward contract, with the resulting expense recognized as interest.

Under the relative fair value allocation method, the initial entry to record the issuance of the units (assuming (1) the proceeds equal the fair value of the note, (2) the forward contract qualifies for equity classification, and (3) the present value of the contract adjustment payments equals the fair value of the forward contract) is as follows (in millions):

| | | | | |
|---|---|---|---|---|
| Cash | $ | 100 | | |
| APIC (to recognize the forward contract) | | 16 | | |
| Note payable | | | $ | 100 |
| Contract adjustment payment liability | | | | 16 |

Any issuance costs incurred should generally be allocated to the two instruments issued concurrently. In this example, the portion of issuance costs allocated to the note should be recorded as a direct reduction from the note payable, resulting in a discount on the note payable that is amortized as interest expense using the interest method as described in ASC 835-30. The portion of issuance costs allocated to the forward contract should be recognized as a reduction in equity.

Refer to section 2.3 for further discussion on the allocation of issuance costs.

Refer to section 6.5 of our FRD publication, ***Earnings per share***, for a discussion of related EPS issues.

### 5.2.1.2 Unit structure — Convertible preferred stock

**Illustration 5-7: Unit structure with convertible preferred stock**

Company A (the issuer) issues $100 million of units to investors in a public offering at $100 per unit. Each unit consists of (1) a three-year variable-share forward purchase contract (the forward contract) and (2) one share of 0% Series A Convertible Preferred Stock (the convertible preferred stock) of Company A, with no par value and a liquidation preference of $100 per share. Key terms of the securities are as follows:

*Convertible Preferred Stock*

- The convertible preferred stock has an initial dividend rate of 0%. At the end of three years, the shares will be remarketed. Company A has the option to remarket the stock beginning after two years and nine months. Upon the remarketing, key terms of the convertible preferred stock, including dividend rate, conversion rate and optional redemption date may be modified to realize proceeds from the remarketing equal to or greater than the $100 liquidation preference. Dividends may be paid in cash, common stock or a combination of both at Company A's option.

- On or after three years, holders can convert the convertible preferred stock at any time. The conversion rate is initially 0.83 common shares per preferred share, which equates to an initial conversion price of $120 per share. The conversion rate is subject to adjustment in certain circumstances (e.g., when dividends are paid to common shareholders above a stated per-share amount equal to the issuer's normal dividend). Upon conversion, the settlement amount can be settled in cash, shares or a combination of both at Company A's option.
- Company A can redeem the shares on or after three years at the liquidation price of $100 per share plus any accumulated but unpaid dividends.
- Holders of the units will initially pledge their ownership interests in the convertible preferred stock to secure their obligations to purchase common shares under the forward contracts. If a holder wants to participate in the remarketing of the convertible preferred stock, they must substitute their ownership interests in the convertible preferred stock with US Treasury securities.

*Forward Purchase Contract*

- The forward contract provides that, at the end of three years (the stock purchase date), investors will purchase and the issuer will sell for $100 a number of shares of the issuer's common stock as illustrated in the following table. The number of shares to be delivered at settlement is subject to adjustment in certain circumstances (e.g., when dividends are paid to common shareholders above a stated per share amount equal to the issuer's normal dividend).

| Common stock price* | Number of common shares delivered at settlement |
|---|---|
| Greater than $100 | Variable number of shares equal to $100 in value |
| Equal to or less than $100 | 1 share |

* Generally based on the weighted average common share price for a period immediately preceding the stock purchase date.

- The forward contract requires the issuer to make quarterly payments to the investors at an annual rate of 7% during the term of the forward contract (the contract adjustment payments). The issuer has the right to defer all or part of these payments until the stock purchase date. Any deferred contract adjustment payments would accrue additional amounts at the rate of 7% until paid, compounded quarterly to, but excluding, the stock purchase date. The issuer can elect to settle these payments in cash, shares or a combination of both.
- The forward contract has an assumed fair value of $16 per unit, which equals the present value of the contract adjustment payments.

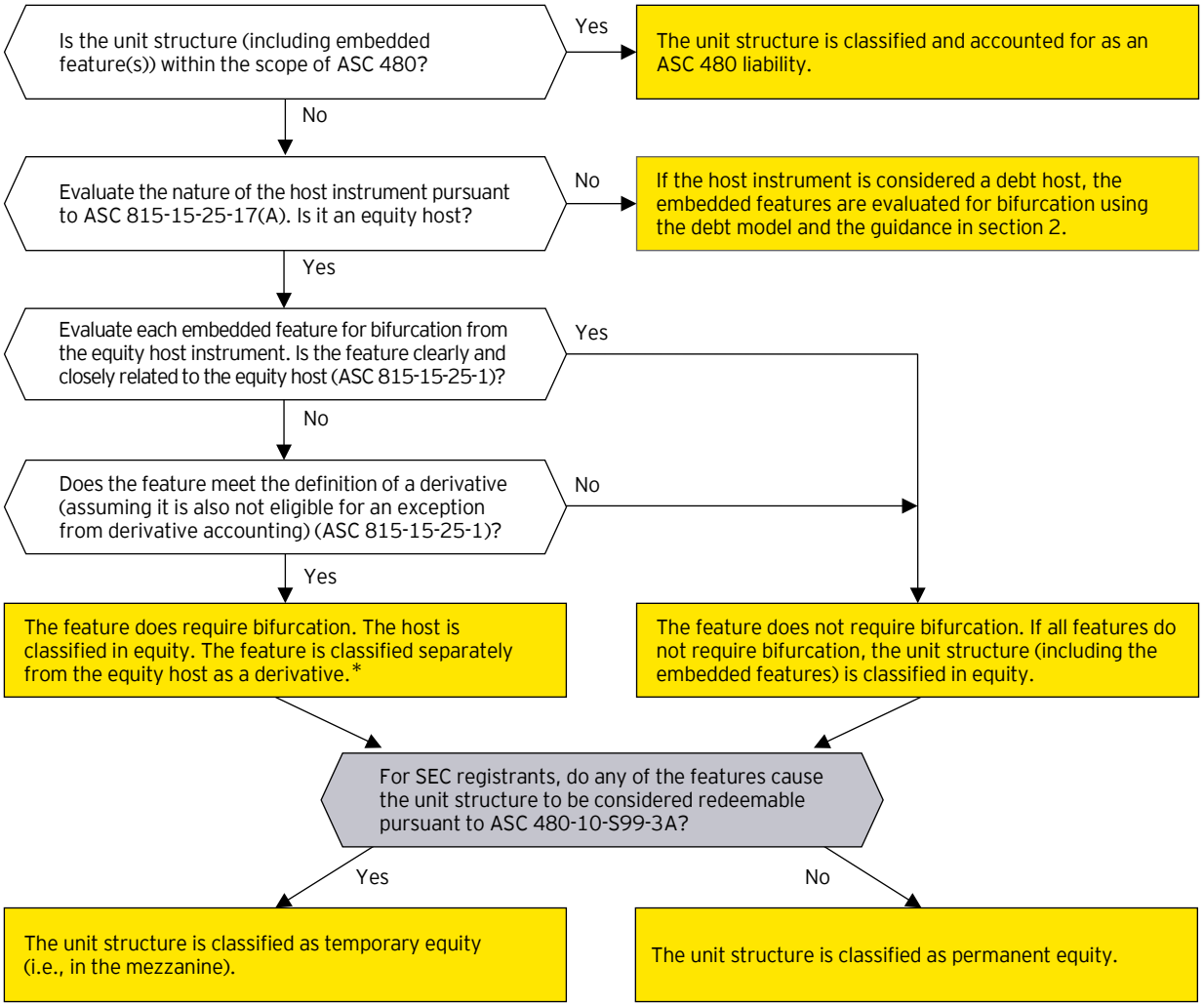
#### 5.2.1.2.1 *Analysis*

Consistent with the analysis above for the unit structure with a debt instrument, the issuer first considers the definition of a freestanding financial instrument under ASC 480. It determines that the convertible preferred stock and the forward contract are freestanding financial instruments because the holder can transfer and settle the forward separately from the stock. However, because the convertible preferred stock and the forward contract were entered into in contemplation of one another and share the same risk (i.e., they are both impacted by changes in the price of common stock), further evaluation of the combination guidance in ASC 815-10-15-9 and EITF 02-2 is warranted. In making the determination of whether the two freestanding financial instruments should be combined, the issuer should consider the facts and circumstances and focus on the economic substance of the unit structure as a whole.

If, based on this assessment, the issuer concludes that combination is not required, it needs to separately assess the two instruments for classification. However, if the issuer concludes that the instruments should be combined, it needs to assess the forward as an embedded feature within the convertible preferred share.

In this fact pattern, the convertible preferred stock and the forward contract are combined and accounted for as one unit based on an analysis of the relevant facts (e.g., they share the same risk). In other words, the forward contract is considered an embedded feature within the convertible preferred stock (together, they are the unit structure). This evaluation will require significant judgment based on facts and circumstances of the arrangement.

The combined instrument represents mandatorily convertible preferred stock with embedded equity-linked features (the forward contract, conversion option and redemption option). Company A needs to evaluate the combined instrument under ASC 480 and ASC 815 to determine how the unit structure should be classified and whether any embedded features require bifurcation and derivative accounting. Refer to the following flowchart to determine the classification of a unit structure that is accounted for as a combined instrument.




* If more than one feature requires bifurcation, bifurcate a single derivative that comprises all of the individual features requiring bifurcation and classify that derivative as an asset or a liability.

Units that require settlement in a variable number of common shares with a monetary value equal to a fixed or predominantly fixed amount may require liability classification pursuant to ASC 480. In this example, the issuer is required to deliver a variable number of shares with a fixed value of $100 when the price of the company's stock is above $100 at the end of three years (the stock purchase date). However, if the stock price is below $100, the issuer will deliver a fixed number of shares.

Because the unit structure includes a range in which the number of shares to be delivered is variable, but the monetary amount of the shares to be delivered is fixed, the unit structure should be evaluated pursuant to ASC 480-10-25-14 to determine whether liability classification is required. The issuer should consider all possible outcomes and information (such as the current stock price, volatility, strike price and equity growth assumptions) in making the determination. Whether a settlement is based "predominantly" on a fixed monetary amount known at inception requires judgment on the basis of facts and circumstances. Refer to section 5.2.1.1.1 above for a detailed discussion of the evaluation under ASC 480-10-25-14.

If the unit structure is not classified as a liability under ASC 480 because settlement within the range of the fixed monetary amount is not considered "predominant," the unit structure should be further analyzed pursuant to ASC 815. This includes determining (1) the nature of the host contract in the convertible preferred stock; (2) whether the economic characteristics and risks of the embedded feature are clearly and closely related to the host contract; (3) if they are not clearly and closely related to the host contract, whether any embedded features meet the definition of a derivative; and (4) if any feature meets the definition of a derivative, whether any scope exception from ASC 815 applies (e.g., ASC 815-10-15-74(a)). Furthermore, the issuer may be required to consider the guidance in ASC 480-10-S99-3A to determine whether temporary equity classification is required for the convertible preferred stock.

One acceptable view is that the present value of the contractual adjustment payments essentially represents a financing of the premium that the issuer was required to pay to enter into the forward contract and is recorded as a liability (with an offset to the preferred stock, since it is a premium paid for the forward contract that is embedded in the preferred stock). The liability subsequently accretes and settles periodically over the term of the forward contract, with the resulting expense recognized as interest.

The initial entry to record the issuance of the units (assuming (1) the $100 million of proceeds equals the fair value of the stock, (2) the present value of the contract adjustment payments is $16 million, and (3) no embedded features require bifurcation) is as follows (in millions):

| | | | | |
|---|---|---|---|---|
| Cash | $ | 100 | | |
| 0% Series A Convertible Preferred Stock | | 16 | | |
| 0% Series A Convertible Preferred Stock | | | $ | 100 |
| Contract adjustment payment liability | | | | 16 |

Any issuance costs incurred may be allocated entirely to the convertible preferred stock on the basis that the costs were primarily incurred to obtain equity financing or could be allocated to the preferred stock and the contract adjustment payment liability. Refer to section 2.3 for further discussion on the allocation of issuance costs.

Refer to section 6.5 of our FRD publication, ***Earnings per share***, for a discussion of related EPS issues.

## 5.3 Auction rate securities (including failed reset auctions)

### 5.3.1 Overview and background

Traditional auction rate securities (ARSs) are typically issued by corporate entities as well as not-for-profit entities, such as hospitals, municipalities or related governmental entities (e.g., cities, counties, school districts, publicly owned airports and seaports) and educational institutions. Fund proceeds are used for projects such as new facilities, housing for municipalities and student loan programs for various educational institutions. ARSs are often regarded as attractive investments because they offer yields higher than other liquid investments, particularly when investors benefit from the tax-exempt status of the issuer.

ARSs are long-term (typically 20 years or longer) variable-rate securities with interest rates (or dividend rates if issued in a form of preferred securities) that reset at short term intervals, usually 7, 14, 28 or 35 days through a "Dutch Auction" process. A Dutch Auction is a competitive bidding process used to determine rates for ARSs on each auction date. Typically, bids are submitted to the auction agent. Each bid and order size is ranked from lowest to highest minimum bid rate. The lowest bid rate at which all the securities can be sold at par establishes the interest rate, otherwise known as the "clearing rate." New buyers wishing to purchase ARSs may submit a bid on the day of the auction. Investors that desire to continue holding their ARSs are notified of the new market rate determined in the auction process. Because the securities are frequently repriced through the auction process, they trade in the market like short-term investments.

The issuer's accounting for an auction rate security is similar to the accounting for variable-rate debt, with the interest accrued based on the rate set at the most recent auction. However, if an auction fails (i.e., not enough bids, therefore no auction clearing rate is available), the ARS often has a mechanism by which the pre-auction holders continue to hold the instrument and the interest rate on the security defaults to a formulaic rate (penalty interest).

Due to disruptions in the credit markets in late 2007 and early 2008, many auctions failed. Such events raise several financial reporting issues for issuers, including balance sheet classification, accounting for penalty interest expense, implications for continued use of hedge accounting and consideration of the failed auction as an event of default or cross-default of other debt arrangements. In addition, issuers may modify ARS indentures, raising issues related to extinguishment or modification accounting, debt issuance costs and balance sheet classification.

## 5.3.2 Analysis

### 5.3.2.1 Entities sponsoring trusts or SPEs issuing ARSs

The market for traditional ARSs has evolved and ARSs have also been issued by trusts and other special-purpose entities (SPEs) in various forms, including collateralized debt obligation (CDO) arrangements. In these situations, various tranches of securities are issued with different levels of seniority, subordination and risk. The most senior tranche issued typically represents an ARS while subordinate tranches are lower rated non-ARS securities either retained by an entity sponsoring the trust or SPE or sold to third-party investors. Sponsoring entities of trusts or SPEs issuing ARSs may provide financial support to prevent an auction from failing by participating in auctions of those ARSs. Without this support, an auction may fail due to insufficient demand. In those cases, sponsoring entities should evaluate whether such support constitutes a variable interest that could require consolidation pursuant to ASC 810. See section 5.4.12 of our FRD publication, ***Consolidation***, for more guidance on identifying implicit variable interests. If a trust or SPE is involved, the analysis below would apply to a sponsor if the sponsor consolidates the trust or SPE after evaluating the provisions of the variable interest entity model.

### 5.3.2.2 Considerations when auction fails

#### *5.3.2.2.1 Penalty interest*

The terms of many ARSs provide for an increased interest rate in the event of a failed auction. In many cases, that rate is a multiple of the typical auction reset rate. The higher rate is in effect until the next auction. The issuer would account for this increased interest expense as incurred.

#### 5.3.2.2.2 *Extinguishing or modifying ARSs*

ARSs may be issued in the form of debt or preferred stock. The form of the instrument may determine the accounting for any extinguishment or modification of the instrument.

If an issuer extinguishes ARSs issued in the form of debt, it should account for the extinguishment pursuant to ASC 470-50-40-2. If an issuer modifies the terms of the ARS (e.g., by negotiating a change to the failed auction default interest formula or even a different interest index entirely), the issuer should determine whether the modification should be accounted for as a troubled debt restructuring pursuant to ASC 470-60. If not a troubled debt restructuring, the guidance in ASC 470-50 requires a substantial modification of the ARS terms for the modification to be accounted for as an extinguishment. This guidance also addresses the accounting for fees exchanged between the issuer and investor, third-party costs incurred as part of a debt restructuring, as well as whether an investment bank involved in a debt restructuring is acting as an agent or a principal.

If an issuer decides to extinguish ARSs issued in the form of a preferred security, provided that the preferred security is classified in equity, extinguishment accounting pursuant to ASC 260-10-S99-2 should be applied. However, any modification to the terms of preferred stock should be carefully evaluated to determine if extinguishment accounting is appropriate.

Some ARSs may have existing contractual terms that can be invoked by the issuer under certain circumstances, giving the issuer the ability to reset the interest rate mechanism of the instrument to a market-based variable index or perhaps even a fixed rate. This is sometimes referred to as an "interest mode change." While this change is likely not a modification of the instrument, as the issuer is exercising a contractual term (rather than amending the ARS), the specific facts and circumstances and contractual terms of the ARS should be considered. If a provision is not present in the ARS security, yet the issuer negotiates a modification to the contractual terms (either on its own initiative or after being contacted by investors or an investment bank) or the ability to effectuate the mode change is not entirely within the control of the issuer, the guidance on modification accounting should be considered.

#### 5.3.2.2.3 *Balance sheet classification*

ARSs issued in the form of debt generally have legal maturities of at least 20 years and thus are generally classified as long-term debt. ARS indentures and related documents should be reviewed to determine if a failed ARS auction may trigger current classification (e.g., is deemed an event of default permitting the investor to put the instrument to the issuer) or cross-defaults in other arrangements.

If financial statements have not been issued, an issuer's actions subsequent to that balance sheet date may affect whether the ARS should be classified as current or noncurrent as of that balance sheet date. For example, subsequent to the balance sheet date but prior to the issuance of the financial statements, assume an issuer extinguishes the outstanding ARS by either the use of current assets or funding with short-term liabilities (e.g., the issuance of commercial paper) or tries to support the intent to refinance with a financial arrangement that does not meet the criteria in ASC 470-10-45-14. In that case, the ARS may require current classification as of the balance sheet date.

However, if the issuer modifies the ARS such that an extinguishment is deemed to occur, and the new debt instrument would qualify as long-term, the modified ARS outstanding at that balance sheet date would retain noncurrent classification. Issuers engaged in extinguishment or modification transactions should provide appropriate disclosure of the subsequent events.

#### 5.3.2.2.4 *Bidding on borrower's own ARSs*

In a letter dated 14 March 2008,[42] the SEC staff clarified that issuers could participate in bidding activities without being considered market making for their own securities. To prevent failing auctions that may trigger a frequently higher failed auction formula rate, issuers of ARSs began to participate (i.e., bid) in the auction of their own ARSs.

Issuers should consult with their legal counsel in connection with any decision to participate in auctions of their own securities, as well as on any related disclosures. If an issuer participates and wins the bid of an auction for its ARSs, those acquired ARSs should be extinguished pursuant to ASC 405-20-40-1. As a result of the issuer acquiring its own debt, the issuer is considered to have extinguished that portion of the ARS liability. Any related issuance costs associated with the portion of ARSs that have extinguished should be written off pursuant to ASC 470-50-40-2.

Before concluding on extinguishment accounting, however, an entity should consider whether it has bid on and acquired debt that it actually issued. If the entity is the named issuer of the acquired debt (e.g., it has acquired the specific instrument that is classified as debt in its own balance sheet) that instrument has been extinguished. In contrast, many ARSs are issued through trust or SPE structures, and the sponsoring entity is not the issuing entity of the ARSs. Rather, the sponsoring entity issues notes to the trust or SPE in exchange for the proceeds the trust or SPE received from issuance of the ARSs to external investors.

If the sponsoring entity does not consolidate the issuing trust or SPE and thus does not recognize the ARSs in its consolidated financial statements, the acquisition of these ARSs by the sponsoring entity may not constitute an extinguishment of its liability. Judgment should be applied in these situations in determining whether the issuer's obligation has been extinguished.

## 5.4 Remarketable put bonds

### 5.4.1 Overview and background

A remarketable put bond is a security that typically has a long-term maturity (e.g., 10 years), but contains put and call features that are exercisable prior to maturity (e.g., two years). A typical remarketable put bond has put and call features with the same strike prices and exercise dates, but different counterparties (with the issuer writing a put to the investor and the investment bank purchasing a call from the investor). There is also an interest rate reset provision at the put/call date. These terms are described below:

- The put feature is an option written by the issuer to the investor and embedded in the bond. If interest rates have increased at the put date, the investor will put the debt back to the issuer, generally at par.
- The call feature is purchased by the investment bank from the investor. It is bundled with the debt issued to the investor but not embedded by the issuer, so it is not evaluated for the issuer's accounting. If interest rates decrease, an investment banker has the right to call the bonds from the current investors, generally at par.
- The embedded interest rate reset feature automatically resets the bond's interest rate if it is outstanding (i.e., is not put) at the end of two years. This reset is typically based on (1) the yield, at the issuance date of the puttable bond, of US Treasury bonds of the same maturity as the bond and (2) the debtor's credit spread at the put/call date. The interest rate reset feature generally results in a new interest rate that is above market at the time of the reset because the investor will likely only not exercise their put when interest rates have decreased.

[42] http://www.sec.gov/divisions/corpfin/cf-noaction/2008/mars031408.pdf.

At the end of the two-year term, the security is either put or called, regardless of changes in interest rates. If put (by the investor), the bond will be settled; if called (by the investment bank), the bond's interest rate will reset and the investment bank will remarket the bond as a new debt with the same remaining maturity as the bond (i.e., eight years).

Economically, the bond in its initial form is priced as a bullet obligation with a maturity at the put/call date. For example, a remarketable put bond that has a 10-year maturity with put and call features exercisable in two years, is priced based on a two-year interest rate at inception. The issuer is able to lower its funding cost (in a form of reduced initial interest rate or receipt of premium) prior to the put and call date by providing the investor with the interest reset feature and put feature.

If interest rates increase, the investor will likely exercise the put feature and the debt will be settled. The issuer keeps the premium (or has enjoyed the lower interest rate), which reduces its overall borrowing cost. If interest rates decrease, the investment bank will likely exercise the call, which will cause the interest to reset and the bond to be remarketed. If remarketed successfully, the bond will continue to be outstanding for the remaining life (eight years in the example above), but bear a rate higher than market based on the reset mechanism.

The new rate on the bond is higher than the market rate at the time of remarketing due to the reset formula starting with the US Treasury rates from the initial issuance. Thus, the bonds are reissued at a premium and these additional proceeds allow the investment bank to monetize the value of the call option it had exercised to purchase the bonds. However, since the bonds are issued at a premium, and a holder has no rights in bankruptcy associated with the premium, the reset formula will provide an even higher interest rate at reissuance for this added risk. Issuers may want to avoid this increased rate. Therefore, the issuer may work with another investment bank (or perhaps the same investment bank that holds the call option) to purchase the existing bonds and exchange them for new bonds that bear interest at a current market rate but with a higher face amount. In this case, the investment bank captures the call option's intrinsic value through a higher face value in the new bonds.

## 5.4.2 Analysis

**Initial accounting:**

Remarketable put bonds are structured in a wide variety of forms and may contain different features. Any puts or calls that are associated with the instruments should be closely evaluated to determine (1) if the issuer of the debt is also a counterparty to that put or call and (2) if the put or call is embedded in the debt or freestanding. Based on those conclusions, the embedded feature or freestanding instrument would be evaluated pursuant to the derivatives guidance. ASC 815-15-55-26 through 55-53 provides several examples of alternative remarketable put bond structures and describes at a high level the accounting analysis of the embedded and freestanding features (refer to section 2.2.5 for guidance on evaluating embedded put and call features). The interest rate reset feature is also an embedded feature that should be evaluated for bifurcation pursuant to ASC 815-15.

**Subsequent accounting:**

As discussed above, in an increasing rate environment, the investor will likely exercise its put option, resulting in settlement of the existing bonds. The derecognition guidance in ASC 405-20-40-1 should be considered. Debt is extinguished if a debtor repays outstanding debt with existing funds or refinances an old debt through issuance of a new debt to new creditors.

In a decreasing rate environment, the investment bank will likely exercise its call option, in which case the bond's interest rate will reset to a rate higher than market due to the reset mechanism. The investment bank will then remarket (sell) the bond bearing the new interest rate to new investors at a premium (premium bond). In some cases, issuers may modify the terms of the remarketed bond by increasing its

face value (to an amount equal to the proceeds that would have been received by the investment bank on the premium bond). Concurrent with the increase in the face value, the issuer would reduce the stated interest rate on the bond to a market-based rate appropriate to the debt with the same maturity as the remarketed bond. The investment bank would be indifferent between remarketing a premium bond with an above-market interest rate and remarketing a bond with a higher face value issued at par with an at-market rate of interest because the proceeds it receives from the remarketing would be the same.

Because these modifications (i.e., the increase in the face value and the decrease in the interest rate) are not contemplated in the original terms of the bond, an evaluation of the debt modification guidance under ASC 470-50 is required. More specifically, because a third-party intermediary is involved, a determination must be made as to whether the investment bank is acting as (1) the borrower's agent or (2) a principal.

- If the investment bank is concluded to be an agent in both purchasing the old bond and reselling the modified bond, the remarketing should be accounted for as an extinguishment of the existing debt and the issuance of new debt because there has been a change in creditors.
- If the investment bank acts as a principal in both purchasing the old bond and reselling the modified bond, whether the remarketing should be accounted for as a modification or as an extinguishment depends on if the difference between the present value of the cash flows associated with the old bond and those associated with the modified bond exceeds 10%.
- If the investment bank acts as a principal only in one of the components (e.g., as a principal in the acquisition of the old bond but as an agent in the reselling of the modified bond), the remarketing should be accounted for as an extinguishment of the existing debt and the issuance of new debt because there has been a change in creditors.

To determine whether the investment bank is acting as a principal or agent in the transaction, the four indicators described in ASC 470-50-55-7 should be considered (refer to section 2.6.2.6). We generally believe that the investment bank must commit its own funds and those funds should be at risk for a sufficient period in order to be acting as a principal. Based on the aforementioned guidance and SEC staff comments made at the 2003 AICPA National Conference on Current SEC Developments,[43] we generally believe issuers may consider the following questions in determining whether the investment bank's funds are at risk in both the old bonds and new bonds:

- Has the investment bank obtained "soft bids" for the replacement bond prior to or concurrent with its decision to exercise the call option on the old bond? "Soft bids" reduce the investment bank's exposure to market risk and may indicate the investment bank's role is that of an agent.
- What period of time will the investment bank hold the bonds before reselling them? We generally do not believe that there is a bright line for the number of days the investment bank must hold the bonds in order to indicate it is acting as a principal. However, the period should generally be long enough for the holder to be at risk for the type of instrument held.
- Has the investment bank been compensated for any costs associated with hedging its exposure to market risk on the new bonds? Are all fees paid to the investment bank at market as an underwriter? Payments to the investment bank through fees or other means to reduce its market risk may indicate the investment bank's role is that of an agent.
- How volatile is the market price of the bond? The combination of the bond's underlying price volatility and the length of time the investment bank will hold the bonds before reselling them may provide an indicator as to whether the investment bank has substantive market risk.

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[43] Robert J. Comerford, 2003, https://www.sec.gov/news/speech/spch121103rjc.htm.

The investment bank is generally considered a principal in the acquisition of the old bond as it generally commits its own funds to purchase the old bond and will hold the old bond for a sufficient period of time. In fact, in its speech, the SEC staff indicates that in modified remarketable put bond transactions the investment bank's role is that of a principal in the old bond. However, once the issuer modifies the debt, the SEC staff states that the bank's role in reselling the remarketed bond is that of the issuer's agent.

While there is a general presumption that the investment bank is acting as an agent in the resale of modified remarketed bonds, this presumption can be overcome. An issuer should evaluate all of the facts and circumstances to determine whether the third-party intermediary has funds at risk with regard to the new bond.

More recent remarketable put bonds may permit the issuer to select reset rates or terms upon remarketing and allow the issuer some discretion on the terms of the new bonds. Careful evaluation of those terms is necessary in determining whether a modification of the existing bond has occurred and thus modification vs. extinguishment accounting pursuant to ASC 470-50 should be considered.

## 5.5 Share lending arrangements

### 5.5.1 Overview and background

An entity may enter into a share lending arrangement that is executed separately from, but in contemplation of, a convertible debt offering (or some other convertible financing transaction). Although the convertible debt instrument is ultimately sold to investors, the share lending arrangement is an agreement between the convertible debt issuer (share lender) and the investment bank (share borrower) and is intended to increase the availability of the issuer's shares and facilitate the ability of the investors to hedge the conversion option in the issuer's convertible debt.

Investors in convertible debt (e.g., private equity or venture capital funds or other institutional investors) will frequently seek to hedge the equity exposure in the convertible debt investment. An investment bank is usually the counterparty to the investor's hedge, and in turn desires to hedge its own risk. The ability of the investment bank to hedge its own risk (generally by borrowing shares and selling them short) depends on its ability to economically obtain shares in the stock lending market. For entities with shares that are costly to borrow from the market (e.g., due to a lack of liquidity or extensive existing open short positions in the shares), the pricing of a convertible debt offering (or even the ability to successfully complete an offering at all), may depend on increasing the availability of shares in the market.

### 5.5.2 Analysis

The Own-Share Lending Arrangements Issued in Contemplation of Convertible Debt Issuance subsections of ASC 470-20 addresses the accounting for an entity's own-share lending arrangement initiated in conjunction with a convertible debt or other financing offering and its effect on EPS. Additionally, the share lending guidance addresses the accounting and EPS implications for defaults by the share borrower when a default becomes probable of occurring and when a default actually occurs.

#### 5.5.2.1 Scope

The share lending guidance in ASC 470-20 applies to equity-classified share lending arrangements. A share lending arrangement is first evaluated pursuant to other guidance (e.g., ASC 480 for certain liability-classified contracts and ASC 815-40 for contracts in an entity's own equity) to determine its balance sheet classification. Generally, share lending arrangements are structured to obtain equity classification by the share lender.

### 5.5.2.2 Classification of share lending arrangements as equity

In determining the classification of a share lending arrangement in conjunction with ASC 480, the issuer should consider whether the share lending arrangement embodies any obligation on the part of the issuer to either transfer assets or deliver equity shares after inception. In a typical share lending arrangement, the contract requires the counterparty (usually an investment bank) only to return the initial equity shares the issuer has loaned to the bank over the contract period. The issuer bears no further obligation after inception to transfer assets or issue a variable number of its own equity shares. Therefore, a share lending arrangement is generally not a liability within the scope of ASC 480.

The issuer should evaluate the share lending arrangement pursuant to ASC 815-40 to determine whether equity classification is appropriate. Generally, a share lending arrangement is considered indexed to the issuer's own stock pursuant to the guidance in ASC 815-40-15. The terms of the arrangement require the issuer to issue shares to the bank in exchange for a nominal loan processing fee at inception. On the final settlement of the contract, generally upon maturity or conversion of the convertible debt, the bank is required to return the loaned shares to the issuer for no additional consideration. That is, the share lending arrangement requires physical settlement in a fixed number of shares. The contract generally does not contain any adjustment provisions that would change the number of shares to be delivered by the bank.

The evaluation of the share lending arrangement pursuant to the equity classification guidance in ASC 815-40-25 focuses on any settlement alternatives provided in the contract. Share lending arrangements generally stipulate that, in the event the bank defaults in returning the loaned shares, the issuer is entitled to a cash payment equal to the fair value of the loaned shares.

We generally believe that this isolated scenario that results in a cash settlement by the bank does not preclude the entire contract from equity classification, as the events that require cash settlement are typically outside of either party's control (usually as a result of legal obstacles or regulations such that the bank is not permitted or unable to deliver shares).

However, this isolated cash settlement scenario could also be viewed as an embedded derivative within a host equity contract (the receivable leg of the share lending arrangement) that is to be bifurcated. During the deliberation of this guidance (pre-Codification EITF 09-1),[44] the EITF acknowledged that in a typical share lending arrangement, the terms of the contract may require cash settlement by the bank instead of delivery of the loaned shares in the event the bank is unable to deliver shares. The guidance addresses this provision and states that if it becomes probable that the counterparty will default (i.e., not return the borrowed shares or consideration equal to the then-current fair value of the borrowed shares at the maturity of the arrangement), the issuer should recognize an expense (with an offset to APIC) equal to the expected loss due to default. The EITF did not indicate that this provision would preclude the entire contract from being classified as equity.

### 5.5.2.3 Initial measurement

The share lending guidance states that at the date of issuance, the share lending arrangement should be measured at fair value and recognized as an issuance cost with an offset to equity (APIC). Issuance costs should be accounted for consistent with other applicable guidance. Any issuance cost considered debt issuance costs are amortized as interest expense generally over a period consistent with that of the associated convertible financing.

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[44] EITF Issue No. 09-1, *Accounting for own-share lending arrangements in contemplation of convertible debt issuance or other financing* (EITF 09-1).

#### 5.5.2.4 Accounting for counterparty default

The share lending guidance states that if it becomes probable that the counterparty will default (i.e., probable of not returning the borrowed shares or consideration equal to the then-current fair value of the borrowed shares at the maturity of the arrangement), the issuer should recognize an expense (with an offset to APIC) equal to the expected loss due to default. While some believe that any loss on an equity contract should be recognized in equity (and should not affect earnings), the EITF noted that the loss is not a result of changes in equity values, but in a failure of the counterparty to perform under the contract. As the entity essentially gave away its shares for no (or insufficient) consideration and that transaction should result in the recognition of a loss.

The expected loss is measured as the difference between the fair value of unreturned shares as of the reporting date and the fair value of probable recoveries, if any. The issuer should remeasure the expected loss at each reporting date until an actual default occurs and the settlement amount has become fixed. Subsequent remeasurement would reflect both increases and decreases in the expected loss in earnings, potentially including the complete reversal of the expected loss if it were no longer probable that the share borrower would default at settlement.

#### 5.5.2.5 Earnings per share

The share lending guidance in ASC 470-20-45-2A states that loaned shares under share lending arrangements should be excluded from the computation of basic and diluted EPS (because absent a default, the shares will be returned), unless an actual default by the share borrower has occurred. Thus, there appears to be an inconsistency within the share lending guidance whereby the loss on default is recognized when probable, but the shares are included in EPS only upon actual default. However, the Task Force's decision on the recognition of a loss is consistent with the requirements of ASC 450 while the EPS conclusion is consistent with the treatment of contingently issuable shares pursuant to ASC 260.

If dividends on the loaned shares are not reimbursed to the entity (reimbursement typically is required in those arrangements), any amounts, including contractual (accumulated) dividends and participation rights in undistributed earnings, attributable to the loaned shares should be deducted in computing income available to common shareholders, consistent with the two-class method set forth in ASC 260-10-45-60B. Upon default by the share borrower, the shares are included in the denominator of both basic and diluted EPS.

Refer to section 6.2 of our FRD publication, ***Earnings per share***, for further discussion of EPS considerations under share lending arrangements.

#### 5.5.2.6 Disclosures

The share lending guidance states the disclosures in ASC 505-10-50, *Equity — Overall*, are required for share lending arrangements within the scope of the share lending guidance. It also requires specific disclosures, as described in detail in ASC 470-20-50-2A through 50-2C. Those disclosures are specific to the share lending arrangement in both annual and interim periods in which a share lending arrangement is outstanding. In periods in which a share borrower default becomes probable, incremental disclosures related to both the loss and the potential effect on EPS are also required.

## 5.6 Trust preferred securities

### 5.6.1 Overview and background

Trust preferred securities are a form of financing issued by a subsidiary (or trust) that is often treated as debt for federal income tax purposes, but not for financial reporting or credit rating purposes. These types of securities have different trademarked names, including MIPS (Monthly Income Preferred Securities), QUIPS (Quarterly Income Preferred Securities) and TOPRS (Trust Originated Preferred Securities).

In a typical structure, a company establishes a new entity in the form of a trust, which issues preferred securities to investors (trust interests). The company purchases all of the trust's common securities, and may guarantee the obligations of the trust if in the future the trust cannot make payments. The trust uses the proceeds from the issuance of the preferred securities and the amount it received for issuing common securities (if any) to make a deeply subordinated loan to the company, with terms identical to those of the trust preferred securities.

A trust preferred security is generally long-term (30 years or more). It generally has periodic fixed or variable dividend payments and permits early redemption by the issuer. In addition, trust preferred securities usually permit the deferral of dividend payments for up to five years.

### 5.6.2 Analysis

Application of ASC 810-10's variable interest model generally would not result in the sponsoring entity consolidating the trust that issues the preferred securities (refer to section 5.4.3 of our FRD publication, ***Consolidation***, for further discussion).

However, if the trust were consolidated by the sponsoring entity and the preferred securities were outside the scope of ASC 480 (due to the scope exception provided for certain mandatorily redeemable NCIs), the guidance in ASC 480-10-S99-3A should be considered to determine whether temporary equity classification is required. If the preferred securities (NCI on a consolidated basis) are classified in temporary equity, the SEC staff has requested registrants include specific descriptive language, such as "Guaranteed Preferred Beneficial Interest in Company's Subordinated Debenture." In this case, dividends are required to be reported as an allocation of income to the NCI holders in the income statement in accordance with ASC 810-10-40-2 (see section 16.1.3 of our FRD publication, ***Consolidation***, for more guidance on the attribution of income or losses to noncontrolling interests held by preferred shareholders).

Alternatively, the SEC staff historically permitted these instruments to be presented within the debt caption in the balance sheet with an appropriate description in the footnotes. Under this presentation, dividends would be recognized as interest expense. The SEC staff preferred, but did not require, that the same caption as required for temporary equity classification be used even if the security were classified as debt. However, in June 2007, through an amendment to EITF D-98,[45] the SEC staff indicated they would no longer accept the presentation as debt. That SEC staff position was applied prospectively to all affected financial instruments (or host contracts) that were entered into, modified or otherwise subject to a remeasurement (new basis) event after a short transition period. It is possible, for longer dated structures, that some grandfathered trust preferred securities may still be classified as debt.

## 5.7 Warrants for redeemable shares

### 5.7.1 Overview and background

Warrants may be issued on shares that, by the terms of the shares themselves, are redeemable at the option of the shareholder. The redemption feature is embedded in the underlying shares, not a term in the warrant, and may require shares to be mandatorily redeemed or redeemed at the option of the holder at any time or only upon occurrence of certain designated events (e.g., change of control, delisting). The accounting for a warrant for redeemable shares is similar to the accounting for a puttable warrant. Refer to section 4.1.1.9 for a description of puttable warrants.

[45] EITF Topic No. D-98, "Classification and Measurement of Redeemable Securities" (EITF D-98).

## 5.7.2 Analysis

A warrant for a redeemable preferred share (a share with an embedded redemption feature) may be required to be classified as a liability when the redemption feature of the underlying preferred share potentially requires the issuer to repurchase its share by transferring assets. That warrant may require liability classification even though the underlying preferred share itself is likely classified as equity (or temporary equity) in the issuer's financial statements.

This inconsistency is a direct result of the FASB's explicit decision to require different classification for a redeemable share and a warrant exercisable into that very same redeemable share. This accounting is also followed for warrants on redeemable common shares.

### 5.7.2.1 Applicable guidance

**Excerpt from Accounting Standards Codification**

**Distinguishing Liabilities from Equity — Overall**

***Implementation Guidance and Illustrations***

***480-10-55-33***

A warrant for puttable shares conditionally obligates the issuer to ultimately transfer assets—the obligation is conditioned on the warrant's being exercised and the shares obtained by the warrant being put back to the issuer for cash or other assets. Similarly, a warrant for mandatorily redeemable shares also conditionally obligates the issuer to ultimately transfer assets—the obligation is conditioned only on the warrant's being exercised because the shares will be redeemed. Thus, warrants for both puttable and mandatorily redeemable shares are analyzed the same way and are liabilities under paragraphs 480-10-25-8 through 25-12, even though the number of conditions leading up to the possible transfer of assets differs for those warrants. The warrants are liabilities even if the share repurchase feature is conditional on a defined contingency.

The accounting for warrants on redeemable shares follows the guidance in ASC 480-10-25-8 through 25-13. Those paragraphs address the classification of instruments, other than an outstanding share, that have both of the following characteristics:

- The instrument embodies an obligation to repurchase the issuer's equity shares, or is indexed to such an obligation.
- The instrument requires or may require the issuer to settle the obligation by transferring assets.

In ASC 480, the term "obligation" refers to either a conditional or unconditional obligation to transfer assets or issue equity shares. In addition, ASC 480 uses the term "indexed to" interchangeably with the phrase "based on variations in the fair value of." Based on those two provisions, a warrant that permits the holder to purchase redeemable shares (refer to discussion below on what makes a share redeemable) is a liability pursuant to ASC 480 because (1) the warrant itself is indexed to an underlying share (i.e., the option's value varies with the fair value of the share) that embodies the issuer's obligation to repurchase the share and (2) the issuer has a conditional obligation to transfer assets if the shares are put back. Those concepts also apply to a forward contract requiring the company to issue redeemable shares.

The following example is provided in ASC 480-10-55-32, which states:

> Entity B issues a warrant for shares that can be put back by Holder immediately after exercise of the warrant. The warrant feature allows Holder to purchase one equity share at a strike price of $10 on a specified date. The put feature allows Holder to put the shares obtained by exercising the warrant back to Entity B on that date for $12, and to require physical settlement in cash. If the share price on the settlement date is greater than $12, Holder would be expected to exercise the warrant obligating Entity B to issue a fixed number of shares in exchange for a fixed amount of cash, and retain the

shares. That feature alone does not result in a liability under paragraphs 480-10-25-8 through 25-12. However, if the share price is equal to or less than $12, Holder would be expected to put the shares back to Entity B and could choose to obligate Entity B to pay $12 in cash. That feature does result in a liability, because the financial instrument embodies an obligation to repurchase the issuer's shares and may require a transfer of assets. Therefore, those paragraphs require Entity B to classify the warrant as a liability. A warrant to issue shares that will be mandatorily redeemable is also classified as a liability, and should be analyzed under Topic 815.

This example is on "shares that can be put back to the Holder immediately after exercise" and that are then puttable for a fixed price ($12 settled in cash). To address how to analyze a warrant for shares that (1) could be put back at other times, (2) were contingently puttable or (3) could be put for a price other than a fixed price, prior to Codification, the FASB issued FSP FAS (Financial Accounting Standard) 150-5, *Issuer's Accounting under FASB Statement No. 150 for Freestanding Warrants and Other Similar Instruments on Shares That Are Redeemable*. This guidance indicated that a warrant for a redeemable share is a liability, despite the share itself not being a liability. Not all of the FSP was codified, and certain omitted portions are instructive.

FSP FAS 150-5 stated in part (selected footnote references retained and all others omitted):

5. Paragraph 11 of Statement 150 applies to freestanding warrants and other similar instruments on shares[1] that are either puttable or mandatorily redeemable regardless of the timing of the redemption feature or the redemption price because those instruments embody obligations to transfer assets. Therefore, paragraph 11 applies to warrants on shares that are redeemable immediately after exercise of the warrants and also to those that are redeemable at some date in the future.

6. The phrase *requires or may require* in paragraph 11 encompasses instruments that either conditionally or unconditionally obligate the issuer to transfer assets. If the obligation is conditional, the number of conditions leading up to the transfer of assets is irrelevant.

Footnote 1 in paragraph 5 of FSP FAS 150-5 (indicated above) observed, in part, "Paragraph 11 of Statement 150 requires warrants or similar instruments to acquire redeemable shares to be classified as liabilities even though the underlying shares may be classified as equity under other accounting guidance." (Paragraph 11 of Statement 150[46] was codified as ASC 480-10-25-8, discussed above.)

While paragraph 5 of FSP FAS 150-5 and its footnote were not included in the Codification, the guidance in paragraph 6 of the FSP was included in ASC 480-10-25-9. Additionally, an example from paragraph 7 in the FSP, which illustrated the concepts in paragraph 5, was included in ASC 480-10-55-33.

This guidance clarified that a warrant for a redeemable share is a liability, despite the share itself not being a liability.

### 5.7.2.2 What makes a share 'redeemable'

Warrants most frequently in the scope of ASC 480 are for preferred shares with triggers that permit or may permit the investor to realize the liquidation preference prior to the liquidation of the issuer. The same accounting analysis applies to warrants for redeemable common shares.

A preferred share is redeemable if there is any feature in the preferred share that will either (1) automatically (unconditionally or mandatorily) or contingently (conditionally) require the issuer to redeem the share or (2) permit the holder to compel the issuer to redeem (i.e., put) the share at any time or on the occurrence of a contingent event. The balance sheet classification of the preferred share (i.e., equity, temporary equity or a liability) is not considered. A warrant on a redeemable preferred share that may require the issuer to transfer assets is a liability unless the issuer can avoid triggering redemption by controlling the exercise contingency (refer to section 5.7.2.2.2).

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[46] Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*.

#### 5.7.2.2.1 *Mandatorily redeemable securities*

ASC 480 defines a mandatorily redeemable financial instrument as "any of various financial instruments issued in the form of shares that embody an unconditional obligation requiring the issuer to redeem the instrument by transferring its assets at a specified or determinable date (or dates) or upon an event that is certain to occur." (Refer to section A.4 for further guidance on identifying mandatorily redeemable securities.) A preferred share that is mandatorily redeemable is classified as a liability under ASC 480-10-25-4. A warrant for a mandatorily redeemable preferred share is also a liability.

Importantly, a share may not be considered mandatorily redeemable because its terms specify that the occurrence of an event — regardless of probability — could prevent the share from being redeemed. However, a warrant on that share is still a liability pursuant to ASC 480 because the share embodies a redemption obligation (even though it is conditional).

For example, if preferred shares require redemption on a date certain, but are also convertible into common stock prior to that redemption date, the preferred shares are not considered mandatorily redeemable, as redemption is conditioned on the shares not being converted prior to that date (refer to the example in ASC 480-10-55-11). As a result, the preferred shares are not classified as a liability pursuant to ASC 480 (but may be classified as temporary equity for SEC registrants). However, a warrant for this share is classified as a liability because the shares are redeemable if the warrant is exercised and the embedded conversion option is not exercised. As noted in ASC 480-10-25-9, the number of conditions leading up to the transfer of assets is irrelevant.

#### 5.7.2.2.2 *Contingently redeemable securities*

A preferred share that is not mandatorily redeemable may be either (1) automatically redeemed upon the occurrence of a contingent event and/or (2) puttable at the option of the holder either currently, with the passage of time or on the occurrence of a contingent event.[47] While the preferred share is not classified as a liability pursuant to ASC 480, further evaluation of the redemption feature is necessary to determine the accounting for the related warrant. If a preferred share is redeemable, a warrant to acquire that share may embody an obligation and thus require liability classification pursuant to ASC 480.

Understanding the nature of the contingent event that requires or permits the redemption of an underlying preferred share is important. If the future event that triggers the redemption (or possible redemption) of the preferred shares is completely within the issuer's control, an obligation does not exist and will not exist until the issuer takes (or fails to take) action. Accordingly, the share is not considered redeemable. All facts and circumstances should be considered to determine whether the issuer has complete control over the event leading to redemption, regardless of probability.

In contrast, a preferred share that is not redeemable currently but may become redeemable with the passage of time or on a contingent event that is not completely within the control of the issuer is considered contingently redeemable. In that case, the issuer is obligated to redeem when or if called upon.

For example, consider a preferred share that is redeemable upon the completion of an IPO. A warrant for that preferred share is not a liability, provided the issuer is considered to control (i.e., avoid) triggering the redemption right in the preferred share by not initiating a public offering. However, a preferred share that is contingently redeemable if an IPO has not been completed by a specific date is considered redeemable (and the warrant for that preferred share is a liability) because, while it is within the issuer's control to start the offering process, it is not within the issuer's control to complete an offering by a specific date.

[47] Shares that become redeemable or puttable are referred to as "contingently redeemable" in this section.

The redeemable equity guidance in ASC 480-10-S99-3A (refer to Appendix C for further discussion) may be helpful in determining whether a triggering event is within the control of the issuer and therefore, whether a warrant on such a share (i.e., contingently puttable share) may embody an obligation to transfer assets. While ASC 480-10-S99-3A may be helpful in making that determination, we generally believe that guidance is not necessarily determinative that instruments in its scope embody obligations of the issuer (e.g., callable shares). The individual facts and circumstances should be considered in making this determination.

For example, a feature in a preferred share may provide for the redemption of the security upon any transaction in which the outstanding shares of common stock are exchanged for consideration and the stockholders of the corporation immediately prior to such an event hold less than 50% of the voting securities of the corporation (or surviving entity) immediately after such event.

If the issuer cannot control (i.e., cannot prevent) the occurrence of a transaction resulting in a change in the shareholders as described above (e.g., by using corporate governance provisions under its articles of incorporation or invoking state or federal securities law), the preferred share would be considered redeemable. A warrant for that preferred share should be classified as a liability.

## 5.8 Tranched preferred share issuances

### 5.8.1 Overview and background

A tranched preferred share issuance, also referred to as a "delayed issuance of preferred shares" or a "contingent issuance of preferred shares," consists of multiple components, the first of which is an initial issuance of preferred shares. The second component which is contractually committed to at the initial closing date, is referred to as the "second" or "later" tranche or a "delayed issuance," and results in preferred shares issued at a specific future date or upon the occurrence of a future event or milestone.

Tranched preferred share transactions are commonly entered into by emerging entities (e.g., biotech and technology) as a source of capital to fund research and development and general operations. The later tranche(s) often are timed to coincide with a future expected need for capital to continue the entity's product development. For example, a later tranche may be contingent upon a biotech company commencing a certain phase of clinical trials.

### 5.8.2 Analysis

The future right or obligation to issue preferred shares in a later tranche (referred to as the "future tranche right or obligation") should be evaluated as either (1) a freestanding financial instrument requiring its own accounting or (2) a contractual feature that is embedded in the preferred shares issued at closing.

Once that determination is made, the accounting for the freestanding instrument or embedded feature should be based on the contractual terms of the preferred share and the future right or obligation and should consider the bifurcation guidance in ASC 815-15. For example, the preferred share may have various dividend features and be (1) perpetual, (2) contingently redeemable or mandatorily redeemable or (3) convertible. In addition, the future tranche right or obligation may (1) mandate the subsequent round of investment, (2) permit the issuer the unilateral right to force the investment or (3) permit the investor the unilateral right to invest. Each of those features and terms has a direct effect on the accounting.

#### 5.8.2.1 Freestanding or embedded

A tranched preferred share issuance may take the form of either a single instrument (e.g., the initial issuance of preferred shares with an embedded feature providing for the future tranche right or obligation) or multiple instruments (e.g., the initial issuance of preferred shares with a separate freestanding instrument for the future tranche right or obligation).

ASC 480 defines a freestanding financial instrument as a financial instrument that meets either of the following conditions: (1) it is entered into separately and apart from any of the entity's other financial instruments or equity transactions or (2) it is entered into in conjunction with some other transaction and is legally detachable and separately exercisable. An instrument or feature not meeting these conditions is generally considered a feature embedded in another contract or transaction.

Because both the initial issuance of preferred shares and the future tranche right or obligation are entered into at the same time (as part of one agreement or multiple contractual agreements executed at the same time) between the same counterparties, condition (2) above should be analyzed.

- Legally detachable — Generally, whether two instruments can be legally separated and transferred such that the two instruments may be held by different parties. For example, if the initial investor can sell its preferred shares and retain the future tranche right or obligation, the instruments are legally detachable. In assessing this criterion, it is not relevant which instrument the initial investor can transfer. For example, if the initial investor can transfer the preferred share but contractually cannot transfer the future tranche right or obligation, the two instruments are still legally detachable. The same would be true if the initial investor had to retain the preferred shares but could transfer the future tranche right or obligation. If the investor is able to separate the two instruments, they are generally considered legally detachable. However, if an instrument can be separately transferred only with the consent of the counterparty, further analysis should be performed. We generally believe that an instrument is not legally detachable if the counterparty can unilaterally prevent the transfer in accordance with the contractual terms. On the other hand, the legal detachability criteria may be met if the counterparty cannot unreasonably withhold consent. The determination of whether two instruments can be legally separated and transferred such that the two components may be held by different parties is a legal matter that may require advice from legal counsel.

- Separately exercisable — Generally, whether one instrument can be exercised without terminating the other instrument (e.g., through redemption, simultaneous exercise, expiration). For example, if the future tranche right or obligation can be exercised while the initial preferred shares continue to be outstanding (which generally is the case with a tranched preferred share issuance), the instruments are separately exercisable.

To conclude under condition (2) above that instruments are freestanding, they should be both legally detachable and separately exercisable. For example, if either the initial preferred shares or the future tranche right or obligation can be transferred to another party (separate from the other instrument), and the initial preferred shares remain outstanding upon the exercise or fulfillment of the future tranche right or obligation (i.e., upon the issuance of the later tranche of preferred shares), the instruments would be freestanding. However, if the future tranche right or obligation cannot be transferred without the initial preferred shares (or the initial preferred shares cannot be transferred without the future tranche right or obligation), yet the initial preferred shares still remain outstanding upon the exercise or fulfillment of the future tranche rights/obligations, the instruments would not be freestanding. That is, the future tranche right or obligation would be an embedded feature (i.e., embedded in the initial preferred shares).

If there are multiple future issuances or tranches of preferred shares in a tranched preferred share transaction, the issuer should also consider whether each subsequent issuance is an individual contract or, instead, a portion of a single contract. For example, if a tranched preferred share issuance has a potential second, third and fourth tranche, the issuer should determine whether those are additional embedded features or freestanding financial instruments and, if freestanding, whether they are freestanding individually or as one combined instrument. That determination should also be made based on the legally detachable and separately exercisable criteria.

Determining whether a future tranche right or obligation is an embedded feature or a freestanding instrument requires an understanding of the contractual terms of the arrangement. In some cases, advice from legal counsel may be required to understand the rights of each party. Although the parties to the arrangement may have intended or expected that the future tranche right or obligation would remain with the initial investor that purchased the preferred shares, the legal documents (e.g., securities purchase agreement, investor rights agreement) may not require such coupling. That is, there may be no contractual provisions in the transaction documents that prevent the initial investor from transferring one component (either the initial preferred stock or the future tranche right or obligation) and retaining the other component. The absence of such a contractual restriction often results in a conclusion that the future tranche right or obligation is a freestanding financial instrument for financial reporting purposes.

#### 5.8.2.2 Accounting for a freestanding future tranche right or obligation

If the future tranche right or obligation is determined to be a freestanding instrument, there are two instruments requiring separate accounting (i.e., the preferred shares issued and the separate future tranche right or obligation). The first step is to determine the proper classification of the freestanding future tranche right or obligation instrument (as an asset or liability or in equity). This classification is important because it determines the method for allocating the arrangement proceeds between the freestanding future tranche right or obligation instrument and the preferred shares issued.

The freestanding future tranche component, which is an equity contract on the issuer's own stock, should be evaluated based on its contractual terms to determine if it is a forward contract (the issuer must issue and the investor must purchase shares in the future, either on fixed or determinable dates or potentially upon the resolution of future contingencies), a purchased put (issuer has the right but not the obligation to issue additional shares) or a written call (investor has the right but not the obligation to purchase additional shares) on the preferred shares.

The classification of the freestanding instrument is first analyzed under ASC 480 to determine if it is classified as a liability. If the freestanding instrument imposes on the issuer a conditional (outside the issuer's control) or unconditional obligation to issue shares that are potentially redeemable, the freestanding instrument is classified as a liability pursuant to ASC 480. This is an important evaluation because frequently the underlying preferred shares to the future tranche right or obligation are redeemable, either at the option of the holder or upon the occurrence of a contingent event outside the issuer's control, thus requiring liability classification for the freestanding future tranche component. Refer to section 5.7 for a discussion on warrants with underlying shares that are redeemable.

If ASC 480 does not require liability classification for the freestanding future tranche component, it is next analyzed under ASC 815-10 to determine if it meets the definition of a derivative, and if so, whether it qualifies for an exception from derivative accounting. The most common exception from derivative accounting for equity-linked instruments is in ASC 815-10-15-74(a) for instruments that are (1) indexed to the company's own stock and (2) would be classified in equity. The evaluation of those two criteria is addressed in ASC 815-40. If the component does not meet the definition of a derivative, it is still evaluated under the guidance in ASC 815-40, only this time for classification in its own right. Regardless, the guidance in ASC 815-40 will help determine the classification of a freestanding future tranche right or obligation that is not addressed by ASC 480. The classification should be reassessed at each reporting date. Section 4 provides detailed guidance on evaluating the classification of a freestanding equity contract, and is supplemented by the discussion in Appendix B.

If the freestanding instrument is a liability under ASC 480, a derivative under ASC 815 (i.e., it meets the definition of a derivative and does not qualify for the exception from derivative accounting) or an asset or liability under ASC 815-40, and is subsequently marked to fair value through earnings at each reporting date, the freestanding instrument is recognized at fair value from the proceeds received at issuance (i.e., the proceeds received from the issuance of the initial preferred shares). This allocation method (as opposed to a relative fair value method) is generally applied in practice when the instrument is subject to ongoing fair value measurements to avoid a day-one loss on adjusting a liability from its allocated value to its full fair value through earnings. If the freestanding instrument is classified in equity, it is allocated its relative fair value from the proceeds and is not subsequently remeasured as long as it continues to be classified in equity. The remaining proceeds are allocated to the preferred shares. Refer to section 1.2.7 for further discussion on the allocation of proceeds.

The preferred shares require their own evaluation to determine their (1) classification as debt or equity (including temporary equity), (2) the nature of the host contract and (3) potential bifurcation of any embedded features. If the preferred shares are issued at a discount due to the allocation of proceeds to the freestanding instrument (i.e., the future tranche component), the discount can affect the accounting for any embedded redemption features (put or call options). Refer to section 3 for discussion of the accounting for features in preferred shares.

#### 5.8.2.3 Accounting for an embedded future tranche right or obligation

If it is determined that a future tranche right or obligation is a feature embedded in the issued preferred share, the guidance in ASC 815-15 should be applied to determine whether the embedded feature should be bifurcated. That application of ASC 815, as above with a freestanding instrument, evaluates whether the embedded feature meets the definition of a derivative, and if so, whether it qualifies for an exception from derivative accounting.

Pursuant to ASC 815, embedded features are separated from their host non-derivative contracts and accounted for as derivative instruments if, and only if, all of the following criteria are met:

- The economic characteristics and risks of the embedded derivative are not "clearly and closely related" to the economic characteristics and risks of the host contract.
- The contract that embodies both the embedded derivative and the host contract is not remeasured at fair value under otherwise applicable US GAAP with changes in fair value reported in earnings as they occur.
- A separate, freestanding instrument with the same terms as the embedded derivative would be a derivative instrument subject to the requirements of ASC 815.

When applying the bifurcation criteria to a tranched preferred share issuance, the last criterion is particularly important. That criterion requires that the embedded future tranche right or obligation feature meet the definition of a derivative pursuant to ASC 815 as if it were a freestanding instrument. Because companies issuing tranched preferred shares are typically not publicly traded, the future tranche right or obligation feature often does not meet the definition of a derivative in ASC 815 (i.e., it is not net settleable because the underlying shares are not readily convertible to cash). In such situations, the embedded future tranche right or obligation would not be bifurcated and would not receive separate accounting.

Any embedded future tranche right or obligation meeting the definition of a derivative would be evaluated for the exception from derivative accounting ASC 815-10-15-74(a). The conclusion to bifurcate (or not) should be reevaluated at subsequent reporting dates. Refer to section 3 for a discussion of accounting for features in preferred shares.

## 5.9 Accelerated share repurchase transactions

### 5.9.1 Overview and background

There are many reasons why an issuer may consider repurchasing its shares. For example, repurchasing shares can be a tax-efficient way to return capital to shareholders, as compared to declaring cash dividends. In addition, some may view a large repurchase as a signal that the issuer believes its shares are undervalued. An issuer may also wish to offset the dilutive impact of (1) issuing shares to acquire another entity (e.g., a merger or acquisition) or (2) exercises of employee stock options. Finally, an issuer may simply wish to reduce its outstanding share count, thereby increasing EPS or other related measures.

There are various ways an issuer may repurchase its own shares. Each alternative has its own benefits and considerations. Although several alternatives are discussed, this section focuses on the accounting considerations for accelerated share repurchase (ASR) programs due to their complexity.

#### Open market repurchase programs

One alternative an issuer may choose to repurchase its own shares is an open market repurchase program (OMR). These programs typically involve the issuer engaging an investment bank (the "dealer") to make spot purchases of the issuer's shares on the issuer's behalf over an extended period of time. Depending on the type of program, purchases may occur only when the issuer instructs the dealer, or pursuant to a schedule or formula. For example, the terms of the OMR may define certain dollar amounts the dealer shall use to purchase shares on a given trading day based on the price of the issuer's shares on that day, up to a maximum dollar amount for the entire program. Typically, the dollar amount permitted each trading day increases as the issuer's stock price decreases.

#### Tender offers

Another alternative is a tender offer, which is a broad solicitation by the issuer to purchase a substantial percentage of its shares for a limited period of time. The tender offer is typically for a fixed price and contingent on shareholders tendering a certain number of their shares. Some tender offers are in the form of a "Dutch auction" whereby the issuer offers to repurchase a fixed maximum number of shares within an identified range of prices.

Tender offers generally allow the issuer to retire a much larger number of shares than an OMR and over a shorter period of time. In addition, the market typically views tender offers as a stronger signal than an OMR that the issuer believes its shares are undervalued. However, a tender offer typically requires the issuer to pay a significant premium over the current price (e.g., 10%) and may involve more significant transaction costs than an OMR. Also, the level of participation and, therefore, the number of shares the issuer will be able to retire, is uncertain.

#### Accelerated share repurchase

A third alternative is an ASR, also known as an accelerated share buyback. An ASR may take many forms, but most provide the benefit of an immediate share count reduction similar to a tender offer, while ultimately only requiring the issuer to pay a price per share equal to an average share price over an extended period of time, as is the case with an open market share repurchase plan. Further, depending on the structure, the issuer may actually pay a discount to an average price, as opposed to a price in excess of a market price after considering commissions or premiums. The most basic forms of these arrangements are often referred to as "fixed-dollar" (i.e., the amount of cash paid is fixed and the number of shares purchased varies based on the stock price observed during the life of the contract) or "fixed-share" (i.e., number of shares is fixed and amount of cash paid varies based on the stock price observed during the life of the contract).

Although most ASRs are documented as a single transaction (i.e., forward purchase contract with up-front delivery), from an accounting perspective, they are most commonly viewed as (1) an initial spot purchase and receipt of shares and (2) a forward sale contract with a forward price equal to the shares' initial purchase price. The following example illustrates the economics of a traditional ASR (i.e., a basic uncollared fixed-dollar ASR) from an issuer's perspective. This example, and the remaining part of section 5.9, also discusses some of the dealer's activities to manage and hedge their side of the transaction as those activities may impact the contractual terms of the ASR and thus significantly impact the economics of and accounting for the ASR.

Assume that an issuer enters into a traditional ASR when its stock price is $10, and pays a dealer $100 million in exchange for 10 million shares (note that the initial share delivery typically occurs no more than three days after executing the agreement). To make such a large share delivery possible without impacting the share price, the dealer borrows the issuer's shares from third-party securities lenders. The significant initial share delivery (resulting in an immediate reduction in shares outstanding) is one of the key benefits of an ASR over the other share repurchase alternatives. This represents the "spot purchase" component of the ASR.

Following the initial share delivery, the dealer purchases shares from the market to cover its short position created by borrowing the shares from securities lenders. Those purchases typically occur over a period that may range anywhere from a few weeks to several months depending primarily on the size of the transaction and the daily trading volume of the issuer's shares. This period of time is often referred to as a "calculation period" because the arithmetic average of the VWAP observed on each day during this time is used to calculate the price the issuer will ultimately pay for the aggregate number of shares received. For example, if the calculation period is three days and the daily VWAP for those days is $10, $11 and $12, respectively, the "average VWAP" for the calculation period is $11, which is simply the sum of the daily amounts divided by three. While the daily VWAP prices are usually volume-weighted for shares purchased that day, the average VWAP is the simple average of all the daily VWAPs during the calculation period (as opposed to volume weighting the daily VWAPs).

At the end of the calculation period, the average VWAP is used to determine a final settlement amount. The ultimate number of shares repurchased (i.e., initial "spot" share delivery plus or minus the shares received or delivered upon settlement of the forward contract) equates to using the prepaid amount to repurchase shares at the average VWAP price. If the average VWAP during the calculation period declines from inception, the issuer will receive additional shares from the dealer at maturity. For example, if the issuer paid the average VWAP over the period — assume that was $8 — and the share price of the spot purchase was $10, the issuer overpaid for each share by $2 and is due back some consideration to be paid in the form of shares. The opposite is generally true (i.e., the issuer will return shares to the dealer at maturity) if the average VWAP increases during the calculation period.

Continuing the above example, if the average VWAP during the calculation period is $8, the issuer will receive an additional 2.5 million shares from the dealer. This amount is determined by the difference between 1) the number of shares the issuer would have received had it paid the average VWAP of $8 and 2) the number of shares it actually received at inception ($100 million prepayment divided by $8 less the 10 million initial share delivery). The net effect of the arrangement is that the issuer paid $100 million to purchase 12.5 million shares at a price per share of $8. This puts the issuer in a similar economic position as simply purchasing the shares in the open market throughout the calculation period; however, the ASR allows the issuer to receive a large number of these shares at inception. Refer to section 5.9.2.4 for the accounting for this ASR.

From the dealer's perspective, if the entire $100 million prepayment was used to purchase shares during the calculation period at an average VWAP of $8, it would have covered the 10 million shares it borrowed, as well as the 2.5 million additional shares owed to the issuer upon settlement. If, on the other hand, the average VWAP was $12.50, the dealer would only have been able to purchase 8 million shares. This is

2 million shares less than the 10 million shares borrowed. However, as the dealer also would have been owed 2 million shares from the issuer upon settlement ($100 million payment divided by $12.50 less the 10 million initial share delivery), it would have enough shares to cover the shares borrowed. Therefore, the calculation period and corresponding settlement mechanics are also important to the dealer as they are designed and negotiated to act as a hedge of the dealer's exposure to stock price while it covers the borrowing of the issuer's shares.

The following summarizes these three share repurchase alternatives:

| | OMR | Tender offer | ASR |
|---|---|---|---|
| Description | Issuer has discretion to purchase shares over time at market prices on a 'best execution' basis (i.e., at the lowest price the dealer can reasonably obtain during the trading day). | Issuer purchases a large number of shares within a specified price range. | Issuer can purchase a large number of shares at inception, with the final price settled at a later date. |
| Benefits | Simple to implement with minimal execution costs. Issuer can be opportunistic with purchases as it controls timing and sizing. | Allows for purchase of a large number of shares quickly and may indicate to the market that the issuer believes its shares are undervalued. Specific price range also reflects issuer's view on the value of its shares. | Results in an immediate purchase of a large number of shares, which may positively impact EPS and may indicate to the market that the issuer believes its shares are undervalued. Many variations to the basic structure provide the issuer flexibility (e.g., discount to VWAP, collared pricing). |
| Considerations | Requires an extended period of time to purchase a significant number of shares and is less visible to the market. Repurchases may have to be curtailed during certain blackout periods under securities laws. | Involves significant execution costs and typically requires a premium to the current share price to induce participation. No control over number of shares purchased. Tender offers may not be allowed during certain blackout periods under securities laws. | Provides minimal flexibility to terminate program once executed, and issuer is exposed to market fluctuations during contract period. |

Because there are many variations of ASRs, their terms should be carefully evaluated in determining the accounting.

## 5.9.2 Analysis

The accounting for ASRs is explicitly discussed in ASC 505-30-25-5 and 25-6 (and implementation guidance in ASC 505-30-55-1 through 55-7 and 60-2). This guidance states that an issuer should account for the ASR as two separate transactions:

- Common stock acquired in a treasury stock transaction
- A forward contract indexed to its own stock

The first transaction (i.e., the spot repurchase of treasury shares) results in a reduction in equity and in the number of the shares in the denominator for EPS on the trade date. The second transaction is a forward contract on the issuer's equity shares. Because the forward contract would require the issuer to provide the dealer with additional consideration (i.e., in the form of cash or shares) if the company's stock price increases, it is commonly viewed as a forward sale contract. It is evaluated under the equity contract road map (refer to section 4) to determine its classification and measurement.

The following discussion applies to both fixed-share and fixed-dollar ASRs, unless otherwise specified.

#### 5.9.2.1 ASC 480 considerations

As with all equity contracts, an ASR's forward contract should first be considered under ASC 480. The basic forward sale contract referenced in ASC 505-30 generally does not fall under the scope of ASC 480 because:

- ASC 480-10-25-8 through 25-13 requires liability (or asset) classification for freestanding financial instruments that represent, or are indexed to, an obligation to buy back the issuer's shares. A forward contract to sell shares does not embody an obligation of the issuer to buy back shares. However, if the ASR involves shares that are themselves redeemable, the forward sale would embody an obligation of the issuer to buy back its own shares by virtue of the redemption feature in the shares.
- ASC 480-10-25-14 states that a financial instrument that embodies an unconditional obligation, or a financial instrument other than an outstanding share that embodies a conditional obligation, that the issuer must or may settle by issuing a variable number of its equity shares, should be classified as a liability (or asset) if, at inception, the monetary value of the obligation is based solely or predominantly on one of three conditions. The monetary value of the issuer's settlement obligation under the forward contract does not meet any of those conditions.

  The monetary value of any obligation embodied in the forward sale contract is not predominantly fixed at inception since the settlement amount the issuer may be obligated to pay to the counterparty fluctuates based on the market price of the issuer's equity shares. Variations in the settlement amount are indexed to the fair value of the issuer's own stock. Lastly, variations in the obligation are not inversely related to changes in the fair value of the issuer's own stock, as the dealer gains when the issuer's share price goes up and loses when the issuer's share price falls.

#### 5.9.2.2 Contracts in an entity's own equity (ASC 815-40)

Typically, the forward sale contract meets the definition of a derivative. The issuer's share price is the underlying, the number of shares received in the initial share delivery is generally the notional, there is typically no, or a minimal, initial investment in the forward sale contract and the forward contract contractually provides for net settlement. As a result, all of the criteria pursuant to the indexation guidance (ASC 815-40-15) and equity classification guidance (ASC 815-40-25) should be evaluated to determine if the forward contract qualifies for the equity scope exception from derivative accounting pursuant to ASC 815-10-15-74(a).

##### Indexation considerations under ASC 815-40-15

ASR agreements (often executed in a standard ISDA form) include many provisions that protect the dealer against risks related to both executing the transaction and subsequently maintaining a standard hedge position over the life of the contract (see section 1.3.1 for information regarding the various agreements that should be reviewed when evaluating transactions executed in a standard ISDA form). For example, certain provisions address how the ASR should settle if it becomes unlawful for the dealer to transact in the issuer's shares, or when a significant transaction occurs that creates discontinuities in the issuer's stock price (e.g., a tender offer). In these circumstances, the dealer cannot adjust its hedge position effectively and would otherwise be exposed to risks that they did not price into the transaction at inception.

ASC 815-40-55-30 includes an example of a provision that adjusts the settlement amount of an equity derivative to offset the effect of a merger announcement on the net change in the fair value of the instrument and of an offsetting hedge position in the underlying shares. The specific provision described in the example does not preclude the equity derivative from being indexed to the issuer's own stock as the ability to maintain a standard hedge position is an input to an option pricing model pursuant to ASC 815-40-15-7E and 15-7G.

However, a critical fact in the example is that the adjustment is not affected by the dealer's actual hedge position, but rather, is based on a commercially reasonable or standard hedge of the transaction. That is, the adjustment allowed in the contract cannot differ in circumstances when the dealer is over-hedged or under-hedged. Accordingly, it is important that all adjustment provisions in the agreements are thoroughly evaluated to understand the extent the dealer's actual hedge position or hedging activity can impact the terms of the transaction, as these could violate the concepts in ASC 815-40-15-7E and 15-7G.

**Equity classification under ASC 815-40-25**

A key consideration in evaluating the forward contract pursuant to ASC 815-40 is determining whether the form of contractual settlement supports a conclusion of equity classification. If the issuer is able, in all circumstances, to settle the forward in net shares, the forward qualifies for equity classification. If, however, the contract must be net cash settled or the holder has a choice of cash or share settlement, then the forward is precluded from being classified in equity.

Similar to indexation considerations, provisions within the agreements should be carefully reviewed to determine whether the criteria for equity classification are met. For example, standardized settlement provisions in the Master Agreement and Equity Definitions of ISDA contracts may invoke net cash settlement (i.e., "cancellation and payment") upon the occurrence of an extraordinary event that triggers an early termination (e.g., merger, tender offer, delisting).

In practice, issuers may address this automatic trigger of net cash settlement by including provisions in the confirmation that override the default settlement mechanics in the Master Agreement or Equity Definitions. An example is a provision stating that the issuer has the right, in its sole discretion, to choose the form of settlement (cash or shares) for any amount paid or received upon early termination and certain extraordinary events. The issuer should also be sure that the other conditions of ASC 815-40-25 are met (e.g., there is a limit to the number of shares that the issuer could possibly deliver).

Refer to sections 4.4 and 4.5 for discussions on the subsequent accounting and settlement accounting for equity contracts, respectively.

#### 5.9.2.3 Effects on EPS as a potential participating security under ASC 260

Entities that enter into an ASR should consider whether the forward sale contract is a participating security under ASC 260. Some ASRs provide the dealer with value in the event an issuer's actual dividend exceeds its ordinary dividend (e.g., historically paid dividend). This may be accomplished through a reduction of the forward price[48] of the forward contract. Such a provision would cause the forward to be a participating security if the transfer of value upon declaration of a dividend is not contingent (as it would be for an option contract). A participating security under ASC 260 requires the use of the two-class method for calculating the ASR's impact on EPS. Refer to section 5.2.3 of our FRD publication, ***Earnings per share***, for further guidance on the EPS impact of ASRs.

Similarly, if the occurrence of an extraordinary dividend does not explicitly require an adjustment to the forward price of the forward contract, but instead triggers an early termination of the transaction, it should be clear whether the amount determined upon the final settlement would include the economic effect of the extraordinary dividend. If so, the ASR would be a participating security as the dealer would obtain the benefit of the dividend.

[48] Under ASC 815-40-55-37, this adjustment to the forward price would not preclude the forward from being indexed to the issuer's own shares because it is based on a variable (i.e., dividends) that would be an input to the fair value of a fixed-for-fixed forward contract on equity shares.

### 5.9.2.4 Illustration

**Illustration 5-8: Fixed dollar ASR**

On 1 January 20X1, Company A executes an ASR agreement when its common stock price is $10 with Dealer B. The key terms are:

- Prepayment amount: $100 million
- Prepayment date: 1 January 20X1
- Initial shares: 10 million shares of Company A's common stock
- Termination date: 30 April 20X1 (after 15 February 20X1, Dealer B has the option to accelerate the terminate date)
- Calculation period: From 1 January 20X1 to 30 April 20X1
- Forward price: The average of the VWAP for the dates in the calculation period
- Settlement methods:
  - If Company A is entitled to receive upon settlement: Share settlement
  - If Company A is obligated to deliver upon settlement: Cash settlement or share settlement at Company A's election

Company A makes the prepayment of $100 million on 1 January 20X1 and receives 10 million shares of common stock. Dealer B does not elect to accelerate the termination date. On 30 April 20X1, Company A calculates the average VWAP over the calculation period and determines the average VWAP during the contract period is $8. Accordingly, the settlement amount is determined to be 2.5 million shares ($100 million/$8, less the 10 million shares initially delivered). In this case, Dealer B is obligated to deliver the 2.5 million additional shares to Company A.

Company A accounts for the ASR contract as two separate transactions: (1) common stock acquired in a treasury stock transaction and (2) a forward sale contract. Company A concludes that the forward contract is not a liability under ASC 480 and meets the requirements for equity classification under ASC 815-40.

Company A records the following journal entries upon the execution of the ASR agreement and the settlement of the forward contract.

*1 January 20X1*

Company A records the treasury stock transaction as follows:

| | | |
|---|---|---|
| Treasury stock | $ 100 million | |
| Cash | | $ 100 million |

There is no entry for the forward sale contract at inception. Because the forward is classified in equity, it is not subsequently remeasured as long as the forward continues to be classified in equity.

*30 April 20X1*

Under the terms of the ASR, Company A is entitled to receive a settlement from Dealer B because the average of the VWAP for the calculation period is less than the initial purchase price of $10. In this case, Company A will receive and Dealer B will deliver the settlement amount in shares.

On the settlement date (typically T+1 after the termination date), Company A's stock price is $7 per share. Company A records the following entry to reflect the additional shares it receives (2.5 million shares x the $7 per share price) as a treasury stock transaction:

| | | |
|---|---|---|
| Treasury stock | $ 17.5 million | |
| Additional paid-in capital | | $ 17.5 million |

The net effect of the arrangement is that Company A paid $100 million to purchase 12.5 million shares at a price of $8 per share. The ASR places Company A in a similar economic position as if it had purchased the shares in the open market throughout the calculation period, but the arrangement allows it to receive most of the shares at inception.

### 5.9.3 Collared ASRs

In a traditional ASR, the issuer's exposure to deliver shares or cash to the dealer at maturity increases as the stock price rises during the calculation period. To reduce this exposure, an ASR may include a cap that sets a maximum price at which the issuer will purchase the shares and, therefore, a minimum number of shares the issuer will purchase under the entire ASR. Economically, this is equivalent to a purchased call option from the issuer's perspective, because it may give the issuer the ability to ultimately repurchase its shares at a price (the cap price) that is less than the average VWAP if the average VWAP exceeds the cap price.

As the issuer must pay for this protection (i.e., pay a premium to purchase this cap), it is not uncommon to see an ASR also include a floor to offset some or all of the cost of the cap. Incorporating a floor sets a minimum price at which the issuer will purchase shares and, therefore, a maximum number of shares that the issuer will purchase for the entire ASR. Economically, this is equivalent to a written put option from the issuer's perspective, because it may ultimately require the issuer to purchase shares at a price (the floor price) that is greater than the average VWAP if the average VWAP falls below the floor. Rather than collecting a premium for the option that is written to the dealer, the issuer effectively offsets the premium due for the written floor against the premium owed for the purchased cap. The combination of a cap and floor is often referred to as a "collar."

When optionality is incorporated into an ASR, the dealer typically establishes a hedge of this exposure. For example, by selling a cap to the issuer, the dealer is economically short the issuer's shares, and therefore, it typically accumulates a long position in the issuer's shares to offset its exposure on the cap. Similar hedging is common if the ASR includes a floor. These hedges, which are dynamically managed for the duration of the ASR, are established in the first few days or weeks after inception, often referred to as the "hedging period." The cap and floor are typically defined at inception as a percentage of the average VWAP during the hedging period, therefore the actual cap and floor prices are not known until the end of the hedging period.

Another element to collared ASRs is the use of interim deliveries of shares. To ensure the issuer will not have any share delivery obligation to the dealer upon settlement (and thus, alleviate the dealer's burden of selling these shares upon receiving them), it is common for collared ASRs to require an initial share delivery that is smaller than a traditional ASR (e.g., issuer may only receive 50% of the shares as opposed to 80–100% under a traditional ASR), and a subsequent delivery (i.e., interim delivery) after the hedging period equal to the excess of the minimum number of shares over the initial share delivery.

**Example — Interim share delivery**

Assume an issuer enters into a collared ASR when its stock price is $10. At inception, the issuer prepays $100 million in exchange for 5 million shares (50% delivery) at inception. The cap and floor prices are defined as 110% and 90% of average VWAP during the dealer's hedging period, respectively. Assume that the average VWAP during the hedging period is $12. Therefore, the cap price would be $13.20 ($12 multiplied by 110%) and the floor price would be $10.80 ($12.00 multiplied by 90%). The minimum number of shares that the issuer is required to purchase under the cap would be approximately 7.58 million ($100 million divided by $13.20). As a result, the dealer would make an interim delivery of approximately 2.58 million shares at the end of the hedging period, resulting in a total of 7.58 million shares having been delivered cumulatively since inception. Thereafter, absent an unusual or extraordinary event,[49] the issuer would have no obligation to deliver any shares to the dealer upon settlement of the ASR, and could only receive additional shares up to the maximum. In this example, the maximum number of shares would be approximately 9.26 million ($100 million prepayment divided by the $10.80 floor price).

See section 5.9.3.1 below for more information regarding potential obligations of the issuer to return shares that may arise in certain unusual scenarios.

### 5.9.3.1 Accounting for collared ASRs

**ASC 480 considerations**

Similar to traditional ASRs discussed in section 5.9.2, collared ASRs would not typically meet the conditions in ASC 480-10-25-8 through 25-13 requiring liability (or asset) classification. However, if an ASR involves shares that are themselves redeemable, the forward sale would embody an obligation to the issuer to buy back its own shares by virtue of the redemption feature in the shares.

In evaluating whether a collared ASR is in the scope of ASC 480, particular consideration should be given to ASC 480-10-25-14. That guidance is applicable only if the issuer has an obligation to issue a variable number of shares. If the issuer never would have to issue shares, this guidance would not apply. Depending on magnitude of the initial share delivery, the issuer could be required to deliver shares to the dealer. As a result, ASC 480-10-25-14 should be considered to determine if the collared ASR is within the scope of ASC 480.

The following discussion focuses on the application of this guidance to a collared ASR with an interim delivery up to the minimum number of shares (refer to example in section 5.9.3). While the likelihood at inception that the issuer will be required to deliver any shares to the dealer is generally low, there are two primary scenarios where this could occur as follows:

- *Stock price increases significantly during the hedging period.* For example, assume that the issuer pays $100 million at inception when its stock price is $10 and receives 5 million shares (50% initial delivery). If average VWAP during the *hedging period* increased such that the cap price was eventually set at a price greater than $20, the minimum shares the issuer could receive in the ASR transaction, could be less than 5 million shares received in the initial share delivery (e.g., $100 million divided by $20.01 is approximately 4.99 million shares). As a result, even without an interim delivery, it would be possible for the initial share delivery to exceed the minimum number of shares the issuer could receive under the ASR and, therefore, the issuer could be required to issue a variable number of shares to the dealer in settlement of the ASR. However, this would be a highly unlikely scenario because, (1) the cap price would have to double the spot price at inception in this

[49] For example, many ASRs include provisions that allow the dealer to adjust the terms of the ASR for events such as mergers, tender offers, nationalizations, insolvencies and delistings, among others. In these events, based on share prices and terms of the agreement, there may be small possibility of the issuer having to deliver shares in an early termination under the contractual terms of the arrangement.

fact pattern (2) the hedging period typically only lasts one or two weeks (so absent extreme volatility such an increase is not likely) and (3) the cap and floor are set on the average for the period, therefore, the stock price would have to be at a very high level for most of the hedging period.

- *Extraordinary event occurs that results in an adjustment to the terms of the ASR.* As noted above, ASRs include provisions that allow the dealer to adjust the terms of the ASR to allow it to maintain a standard hedge of the transaction. For example, if a merger event or tender offer occurs that creates discontinuities in the issuer's stock price, the dealer generally can adjust the terms of the ASR to capture the economic effect of these events. This could involve the dealer increasing the cap price, thereby reducing the minimum number of shares.

While these scenarios are possible of occurring, they do not represent an obligation with a monetary value that is predominantly fixed, inversely related to the issuer's stock price or unrelated to the issuer's share price.

While these scenarios generally would not cause an ASR to be classified as a liability under ASC 480, the specific facts and circumstances of the ASR and issuer should be evaluated. Any obligation or contingent obligation that is deemed substantive should be further evaluated as to whether it 1) may be settled in a variable number of shares and 2) has monetary value that is predominately fixed, inversely related to the issuer's share price or unrelated to the issuer's share price.

ASC 480 provides limited interpretive guidance on the term "predominantly." The determination of whether a settlement obligation's monetary value is predominant will depend on the specific facts and circumstances and requires judgment. In making that determination, the issuer should consider the terms of the forward contract and all applicable information at inception, which include its current stock price and volatility, the forward price of the instrument and other factors.

**Contracts in an entity's own equity (ASC 815-40)**

As with a traditional ASR, the forward contract component of a collared ASR will typically meet the definition of a derivative. However, it is common for a collared ASR to involve a relatively smaller initial share delivery (see section 5.9.3). This partial share delivery feature may affect whether the forward contract should be viewed as a freestanding derivative or a hybrid instrument with an embedded forward contract (prepaid forward). Under either case, derivative accounting would generally not be required if the requirements of ASC 815-40 are met.

*Indexation considerations under ASC 815-40-15*

The majority of the provisions in a collared ASR confirmation are typically consistent with a traditional ASR and, therefore, the same care should be given to the evaluation. One difference is the provisions that facilitate the establishment of the collar. As discussed above, the confirmation will typically define the cap and floor prices as fixed percentages of average VWAP during the hedging period (e.g., 110% and 90%, respectively). However, as the dealer often has some discretion to determine the length of the hedging period, the dealer's hedging activity impacts the cap and floor prices and, therefore, the ultimate settlement amount. For example, if the dealer used one week establishing its hedge, the cap and floor prices would likely be different than had the dealer used two weeks.

As discussed in section 5.9.2.2, the guidance in ASC 815-40-15-7E and 15-7G (as described by ASC 815-40-55-30) permits adjustments to a contract to allow the dealer to maintain a standard hedge position. However, these adjustments cannot be based on the dealer's actual hedge. Therefore, it is important that the hedging period is explicitly based on a commercially reasonable period of time that would be necessary to establish a commercially reasonable hedge, rather than an arbitrary period of time or type of hedge that the dealer may choose at its sole discretion.

*Equity classification under ASC 815-40-25*

Although there is typically a low probability that the issuer will ever have to issue shares under any settlement in a collared ASR with an interim delivery up to the minimum shares (e.g., in an early termination), it is still necessary to ensure that the issuer can choose to settle in shares under all possible settlement scenarios regardless of how remote.

Refer to sections 4.4 and 4.5 for discussions on the subsequent accounting and settlement accounting for equity contracts, respectively.

## 5.10 Equity contracts on noncontrolling interests

### 5.10.1 Overview and background

NCI is the portion of equity (net assets) in a subsidiary not attributable, directly or indirectly, to the parent. It is sometimes called a minority interest. NCI is created, among other ways, when a parent acquires a controlling interest in a target company and leaves an NCI with other investors, or when a parent decides to sell a portion of its wholly owned subsidiary but retains a controlling interest.

Refer to sections 4.6 and A.2.4 of our FRD publication, ***Business combinations,*** for further discussion on the initial recognition of NCI in a business combination and an asset acquisition, respectively. Refer to section 13 of our FRD publication, ***Consolidation***, when the subsidiary is a variable interest entity, and refer to section 18 of that publication for further discussion on the initial recognition of NCI in other transactions.

Like equity contracts on the shares of a parent company, equity contracts may also be written or purchased on shares of a consolidated subsidiary. For example, when a parent is acquiring a target company, the former controlling shareholders may want to retain a portion of their shares for a period of time but have the ability to sell their equity interests to the controlling interest holder on certain dates or upon certain trigger events. A parent and the NCI holders of a subsidiary may enter into such arrangements for the following reasons:

- Tax planning — A seller may want to defer capital gains that would result from selling 100% of an entity by selling a controlling interest with a put option giving it the right to sell the remaining interest or a call option giving the buyer the right to acquire the remaining interest (or both) in the future.
- Flexibility for the buyer — Call options and forward contracts provide flexibility for the buyer in financing an acquisition.
- Liquidity to the seller — Put options and forward contracts give the seller an exit strategy for its retained interest.
- Seller retention — Call options, put options or forward contracts with a fair value exercise price create an incentive for the seller to remain involved with the business and help make it successful.

Those arrangements can take the form of options (written or purchased, puts or calls), forwards (date certain or contingent) or even swap-like contracts and may include one or more of the following:

- Grant the NCI holders an option to sell their equity interests in the subsidiary to the parent (i.e., a written put option from the parent's perspective)
- Grant the parent an option to acquire the equity interests in the subsidiary held by the NCI holders (i.e., a purchased call option from the parent's perspective)
- Obligate the parent to acquire and the NCI holders to sell their equity interests in the subsidiary (i.e., a forward contract to purchase shares from the parent's perspective)
- Grant the parent a purchased call option and grant the NCI holders a written put option (often these two instruments have the same strike price and expiration dates making them similar to, but not exactly the same as, a forward contract)

In some cases, the arrangements may be papered between the parent and the NCI holders, and in other cases between the subsidiary and the NCI holders.

### 5.10.2 Analysis

NCI, which is generally in the form of common shares or preferred shares issued by the subsidiary, should be classified as a separate component of consolidated equity pursuant to ASC 810-10-45. To be classified as equity in the consolidated financial statements, the instrument issued by the subsidiary should be classified as equity by the subsidiary based on other authoritative literature. If the instrument is classified as a liability in the subsidiary's financial statements (e.g., under any of the guidance in ASC 480), it cannot be presented as NCI in the consolidated entity's financial statements because that instrument does not represent an ownership interest in the consolidated entity under US GAAP.

For example, if mandatorily redeemable preferred shares issued by a subsidiary were classified as a liability in the subsidiary's financial statements pursuant to ASC 480, the preferred shares would not be classified as NCI in the consolidated financial statements.

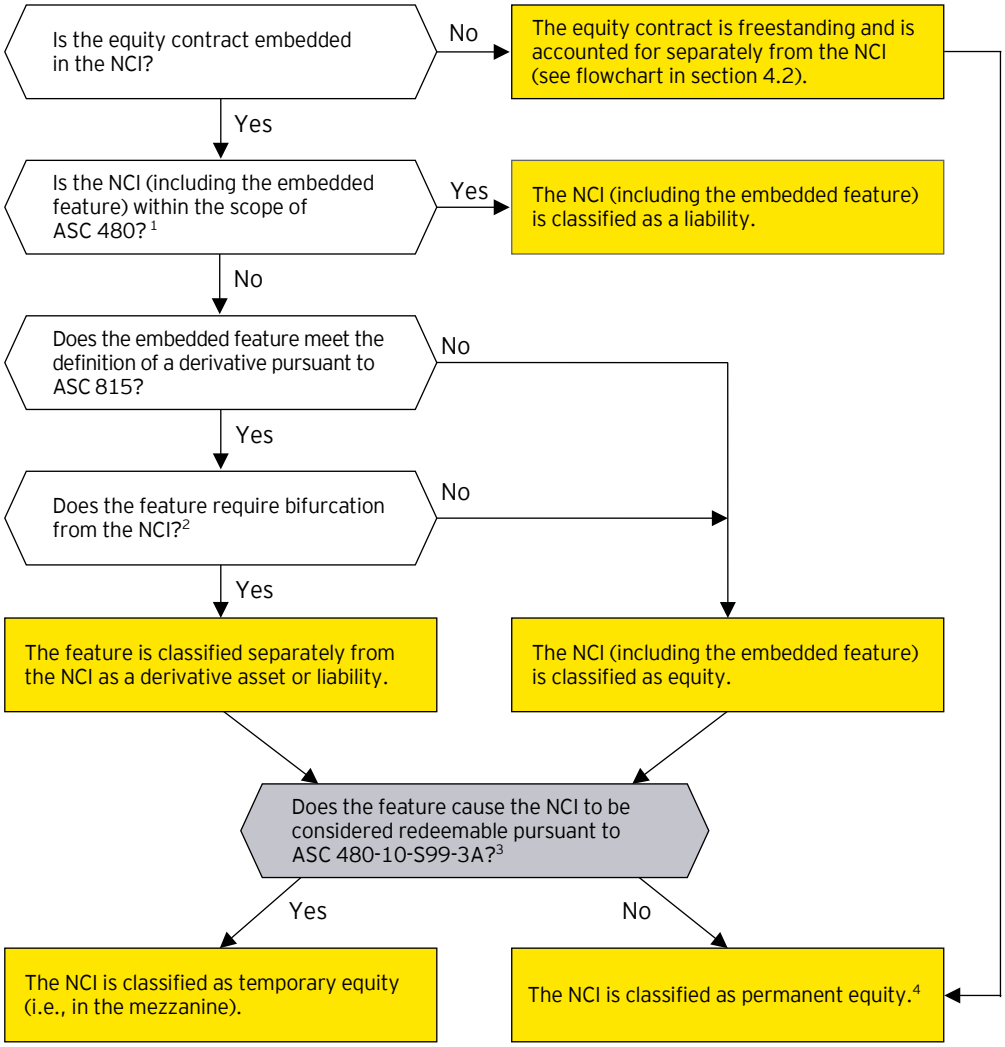
The various options and forwards described above are contracts on the shares (common or preferred) of a subsidiary. If the underlying share is classified in equity (as NCI), the equity contracts on the NCI should be separately evaluated to determine their classification.

The accounting in this area can be complex because of the variety of authoritative guidance that should be considered and the terms of the transaction. For example, (1) the equity contract may be entered into contemporaneously with the creation of the NCI or subsequent to its creation, (2) the equity contract on the NCI may be considered embedded or freestanding and (3) the strike price of the equity contract may be set at either a fixed or variable (formulaic) price, or at fair value. Each of those variations can affect the accounting. Additionally, equity contracts on NCI may be issued as share-based payments to employees or nonemployees. In these cases, entities should consider the guidance in ASC 718 and their accounting policy for stock options on subsidiary stock (see section 18.5.1 of our FRD publication, ***Consolidation***). Refer to our FRD publication, ***Share-based payment***, for further guidance related to accounting for share-based payment arrangements.

The following summarizes, at a high level, the relevant accounting considerations applicable to equity contracts associated with NCI that are not issued in a share-based payment arrangement. A parent that has entered into equity contracts on NCI also should carefully evaluate how these arrangements affect future earnings and EPS.

### 5.10.2.1 Road map for initial classification of equity contracts over NCI

The following flowchart provides a road map for determining the classification of equity contracts over NCI and should be used in conjunction with the interpretive guidance that begins after the flowchart.




[1] This includes assessment of whether equity contracts embedded in the NCI should be deemed financing arrangements pursuant to ASC 480-10-55-59 through 55-62.

[2] This includes determining whether the economic characteristics and risks of the embedded feature are clearly and closely related to the host contract and, if not, whether the embedded feature is eligible for a scope exception from ASC 815 (e.g., ASC 815-10-15-74(a)).

[3] Redemption features (e.g., put options) embedded in the NCI, regardless of whether they are bifurcated and accounted for separately from the NCI, are considered in determining whether the NCI is subject to ASC 480-10-S99-3A.

[4] If the freestanding equity contract is a fixed-priced forward to buy NCI at a stated future date that requires physical settlement, the transaction is effectively a financing of the parent's purchase of the NCI and consequently, the parent consolidates 100% of the subsidiary and does not recognize the NCI at the consolidated entity level.

### 5.10.2.2 Is the equity contract embedded in the NCI or freestanding?

The first step in accounting for an equity contract associated with an NCI is to determine whether the equity contract is an embedded feature in the NCI or a freestanding financial instrument, because the accounting can be significantly different. For example, the accounting for a freestanding written put on a subsidiary's shares is different than that for puttable shares issued by the subsidiary. While ASC 480 provides little interpretive guidance on the definition of a "freestanding" financial instrument, we believe that the substance of a transaction should be considered in making this determination.

The determination of whether an instrument is embedded or freestanding involves understanding both the form and substance of the transaction, and may involve substantial judgment. In this regard, documenting an instrument in a separate contract is not necessarily determinative that it is freestanding, particularly when a contract is entered into in conjunction with another transaction. Similarly, an instrument that is documented in the same contract isn't necessarily embedded. If the transactions are entered contemporaneously between the same parties and involve the same underlying (in this context, the issuer's shares), it is important to assess whether the instruments are (1) legally detachable and (2) separately exercisable. Those concepts can be further described as follows:

- Legally detachable — Generally, whether two instruments can be legally separated and transferred such that the two components may be held by different parties.
- Separately exercisable — Generally, whether one instrument can be exercised without terminating the other instrument (i.e., through redemption, simultaneous exercise or expiration).

If the exercise of one instrument must result in the termination of the other, the instruments would generally not be considered freestanding pursuant to ASC 480. On the other hand, if one instrument can be exercised while the other instrument continues to be outstanding, the instruments would be considered freestanding under ASC 480, if it is also legally detachable from the other instrument.

For example, if a parent enters into a contract with the only noncontrolling shareholder of its privately held subsidiary that permits the shareholder to put its shares in the subsidiary to the parent at a fixed price, that put option generally would be considered to be embedded in the related shares. This is because the shares held by the NCI holder are the shares that must be delivered upon exercise of the put option by the NCI holder. In contrast, if the same parent enters into a put option on publicly traded common stock of a different subsidiary, and that put option permits the counterparty to put any common shares of the subsidiary to the parent at a fixed price (e.g., the counterparty could put shares of the subsidiary already owned or buy shares in the market), that written put option would be considered freestanding, provided that it is also legally detachable from the shares.

It is not uncommon for a parent to enter into options or forward contracts with the NCI holders to acquire the NCI after the NCI was initially recognized. These contracts may still be considered embedded in or attached to the NCI, based on the individual facts and circumstances. For example, if the parent subsequently enters into a nontransferable equity forward contract with the only noncontrolling shareholder to acquire that holder's equity interest and the contract requires physical settlement, the transaction may, in substance, represent an embedded or attached redemption feature. In certain circumstances, the addition of options or forward contracts may represent a modification of the NCI, requiring additional analysis. Refer to section 3.6 for more information regarding modifications or exchanges of stock instruments.

#### *5.10.2.2.1 Equity contracts considered embedded*

If the equity contract is considered a feature embedded in the subsidiary's shares, that embedded feature should first be analyzed to determine whether the NCI should be a mandatorily redeemable financial instrument subject to ASC 480. Because a forward contract embedded in NCI shares represents an obligation of the parent to mandatorily redeem the NCI for cash, the NCI (including the embedded forward contract) generally is recognized as a liability within the scope of ASC 480. Conversely, a call or put option embedded in the NCI shares usually does not result in the shares being considered mandatorily redeemable because the contract conveys an option rather than an obligation.

If the shares are not a liability, then the NCI should be classified in equity and the embedded feature analyzed for bifurcation pursuant to ASC 815. Likewise, if the shares are classified as a liability (and not subsequently measured at fair value), then any embedded features should be analyzed for bifurcation. To determine whether the embedded feature should be bifurcated, the hybrid instrument (the subsidiary's shares and embedded feature) should be evaluated under ASC 815-15. As part of that analysis, if the

hybrid instrument is classified as equity (i.e., it is not a mandatorily redeemable financial instrument subject to ASC 480), the nature of the host contract (debt-like or equity-like) should first be determined. If the nature of the host is more akin to debt, the embedded feature (i.e., the redemption feature) should be analyzed using the debt instrument model (refer to section 2.2.5).

If the host is more akin to equity, in many cases, unless the subsidiary itself is a publicly traded entity, the feature will not meet the definition of a derivative pursuant to ASC 815-10-15 because those features usually require gross physical settlement or the transfer of the full amount of consideration payable in exchange for the full number of underlying nonpublic subsidiary shares. As the underlying nonpublic shares are not readily convertible to cash, this gross physical settlement does not meet any of the forms of net settlement pursuant to ASC 815-10-15-99. However, if the instrument meets the definition of a derivative, it should be evaluated under ASC 815-10-15-74(a) to determine if an exception from bifurcation is available.[50]

The exception in ASC 815-10-15-74(a) is applicable if the feature is considered indexed to the issuer's own stock and would be classified in equity. ASC 815-40 includes guidance that should be considered in making this determination. There are special considerations as to whether the feature is considered indexed to the issuer's own stock when subsidiary shares are involved, as discussed in ASC 815-40-15-5C.

If the embedded feature (e.g., call option, put option) does not require bifurcation pursuant to ASC 815-15, it remains with the NCI host instrument and no amount should be allocated to the embedded feature. On the other hand, if the embedded feature requires bifurcation, a single derivative (or a compound derivative comprising all the features requiring bifurcation) should be separated from the NCI and recorded at fair value, which would reduce the amount allocated to NCI at the transaction date. The NCI classified in equity is subsequently accounted for in accordance with ASC 810.

When the NCI is classified in equity (because it is not considered to be mandatorily redeemable) and contains an embedded redemption feature (regardless of whether the redemption feature is bifurcated), the redeemable equity guidance discussed below in section 5.10.2.4, should be considered.

Refer to section 3.2.4 for further guidance in evaluating shares with embedded features.

#### *5.10.2.2.2 Equity contracts considered freestanding*

An equity contract that is considered a freestanding financial instrument from the NCI should be evaluated pursuant to ASC 480 to determine whether liability classification is required as, for the purposes of ASC 480, an issuer's equity share includes the equity shares of any entity whose financial statements are included in the consolidated financial statements. Instruments that may require the issuer to transfer cash or other assets in exchange for its own shares are among those classified as liabilities pursuant to ASC 480. For example, a physically settled forward contract that requires the parent to pay cash in exchange for the subsidiary's shares is within the scope of ASC 480. Further, a freestanding written put option on the subsidiary's shares is also a liability under ASC 480 regardless of whether it settled gross or net.

If the equity contract is not a liability pursuant to ASC 480, it is evaluated under the guidance in ASC 815-40 to determine the classification. ASC 815-40 provides that contracts should be classified as equity instruments (and not as assets or liabilities) if they are both (1) indexed to the issuer's own stock and (2) classified in stockholders' equity in the issuer's statement of financial position. Equity contracts (regardless of whether they meet the definition of a derivative) that (1) are not indexed to the issuer's shares or (2) are indexed to the issuer's shares but do not meet the equity classification guidance are

[50] The embedded feature would be considered a derivative if the underlying shares were publicly traded. If the feature meets the net settlement criterion by way of a required or alternative settlement in net cash or net shares, the conclusion that the feature was embedded should be revisited.

classified as assets or liabilities and measured at fair value with changes in fair value recorded in earnings. If the equity contracts also meet the definition of a derivative under ASC 815 (including consideration of all scope exceptions), the disclosures in that guidance are also required.

The NCI, as a separate freestanding financial instrument, would be classified in equity and subsequently accounted for in accordance with ASC 810.

Refer to section 4 for detailed guidance on evaluating the classification of a freestanding equity contract.

### 5.10.2.3 Equity contracts deemed to be financing arrangements

In limited situations, a parent may enter into an equity contract to acquire a subsidiary's shares that should be accounted for as a financing of the parent's purchase of the NCI. In those situations, equity contracts are entered into between the parent and NCI holder at the inception of NCI that require physical settlement. The contracts may be either (1) a fixed-priced forward to buy the remaining interest in the subsidiary at a stated future date and the forward is considered freestanding or (2) a combination of a purchased call option and written put option with same (or not significantly different) fixed strike price and same fixed exercise date that are embedded in the shares.

Essentially, the parent does not recognize the NCI for the proportion of shares that is subject to the financing but rather recognizes a liability for the financing (i.e., the future purchase of the NCI). In those circumstances, the risks and rewards of owning the NCI have been obtained by the parent during the period of the equity contract, even though the legal ownership of the NCI is still retained by the NCI holders. Combining the equity contract and the NCI reflects the substance of the transaction; that is, the NCI holder is financing the noncontrolling interest.

ASC 480-10-55-53 through 55-62 discuss equity contracts indexed to the noncontrolling interest of a consolidated subsidiary that may be accounted for as financing arrangements. Further, ASC 480-10-55-54 states that the forward contract should be recognized as a liability, initially measured at the present value of the fixed forward price. Subsequently, the liability is accreted to the fixed forward price over the term of the forward contract with the resulting expense recognized as interest cost. Similar accounting and measurement would be applied to the combined NCI and embedded options.

The initial measurement guidance in ASC 480-10-55-54 is not consistent with the general initial measurement requirement of ASC 480 for physically settled forward purchase contracts. The general measurement guidance in ASC 480-10-30-3 states that a freestanding physically settled forward contract should be measured initially at the fair value of the underlying shares at inception, adjusted for any consideration or unstated rights or privileges. While the methods are different, we generally believe that they should result in approximately the same initial measurement. Any significant differences would require additional analysis to determine if there are additional rights or privileges in the transaction.

### 5.10.2.4 Application of the redeemable equity guidance

Generally, an embedded feature, whether or not bifurcated, that permits or requires the NCI shareholder to deliver the subsidiary's interests in exchange for cash or other assets from the controlling entity (or the subsidiary itself) will result in the NCI being considered redeemable equity if the NCI is not presented as a liability. Public entities should consider the SEC staff's guidance on redeemable equity securities (included in Codification at ASC 480-10-S99-3A) when classifying and measuring redeemable NCI. Those interests should first follow the accounting and measurement guidance in ASC 810-10 (including allocation of earnings, adjustments for dividends, etc.). The SEC staff's guidance should then be considered, which could affect the classification (presented in the mezzanine rather than in equity), and if so, may also adjust the measurement of any NCI and the related EPS calculations.

In certain instances, the issuer may be required, or may have a choice, to exchange the subsidiary's interests by delivery of its own shares, rather than cash or other assets. In those instances, the SEC staff's guidance requires the issuer to consider the guidance in ASC 815-40-25 to determine whether it can deliver the shares that could be required under the settlement of the exchange. If the issuer does not completely control settlement by delivery of its own shares (i.e., it cannot satisfy the settlement in shares), cash settlement would be presumed and temporary classification may be required for the NCI. Refer to Appendix C for further discussion on the application of the redeemable equity guidance in ASC 480-10-S99-3A.

#### *5.10.2.4.1 Measurement and reporting issues related to redeemable equity securities*

ASC 480-10-S99-3A requires redeemable NCI to be initially recognized in temporary equity at the initial carrying amount of the NCI determined in accordance with ASC 805-20-30. That guidance applies to business combinations and requires the acquirer to measure the NCI in the acquiree at fair value on the acquisition date. Refer to section 4.6 of our FRD publication, ***Business combinations***, for further discussion on the initial recognition of NCI in a business combination.

ASC 480-10-S99-3A does not address the initial measurement of a redeemable NCI if it is not created as part of a business combination subject to the guidance in ASC 805. For example, consider when a parent sells a 5% NCI in a subsidiary while retaining a controlling financial interest. If that transaction is determined to be in the scope of ASC 810, it would be accounted for as an equity transaction under ASC 810-10-45-21A through 45-24, in which case the carrying amount of the NCI should reflect the NCI holder's ownership in the subsidiary's net assets, inclusive of any consideration received by the subsidiary. However, if the NCI is redeemable and subject to ASC 480-10-S99-3A, we generally believe that the redeemable NCI should be initially measured at fair value. Whether or not any adjustment to bring the initial carrying amount of the NCI under ASC 810 to fair value will affect EPS will depend on facts and circumstances.

Refer to section A.2.4 of our FRD publication, ***Business combinations***, for further discussion on the initial recognition of NCI in an asset acquisition. Also, refer to section 13 of our FRD publication, ***Consolidation***, when the subsidiary is a variable interest entity, and refer to section 18 of that publication for further discussion on the accounting for subsequent changes in the ownership interest under ASC 810.

For all companies, both public and nonpublic, NCI is subsequently accounted for pursuant to ASC 810. If the NCI is considered redeemable pursuant to ASC 480-10-S99-3A, the redeemable NCI is presented in temporary equity. The measurement guidance in ASC 480-10-S99-3A is not applied in lieu of the accounting for NCI under ASC 810. Rather, it is an incremental measurement that starts with the carrying amount pursuant to ASC 810 and adjusts for any increase (but not decrease) to the carrying amount of temporary equity. Paragraph 16e of ASC 480-10-S99-3A states that the amount in temporary equity should not be less than the redeemable instrument's initial amount reported in temporary equity. It further states that reductions in the carrying amount of a temporary equity instrument are appropriate only to the extent of increases in the redeemable instrument's carrying amount from the application of the SEC staff's guidance. We generally believe only the incremental measurement pursuant to the SEC staff's guidance is subject to this requirement. An issuer could potentially adjust a redeemable NCI's balance below its initial carrying amount when applying ASC 810 (e.g., for allocated losses or dividends paid).

As a result, a parent should first attribute net income or loss of the subsidiary and related dividends to the NCI pursuant to ASC 810. After that attribution, the issuer should consider the provisions of ASC 480-10-S99-3A to determine whether any further adjustments are necessary to increase the carrying value of redeemable NCI. Adjustments to the carrying amount of redeemable NCI from the application of the SEC staff's guidance are charged to retained earnings (or to additional paid-in capital if there are no retained earnings) and do not affect net income or comprehensive income in the consolidated financial statements. The amount presented in temporary equity should be the greater of the NCI balance determined under ASC 810 or the amount determined under ASC 480-10-S99-3A.

The illustration below demonstrates the application of the guidance in ASC 480-10-S99-3A to redeemable NCI that is created in an equity transaction accounted for under ASC 810-10.

**Illustration 5-9: Redeemable NCI created in an ASC 810 transaction without loss of control**

Subsidiary A has 10,000 shares of common stock outstanding, all of which are owned by Parent B. Parent B is a calendar-year entity and has $4,000,000 of retained earnings as of 1 January 20X1. The carrying amount of Subsidiary A's equity is $2,000,000.

On 1 January 20X1, Parent B sells 2,000 shares of Subsidiary A's common stock to Company C for $500,000 (representing the fair value of 20% ownership interest in Subsidiary A), reducing its ownership interest to 80%. The 20% ownership interest is redeemable by Company C at fair value at any time.

Parent B retains its controlling financial interest in Subsidiary A and therefore accounts for the sale as an equity transaction pursuant to ASC 810-10-45-23. In addition, Parent B determines that the NCI recognized under ASC 810 does not require a liability classification because it is not mandatorily redeemable, and that the redemption option is an embedded feature that does not require bifurcation and derivative accounting under ASC 815. Because the NCI is redeemable at the option of Company C, it is therefore subject to ASC 480-10-S99-3A.

*Initial recognition and measurement*

On 1 January 20X1, Parent B records a noncontrolling interest of $400,000 ($2,000,000 x 20%), which reflects the NCI holder's ownership in the subsidiary. The $100,000 excess of cash received over the carrying amount of the NCI is recorded as an increase to APIC. Parent B records the following entry:

| | | | | |
|---|---|---|---|---|
| Cash | $ | 500,000 | | |
| Additional paid-in capital | | | $ | 100,000 |
| Noncontrolling interest | | | | 400,000 |

Under ASC 480-10-S99-3A, the redeemable NCI is initially measured at fair value. Parent B records the following entry to adjust the NCI's carrying amount to fair value (i.e., the amount of the cash received):

| | | | | |
|---|---|---|---|---|
| Retained earnings (or APIC) | $ | 100,000 | | |
| Noncontrolling interest | | | $ | 100,000 |

*Subsequent measurement*

On each subsequent reporting date, Subsidiary A's net income or loss is attributed to the controlling interest and NCI in accordance with ASC 810-10. Parent B also performs a valuation of the redeemable NCI as of each reporting date. Because the NCI is currently redeemable, once the ASC 810-10 attribution adjustment is recorded, the NCI should be adjusted to its maximum redemption amount at the balance sheet date pursuant to paragraph 14 of ASC 480-10-S99-3A.

The following table provides the ASC 810-10 adjustments for each year, the cumulative ASC 810-10 adjustments, the NCI's fair value and the NCI's carrying amount (after the ASC 810-10 and ASC 480 adjustments) at each year end:

| Year | Net income (loss) attributable to NCI under ASC 810-10 | NCI at 31 December after cumulative ASC 810-10 adjustments | Fair value of NCI at 31 December | Carrying amount of NCI at 31 December after ASC 810-10 and ASC 480 adjustments |
|---|---|---|---|---|
| 20X1 | $ 20,000 | $ 520,000 | $ 530,000 | $ 530,000 |
| 20X2 | $ 40,000 | $ 560,000 | $ 520,000 | $ 560,000 |
| 20X3 | $ (100,000) | $ 460,000 | $ 440,000 | $ 460,000 |
| 20X4 | $ (24,000) | $ 436,000 | $ 450,000 | $ 450,000 |

**31 December 20X1**

Pursuant to ASC 810-10, Parent B adjusts the $500,000 initial carrying amount of the NCI for the net income attributable to the redeemable NCI for the period:

| | | | | |
|---|---|---|---|---|
| Income attributable to noncontrolling interest | $ | 20,000 | | |
| Noncontrolling interest | | | $ | 20,000 |

However, under the SEC staff's guidance on redeemable equity securities, the amount of NCI should be the greater of the balance determined under ASC 810 (reflecting the cumulative attribution adjustments) or the redemption amount determined under ASC 480-10-S99-3A. The NCI is currently redeemable at its fair value of $530,000, which is greater than its adjusted carrying amount of $520,000 pursuant to ASC 810-10. Therefore, Parent B records the following entry to increase the NCI's carrying amount to its redemption amount (which is based on fair value) under ASC 480-10-S99-3A:

| | | | | |
|---|---|---|---|---|
| Retained earnings (or APIC) | $ | 10,000 | | |
| Noncontrolling interest | | | $ | 10,000 |

**31 December 20X2**

Pursuant to ASC 810-10, Parent B adjusts the $530,000 carrying amount of the NCI for the net income attributable to the redeemable NCI for the period:

| | | | | |
|---|---|---|---|---|
| Income attributable to noncontrolling interest | $ | 40,000 | | |
| Noncontrolling interest | | | $ | 40,000 |

After the ASC 810-10 adjustment, the carrying amount of the NCI on 31 December is $570,000. However, that amount exceeds both (1) $560,000, which is the $500,000 initial carrying amount of the NCI determined under ASC 810, adjusted for the $60,000 of cumulative net income attributed under ASC 810, and (2) $520,000, which is the redemption amount of the NCI determined under ASC 480-10-S99-3A. Parent B records the following entry to decrease the carrying amount of the NCI to $560,000, which represents the greater of the NCI balance under ASC 810 and the redemption amount under ASC 480-10-S99-3A. Note that this decrease is limited to the previous increase in the NCI's carrying amount (i.e., $10,000) due to the application of the subsequent measurement guidance in ASC 480-10-S99-3A:

| | | | | |
|---|---|---|---|---|
| Noncontrolling interest | $ | 10,000 | | |
| Retained earnings (or APIC) | | | $ | 10,000 |

**31 December 20X3**

Pursuant to ASC 810-10, Parent B adjusts the $560,000 carrying amount of the NCI for the net loss attributable to the redeemable NCI for the period:

| | | | | |
|---|---|---|---|---|
| Noncontrolling interest | $ | 100,000 | | |
| Loss attributable to noncontrolling interest | | | $ | 100,000 |

After the ASC 810-10 adjustment, the carrying amount of the NCI on 31 December is $460,000, which is greater than its fair value of $440,000 at the reporting date. The NCI's carrying amount of $460,000 is less than its initial carrying amount of $500,000. Although ASC 480-10-S99-3A states that the amount in temporary equity should not be less than the redeemable instrument's initial amount reported in temporary equity, the reduction in the NCI's carrying amount below its initial carrying amount is appropriate because it is due to the application of ASC 810-10 rather than to adjustments under ASC 480-10-S99-3A. No adjustment under ASC 480-10-S99-3A is required for the period.

**31 December 20X4**

Pursuant to ASC 810-10, Parent B adjusts the $460,000 carrying amount for the net loss attributable to the redeemable NCI for the period:

| | | | | |
|---|---|---|---|---|
| Noncontrolling interest | $ | 24,000 | | |
| Loss attributable to noncontrolling interest | | | $ | 24,000 |

After the ASC 810-10 adjustment, the carrying amount of the NCI on 31 December is $436,000, which is less than its fair value of $450,000. Parent B records the following entry to increase the NCI's carrying amount to its redemption amount as required by ASC 480-10-S99-3A:

| | | | | |
|---|---|---|---|---|
| Retained earnings (or APIC) | $ | 14,000 | | |
| Noncontrolling interest | | | $ | 14,000 |

The NCI's carrying amount of $450,000 remains below its initial carrying amount of $500,000, which is appropriate because it is due to the application of ASC 810-10 rather than adjustments under ASC 480-10-S99-3A.

Pursuant to ASC 480-10-S99-3A, a security (including NCI) that is currently redeemable is measured at the current redemption amount. For a security that is not redeemable currently, but probable of becoming redeemable in the future, the SEC staff's guidance permits the following two methods of adjusting the carrying amount of the redeemable security:

- Method 1 — Accrete the carrying amount of the redeemable security to the redemption amount over time, from the date of issuance (or the date that it is probable that the instrument will become redeemable) to the earliest redemption date, using an appropriate method (e.g., the interest method).
- Method 2 — Adjust the carrying amount of the redeemable security to what would be the redemption amount assuming the security was redeemable at the balance sheet date.

The SEC staff's guidance does not specify which method is required. We generally believe issuers should evaluate the specific facts and circumstances of the applicable redemption feature and the level of subjectivity and assumptions necessary and apply the method that best presents the economics of the redeemable NCI. Once the method is selected, it should be consistently applied.

If the NCI is not currently redeemable and also not probable of becoming redeemable (e.g., it is not probable a contingency that triggers redemption will be met), the NCI should be classified in temporary equity, but adjustment to the initial carrying amount is not necessary until it is probable that the NCI will become redeemable.

Refer to section C.4.2 for a discussion of the measurement of redeemable NCI pursuant to the SEC staff's guidance.

### 5.10.2.5 Earnings per share considerations

As noted in ASC 480-10-S99-3A paragraph 22, adjustments to the carrying amount of redeemable NCI from the application of the SEC guidance do not affect net income or comprehensive income in the consolidated financial statements. However, the adjustments may affect EPS. The effect, if any, will depend on (1) whether the NCI is represented by the subsidiary's common shares or preferred shares and (2) if common shares, whether the redemption amount is at the then-current fair value or some other value (e.g., a fixed amount).

If the redemption of NCI in the form of common stock is at fair value, adjustments to the carrying amount of redeemable NCI that result from applying the guidance in ASC 480 do not affect EPS because redemption at fair value does not result in the NCI shareholder receiving a distribution different from what other common shareholders would receive in an arms-length transaction.

However, if the redemption amount is anything other than fair value (e.g., fixed), the NCI shareholder will receive a distribution that is different from what other common shareholders could receive if selling their shares. In those cases, the increases and decreases (only to the extent that those decreases reflect recoveries of amounts previously reflected in the computation of EPS) in the carrying amount of redeemable NCI are treated in the same manner as dividends on nonredeemable common stock.

There are two acceptable approaches for computing EPS for the effect of NCI in the form of common stock that is redeemable at other than fair value:

- Treat the entire periodic adjustment resulting from the SEC's guidance to the instrument's carrying amount like a dividend
- Treat only the portion of that periodic adjustment to the instrument's carrying amount that reflects redemption in excess of fair value like a dividend

These alternative approaches are accounting policy elections that should be applied consistently and disclosed in the notes to the financial statements.

In addition, the parent has two alternatives to present the effect of adjustments to the carrying amount of redeemable NCI that result from applying the guidance in ASC 480: (1) adjust net income attributable to the parent (as reported on the face of the income statement) for changes in the carrying amount of the redeemable NCI, or (2) do not adjust net income attributable to the parent and consider only the effect of the redemption feature in the calculation of income available to common shareholders of the parent (which may be disclosed on the face of the income statement under SEC guidance). These approaches affect presentation and disclosure only. They do not affect the amount of reported EPS. The approach selected should be applied consistently.

Refer to section 3.2.2 of our FRD publication, ***Earnings per share***, for further discussion of the EPS effects of redeemable equity instruments (including redeemable NCI).

### 5.10.2.6 Examples of the presentation of NCI with equity contracts issued on those interests

The following table summarizes the accounting for certain common equity contracts used to acquire interests in a subsidiary, assuming that the equity contracts are issued on all of the outstanding NCI (i.e., for the fixed number of shares not held by the parent) and are entered into by the controlling interest.

This accounting described in the table should be applied only after determining (1) when the equity contract was entered into relative to the creation of the NCI[51] (2) whether its price is fixed, variable or at fair value and (3) whether the instrument is embedded or freestanding. The guidance in the table should be used as a starting point in applying the literature. Parenthetical references cite the relevant literature. Application of ASC 480-10-S99-3A is not specifically addressed in the table, but references to SEC staff guidance that require additional consideration are included.

[51] This table assumes the equity contracts issued after the creation of the NCI are freestanding. Depending on the facts and circumstances, certain equity contracts issued after the creation of the NCI could be considered embedded. If the instrument is considered to be embedded, the guidance on equity contracts embedded in the NCI should be applied, and the guidance in ASC 480-10-S99-3A should be considered.

This guidance in the table does not contemplate all possible instruments and assumes subsidiaries represent substantive entities as contemplated in ASC 815-40-15-5C. Careful consideration of the facts and circumstances will be necessary to determine the appropriate accounting for any instrument issued on NCI.

| Instrument | Entered into | Redemption amount | Accounting |
|---|---|---|---|
| Written put option permitting the NCI holder to put its interest to the controlling interest | Contemporaneous with creation of NCI | Fixed, fair value or variable | ***If embedded and not bifurcated***<br>If the embedded written put option does not require bifurcation pursuant to ASC 815-15, the put option is recognized as part of the NCI. Changes in the fair value of the option over its life are not recognized. Earnings are generally attributed to the controlling interest and NCI without considering the put option.<br>If the embedded put option is exercised, the NCI is reduced and APIC is adjusted for any difference between the NCI's carrying value and the consideration paid.[52]<br>For SEC reporting, additional consideration of ASC 480-10-S99-3A is required for the NCI.<br>***If freestanding***<br>ASC 480 requires the written put option to be classified as a liability and measured at fair value with the changes in value recognized in earnings.<br>The exercise of the option results in the acquisition of NCI and any difference between the cash paid and the combined value of the freestanding instrument and the NCI's carrying value would be recorded to APIC.<br>***If embedded and bifurcated***<br>The written put option is bifurcated and reported separately at fair value with changes in fair value recorded in earnings. The NCI is recognized and measured pursuant to ASC 810.<br>For SEC reporting, additional consideration of ASC 480-10-S99-3A is required for the host equity contract. |
| | After creation of NCI | Fixed, fair value or variable | The written put option is recognized as a liability that is initially and subsequently measured at fair value pursuant to ASC 480. The NCI is recognized and measured in accordance with ASC 810. |
| Purchased call option permitting the controlling interest to acquire the NCI | Contemporaneous with creation of NCI | Fixed, fair value or variable | ***If embedded and not bifurcated***<br>If the embedded purchased call option does not require bifurcation pursuant to ASC 815-15, the call option is recognized as part of the NCI. Changes in the fair value of the option over its life are not recognized. Earnings are generally attributed to the controlling interest and NCI without considering the call option.<br>If the embedded call option is exercised, the NCI is reduced and APIC is adjusted for any difference between the NCI's carrying value and the consideration paid.<br>***If embedded and bifurcated***<br>The purchased call option is reported separately and measured at fair value with changes in value recognized in earnings. The NCI is recognized and measured pursuant to ASC 810. |

[52] ASC 810-10 requires transactions between the controlling interest and NCI that do not result in a change in control to be recognized in equity. See section 18 of our FRD publication, ***Consolidation***, for additional guidance.

| Instrument | Entered into | Redemption amount | Accounting |
|---|---|---|---|
| Purchased call option permitting the controlling interest to acquire the NCI (continued) | Contemporaneous with creation of NCI (continued) | Fixed, fair value or variable (continued) | *If freestanding*<br>Follow ASC 815-40 to determine the appropriate classification and subsequent measurement of the instrument as an asset or equity.<br>If the purchased call option is not classified in equity, it is reported separately and measured at fair value with changes in fair value recognized in earnings. The NCI continues to be recognized and measured pursuant to ASC 810. For a freestanding call option classified as equity pursuant to ASC 815-40, if the call option was entered into by the parent and expires unexercised, the carrying amount of the instrument should be reclassified from the NCI to the controlling interest. If it was entered into by the subsidiary and expires unexercised, there is no reclassification to be made. |
| | After creation of NCI | Fixed, fair value or variable | Follow ASC 815-40 to determine the appropriate classification and subsequent measurement of the instrument as an asset or equity.<br>If the purchased call option is not classified in equity, it is reported separately and measured at fair value with changes in fair value recognized in earnings. The NCI continues to be recognized and measured pursuant to ASC 810.<br>For a freestanding call option classified as equity pursuant to ASC 815-40, if the call option was entered into by the parent and expires unexercised, the carrying amount of the instrument should be reclassified from the NCI to the controlling interest. If it was entered into by the subsidiary and expires unexercised, there is no reclassification to be made. |
| Forward contract to acquire the NCI | Contemporaneous with creation of NCI | Payment amount and settlement date are fixed | *If embedded*<br>The NCI would be a mandatorily redeemable financial instrument classified as a liability pursuant to ASC 480-10-30-1 and measured initially at fair value. NCI is not recognized and no earnings are allocated to the NCI. The parent accounts for this transaction as a financing and recognizes 100% of the subsidiary's assets and liabilities.<br>*If freestanding*<br>The forward contract is classified as a liability and initially measured at an appropriate value.[53] The liability is accreted to the settlement amount over the term of the forward contract with the resulting expense recognized as interest cost. NCI is not recognized and no earnings are allocated to the NCI. The parent accounts for this transaction as a financing and recognizes 100% of the subsidiary's assets and liabilities (ASC 480-10-30-3 and ASC 480-10-55-53 through 55-54).<br>When the forward contract is settled, the liability is derecognized. |

[53] When addressing the initial measurement of a forward contract on shares of a subsidiary, there are three measurement models. A freestanding forward contract under ASC 480-10-30-3 is initially measured at the fair value of the shares to be repurchased, adjusted for any consideration or unstated rights or privileges. A freestanding forward contract under ASC 480-10-55-54 is initially measured at the present value of the contract amount, which we believe should be discounted using a market-based rate reflecting the issuer's own credit risk. A mandatorily redeemable NCI is measured at fair value under ASC 480-10-30-1. We generally believe that these methods should result in approximately the same initial measurement. Any significant differences would require additional analysis to determine whether there were additional rights or privileges granted in the transaction.

| Instrument | Entered into | Redemption amount | Accounting |
|---|---|---|---|
| Forward contract to acquire the NCI (continued) | Contemporaneous with creation of NCI (continued) | Payment amount or settlement date vary based on certain conditions | *If embedded*<br>The resulting mandatorily redeemable financial instrument is a liability pursuant to ASC 480 and measured initially at fair value.[54] NCI is not recognized and no earnings are allocated to the NCI. The parent accounts for this transaction as a financing and recognizes 100% of the subsidiary's assets and liabilities.<br>*If freestanding*<br>The forward contract is not subject to ASC 480-10-55-54 as the settlement price is not fixed. Pursuant to other sections of ASC 480, a liability should be recognized at the fair value of the shares at inception, adjusted for any consideration or unstated rights or privileges. The liability is subsequently measured at the amount that would be paid on the reporting date with any change in value from the previous reporting date recognized as interest cost. NCI is not recognized and no earnings are allocated to the NCI. The parent accounts for this transaction as a financing and recognizes 100% of the subsidiary's assets and liabilities. |
| | After creation of NCI | Payment amount and settlement date are fixed | Pursuant to ASC 480, the freestanding forward contract is recognized as a liability at the date on which the forward contract was entered into. The liability is initially measured at the fair value of the shares at inception adjusted for any consideration or unstated rights or privileges. Subsequent measurement is at the present value of the amount to be paid at settlement, accruing interest cost using the rate implicit at inception based on the initial measurement. The previously recognized NCI is derecognized and any difference between the amount of the liability and the NCI's carrying amount is recognized in APIC. No further attribution of earnings is necessary because there is no NCI. |
| | | Payment amount or settlement date varies based on certain conditions | The accounting is the same as if the settlement date is fixed except that the liability is subsequently measured at the amount that would be paid on the reporting date with any change in value from the previous reporting date recognized as interest cost. No further attribution of earnings is necessary because there is no NCI. |

[54] Whether the subsequent measurement requirements of ASC 480-10 or ASC 480-10-S99 would be required depends on the scope exception provided in ASC 480-10-15-7E(b) (refer to section A.3.5.2 for further discussion). If the measurement guidance under ASC 480-10 is applicable, the liability is subsequently measured at the settlement amount as if settlement occurred at the reporting date. Facts and circumstances should be considered in determining the measurement amount that best represents economics of the mandatorily redeemable NCI.

| Instrument | Entered into | Redemption amount | Accounting |
|---|---|---|---|
| Written put option and purchased call option with same (or not significantly different) strike price and same exercise date | Contemporaneous with creation of NCI | Fixed price | ***If embedded and not bifurcated***<br>Pursuant to ASC 480-10-55-59 through 55-62, the options are viewed on a combined basis with the NCI. The combined instrument is classified as a liability, initially measured at the present value of the settlement amount.[55] Subsequently, the liability is accreted to the strike price with the accretion recognized as interest expense. NCI is not recognized and earnings are not attributed. The parent accounts for this transaction as a financing and consolidates 100% of the subsidiary (ASC 480-10-55-55, 55-59 and 55-62).<br>***If embedded and bifurcated***<br>Pursuant to ASC 480-10-55-59 through 55-62, the options are viewed on a combined basis with the NCI. The combined instrument is classified as a liability, initially measured at the present value of the settlement amount. In accordance with ASC 815-15, any option requiring bifurcation from the liability is separated at fair value, which creates a discount to the liability. Changes in fair value of any separated option are recorded in earnings.<br>Subsequently, the liability is accreted to the strike price with the accretion recognized as interest expense. NCI is not recognized and earnings are not attributed. The parent accounts for this transaction as a financing and consolidates 100% of the subsidiary (ASC 480-10-55-55, 55-59 and 55-62).<br>***If freestanding***<br>The written put and purchased call should be evaluated to determine whether they are a single instrument or two instruments. If they are viewed as a single instrument, the combined instrument containing a written put is recognized as a liability (or assets in certain instances) and measured at fair value. If they are viewed as two freestanding instruments, the written put option is recognized as a liability pursuant to ASC 480 and the purchased call option is evaluated pursuant to ASC 815-40 and ASC 815-10 and may be recognized as an asset or equity (refer to discussion in the table above for separate written puts and purchased calls). |

[55] This instrument is not considered mandatorily redeemable, since it is possible (though highly unlikely) that on the exercise date the NCI will have a fair value equal to the strike price in the options and neither party will be economically motivated to exercise (as opposed to an embedded forward contract that requires settlement and renders the shares mandatorily redeemable). Therefore, the guidance in ASC 480-10-30-1 is not applicable. However, refer to footnote 53 in section 5.10.2.6, which discusses why the various initial measurement methods in ASC 480-10 should result in approximately the same measurement.

| Instrument | Entered into | Redemption amount | Accounting |
|---|---|---|---|
| Written put option and purchased call option with same (or not significantly different) strike price and same exercise date (continued) | Contemporaneous with creation of NCI (continued) | Other than fixed price | *If embedded and not bifurcated*<br>The NCI with the embedded options is not subject to ASC 480-10-55-59 through 55-62. NCI is not mandatorily redeemable, and no liability should be recognized at inception. The options are recognized as part of the NCI. Changes in the fair value of options are not recognized. Earnings are generally attributed to the controlling interest and NCI without considering the options.<br>For SEC reporting, additional consideration of ASC 480-10-S99-3A is required.<br>*If embedded and bifurcated*<br>The combined option is reported separately at fair value with changes in fair value recorded in earnings. The NCI is recognized and measured pursuant to ASC 810.<br>For SEC reporting, additional consideration of ASC 480-10-S99-3A is required for the host equity contract.<br>*If freestanding*<br>The written put and purchased call should be evaluated to determine whether they are a single instrument or two instruments. If they are viewed as a single instrument, the combined instrument containing a written put is recognized as a liability (or assets in certain instances) and measured at fair value. If they are viewed as two freestanding instruments, the written put option is recognized as a liability pursuant to ASC 480 and the purchased call option is evaluated pursuant to ASC 815-40 and ASC 815-10 and may be recognized as an asset or equity (refer to discussion in the table above for separate written puts and purchased calls). |
| | After creation of NCI | Fixed price or other than fixed price | Refer to freestanding analysis above. |

### 5.10.2.7 Redeemable or convertible equity securities and UPREIT structures (updated September 2024)

A real estate investment trust (REIT) with an "umbrella partnership REIT" structure (UPREIT) typically has a consolidated operating partnership (OP) that issues ownership units to noncontrolling parties. Based on the features typically found in the OP units, a REIT should carefully consider the guidance in ASC 480-10-S99-3A when classifying and measuring noncontrolling OP units in its consolidated financial statements.

When a REIT acquires a property, it may issue redeemable OP units to the seller (OP units generally are used to defer a taxable event for the sellers). Those sellers become noncontrolling investors in the OP. The structure of redemption features as part of the OP units or the unit holder agreement with the investor can vary based on various legal considerations for the parent REIT and the OP, including the state of incorporation or organization for the legal entity, interpretations of tax law or other factors.

For example, arrangements vary as to with which entity the investor can redeem the units (e.g., only with the OP or only with the parent REIT or with the parent REIT deciding which entity will redeem the units). Typically, the redeeming entity (parent REIT or OP) will have the choice of the redemption consideration, which could be cash or shares of the parent REIT. The amount of the redemption could be based on a fixed amount, a formulaic amount, or most frequently, a fixed exchange ratio of OP units for parent REIT shares (or the then-current value of those public shares in cash).

As the OP units are redeemable (or exchangeable) at the option of the investor, the OP units potentially represent redeemable NCI in the consolidated financial statements. Pursuant to the redeemable equity guidance in ASC 480-10-S99-3A, if the OP units may be redeemed for cash outside the control of the reporting entity (the consolidated REIT in this case), the NCI should be classified in the mezzanine section and measured in accordance with the SEC staff's guidance. Therefore, identifying what settlement alternatives exist and whether they are solely within the control of the reporting entity is important.

In addition, there may be separate SEC reporting requirements for the OP. For example, if the OP has public debt outstanding, the redeemable equity guidance would be considered in determining the classification of the OP units in the standalone financial statements of the OP. However, it is important to understand that the OP units would be redeemable equity instruments rather than redeemable NCI, and therefore, different elements of ASC 480-10-S99-3A would need to be considered.

Based on discussions with the SEC staff, for purposes of applying the guidance in ASC 480-10-S99-3A to the consolidated financial statements of the REIT and to the standalone financial statements of the OP, we believe that the parent REIT and OP can be considered essentially a single decision maker in evaluating the redemption provisions if both of the following conditions are met:

- The parent REIT is the general partner in the operating partnership and the entities share the same corporate governance structures.
- The only significant asset of the parent REIT is its investments in the OP.
- Legally, there is no conflict in fiduciary duties or interest between the OP and the parent REIT with respect to the parent REIT's ability to exercise all choices afforded it without conflicting with its fiduciary duties to its shareholders.

This will often result in a conclusion that the parent REIT/OP can elect share settlement upon redemption of the OP units. However, as discussed in ASC 480-10-S99-3A, the guidance in ASC 815-40-25 should be evaluated to determine whether the parent REIT/OP controls the actions or events necessary to issue the maximum number of parent REIT shares that could be required to be delivered under share settlement of the contract. If the parent REIT/OP controls those actions or events, the OP units would not be within the scope of the SEC staff's guidance. However, if those actions or events are not completely within their control, the presentation and measurement guidance in ASC 480-10-S99-3A would apply.

This approach is limited to the REIT/OP fact patterns discussed above and should not be analogized to any other fact patterns.

Refer to Appendix C for further discussion on the application of ASC 480-10-S99-3A.

### 5.10.2.8 Redeemable NCI denominated in a foreign currency

When a redeemable NCI is denominated in a foreign currency, additional consideration should be given to the interaction of ASC 830 and ASC 480-10-S99-3A's measurement guidance. Neither ASC 830 nor ASC 480-10-S99-3A provide specific guidance. Judgment is required to determine whether and, if so, how to adjust the carrying amount of the redeemable NCI for the effect of currency exchange rate movements while also respecting the redeemable equity measurement guidance. Refer to Question 3.8 of our FRD publication, ***Foreign currency matters***, for additional guidance.

### 5.10.2.9 Illustrative examples of equity contracts on NCI

Illustrations 5-10 through 5-15 demonstrate the application of the concepts discussed above to some of the more common business combination scenarios involving the use of equity contracts over NCI. The analysis section in each illustration follows the flowchart depicted in section 5.10.2.1.

**Illustration 5-10: Written put option embedded in NCI created in a business combination**

On 1 January 20X7, Company P (an SEC registrant) acquires 80% of the outstanding common shares of Target, a private company, from Company Y for cash consideration in a business combination as defined in ASC 805. Company Y retains a 20% noncontrolling interest in Target. As a result of the acquisition, Company P consolidates Target in accordance with ASC 810. In connection with the acquisition, Company P and Company Y enter into an agreement that permits Company Y to sell its remaining 20% interest in Target to Company P on or after 1 January 20X9 for $475 in cash. The put option is non-transferrable and terminates if Company Y sells its shares.

At the acquisition date, the fair value of the NCI is $500. Target recognized net losses of $250 for 20X7. Company P has adopted an accounting policy of treating the entire periodic adjustment to the redeemable NCI's redemption amount like a dividend.

**Analysis**

*Is the put option embedded in the NCI?*

Yes. The put option is not legally detachable from the NCI because it is non-transferrable. Further, it is not separately exercisable because the NCI terminates upon exercise of the option. As a result, the put option would be considered embedded in the underlying NCI.

*Is the NCI (including the embedded feature) within the scope of ASC 480?*

No. The put option permits but does not require the NCI to be redeemed at a specified or determinable date or upon occurrence of an event certain to occur. Therefore, the NCI, with the embedded put option, is not considered a "mandatorily redeemable" financial instrument within the scope of ASC 480.

*Does the put option require bifurcation under ASC 815?*

No. Company P considered the guidance in ASC 815-15 and determined the nature of the host contract to be more akin to equity. Although a redemption feature in an equity host is generally not considered to be clearly and closely related to the host contract, the put option does not meet the definition of a derivative (as it requires gross physical settlement and the shares of Target are not publicly traded — i.e., not readily convertible to cash). Therefore, the put option does not require bifurcation under ASC 815.

*Does the put option cause the NCI to be redeemable under ASC 480-10-S99-3A?*

Yes. Because the put option permits Company Y to sell its equity interest to Company P (which is an SEC registrant) for cash, the NCI is considered to be redeemable equity under ASC 480-10-S99-3A. Therefore, the NCI is classified as "mezzanine" (between liabilities and equity) on Company P's balance sheet.

At the acquisition date, the cash consideration transferred plus the fair value of the NCI determined pursuant to ASC 805-20-30 would be used to determine the amount of goodwill. The NCI balance of $500 would be presented as "mezzanine" equity. After the acquisition date, the amount presented in "mezzanine" would be determined first by applying the guidance in ASC 810 and attributing the losses of Target to the controlling and noncontrolling interest. Therefore, at 31 December 20X7, before applying the guidance in ASC 480-10-S99-3A, the carrying amount of the NCI would be $450 ($500 − (20% x $250)).

While the NCI is not currently redeemable, it will become redeemable only with the passage of time (i.e., on 1 January 20X9). As discussed above, ASC 480-10-S99-3A permits two methods of adjusting the carrying amount of the redeemable security. For purposes of this illustration, assume that Company P elects to accrete the carrying amount for changes in the redemption value over time using the effective interest method, and that the accreted redemption value as of 31 December 20X7 is $470.

Accordingly, Company P adjusts the carrying amount of its redeemable NCI from $450 to its redemption value of $470 with a $20 credit to the NCI and a corresponding debit to retained earnings (or if there were no retained earnings, to additional paid-in capital).

That $20 debit to retained earnings would reduce the numerator in the EPS calculation. This is because the redemption value of the NCI in the form of common stock is a fixed amount (i.e., not at fair value). This reduction could be presented either as an adjustment on the income statement in determining net income attributable to the parent (refer to Alternative 1 below) or through the calculation of income available to common shareholders when deriving EPS (refer to Alternative 2 below). The manner in which the reduction is treated is an accounting policy election that should be applied consistently and disclosed in the notes to the financial statements.

The following is an excerpt from Company P's income statement for the year ended 31 December 20X7.

| | Alternative 1 | Alternative 2 |
|---|---|---|
| **Net income** | 1,750 | 1,750 |
| Plus: Net loss attributable to redeemable noncontrolling interest | 30 [A] | 50 [B] |
| **Net income attributable to Company P** | 1,780 | 1,800 |
| **Earnings per share — basic:** | | |
| Net income attributable to Company P common stockholders | $1.78 | $1.78 |
| **Earnings per share — diluted:** | | |
| Net income attributable to Company P common stockholders | $1.41 | $1.41 |
| Weighted average shares outstanding: | | |
| Basic | 1,000 | 1,000 |
| Diluted | 1,264 | 1,264 |

The following table is an excerpt from the notes to the financial statements where basic and diluted net income attributable to Company P common stockholders per share has been computed:

| | 31 December 20X7 |
|---|---|
| **Alternative 1** | |
| Net income attributable to Company P common shareholders | 1,780 |
| **Or** | |
| **Alternative 2** | |
| Net income attributable to Company P | 1,800 |
| Accretion of redeemable noncontrolling interest, net of tax | (20) [C] |
| Net income attributable to Company P common shareholders after accretion of redeemable noncontrolling interest | 1,780 |
| **Basic:** | |
| Weighted average shares outstanding and used in the computation of basic net income per share | 1,000 |
| Net income attributable to Company P common shareholders per share — basic | $1.78 |
| **Diluted:** | |
| Shares used in the computation of basic net income per share | 1,000 |
| Dilutive effect of stock options | 264 |
| Shares used in the computation of diluted net income per share | 1,264 |
| Net income attributable to Company P common stockholders per share — diluted | $1.41 |

[A] Comprised of loss attributable to noncontrolling interest in Target (calculated as $250 x 20%) less accretion of redeemable noncontrolling interest (calculated as $470 accreted redemption value as of 31 December 20X7 — $450 carrying amount prior to adjustment)

[B] $250 x 20%

[C] $470 accreted redemption value as of 31 December 20X7 — $450 carrying amount prior to adjustment

**Illustration 5-11: Purchased call option embedded in NCI created in a business combination**

On 1 January 20X7, Company P (an SEC registrant) acquires 80% of the outstanding common shares of Target, a private company, from Company Y for cash consideration in a business combination as defined in ASC 805. Company Y retains a 20% noncontrolling interest in Target. As a result of the acquisition, Company P consolidates Target in accordance with ASC 810. In connection with the acquisition, Company P and Company Y enter into an agreement that permits Company P to purchase the remaining 20% interest in Target from Company Y on or after 1 January 20X9 for $525 in cash. The call option is non-transferrable and terminates if Company P purchases the shares.

At the acquisition date, the fair value of the NCI is $500. Target's earnings for 20X7 are $200.

**Analysis**

*Is the call option embedded in the NCI?*

Yes. The call option is not legally detachable from the NCI because it is non-transferrable. Further, it is not separately exercisable because the NCI terminates upon exercise of the option. As a result, the call option would be considered embedded in the underlying NCI.

*Is the NCI (including the embedded call option) within the scope of ASC 480?*

No. The NCI is not mandatorily redeemable because the redemption is at the option of Company P.

*Does the call option require bifurcation under ASC 815?*

No. Company P considered the guidance in ASC 815-15 and determined the nature of the host contract to be more akin to equity. Although a redemption feature in an equity host is generally not considered to be clearly and closely related to the host contract, the call option does not meet the definition of a derivative (as it requires gross physical settlement and the shares of Target are not publicly traded — i.e., not readily convertible to cash). Therefore, the call option does not require bifurcation under ASC 815.

*Does the call option cause the NCI to be redeemable under ASC 480-10-S99-3A?*

No. Because the exercise of the embedded call option is within the control of Company P (i.e., Company P is not obligated to transfer cash to Company Y unless Company P exercises the call option), the embedded call option does not cause the NCI to be a redeemable equity instrument under ASC 480-10-S99-3A.

Therefore, the call option is recognized as part of the NCI in equity. Changes in the fair value of the call option are not recognized. At the acquisition date, the cash consideration transferred plus the fair value of the NCI determined pursuant to ASC 805-20-30 would be used to determine the amount of goodwill. After the acquisition date, earnings would be attributed to the controlling and noncontrolling interests without consideration of the call option. Accordingly, the carrying amount of the NCI at 31 December 20X7 would be $540 ((20% x $200) + $500).

**Illustration 5-12: Forward contract embedded in NCI created in a business combination**

On 1 January 20X7, Company P (an SEC registrant) acquired 80% of the outstanding common shares of Target, a private company, from Company Y for cash consideration in a business combination as defined in ASC 805. Company Y retains a 20% noncontrolling interest in Target. As a result of the acquisition, Company P consolidates Target in accordance with ASC 810. In connection with the acquisition, Company P and Company Y executed a forward contract that requires Company P to purchase Company Y's remaining 20% interest in Target on 1 January 20X9 for a fixed price of $300. The forward contract is non-transferrable and will terminate when Company P acquires the shares.

Analysis

*Is the forward contract embedded in the NCI?*

Yes. The forward contract is not legally detachable from the NCI because it is non-transferrable. Further, it is not separately exercisable because the NCI terminates through its settlement. As a result, the forward contract would be considered embedded in the underlying NCI.

*Is the NCI (including the embedded feature) within the scope of ASC 480?*

Yes. Because the forward contract embodies an obligation of Company P to redeem the NCI for cash on a date certain (1 January 20X9), the NCI (including the embedded forward contract) is considered a mandatorily redeemable financial instrument that would be classified as a liability under ASC 480.

As a result, Company P will account for this transaction as a financing, which means that it will not recognize any NCI. Instead, Company P will recognize a liability for the future purchase of the NCI. At the acquisition date, the cash consideration transferred plus the fair value of the liability-classified mandatorily redeemable NCI would be used to determine the amount of goodwill in accordance with ASC 805. Company P would subsequently measure the liability at the present value of the amount to be paid at settlement, accruing interest using the rate implicit at inception under ASC 480.

Because NCI is not recognized in equity, no earnings would be allocated to the NCI after the acquisition date. The accretion of the liability-classified NCI would be presented as interest expense in the income statement.

**Illustration 5-13: A combination of call and put options with the same fixed price and exercise date embedded in NCI created in a business combination**

On 1 January 20X7, Company P (an SEC registrant) acquired 80% of the outstanding common shares of Target, a private company, from Company Y for cash consideration in a business combination as defined in ASC 805. Company Y retains a 20% noncontrolling interest in Target. As a result of the acquisition, Company P consolidates Target in accordance with ASC 810. In connection with the acquisition, Company P and Company Y enter into an agreement that permits Company P to purchase the remaining 20% interest from Company Y for a fixed price of $300 on 1 January 20X9 and permits Company Y to sell its remaining 20% interest to Company P under those same terms. The call and put options are non-transferrable and will terminate if Company P purchases the shares or Company Y sells the shares.

Analysis

*Are the call and put options embedded in the NCI?*

Yes. For purposes of this step, Company P's call option and Company Y's put option are evaluated separately to determine whether the features are embedded in or freestanding from the 20% NCI. The call and put options are not legally detachable from the NCI because they are non-transferrable. Further, they are not separately exercisable because the NCI terminates upon exercise of the options. As a result, the call and put options would be considered embedded in the underlying NCI.

*Is the NCI (including the embedded feature) within the scope of ASC 480?*

Yes. Pursuant to ASC 480-10-55-59 through 55-62, the call and put options are viewed on a combined basis with the NCI [A]. Because the risks and rewards of owning the NCI have been retained by Company P during the period that the options are outstanding (notwithstanding the legal ownership of the NCI by Company Y), combining the two transactions reflects the economic substance of the transaction. That is, Company Y's investors are providing financing to Company P for the acquisition of 20% NCI. Under this approach, Company P consolidates 100% of Target and does not recognize the NCI (including the embedded call and put options). Instead, it will recognize a liability for the financing (i.e., the future purchase of the NCI).

At the acquisition date, the cash consideration transferred plus the present value of the settlement amount of the liability-classified NCI would be used to determine the amount of goodwill in accordance with ASC 805. Subsequently, the liability is accreted to the strike price with the accretion recognized as interest expense under ASC 480.

Because NCI is not recognized in equity, no earnings are allocated to the NCI after the acquisition date. The accretion of the NCI liability would be presented as interest expense in the income statement.

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[A] This instrument is not considered mandatorily redeemable, since it is possible (though highly unlikely) that on the exercise date the NCI will have a fair value equal to the strike price in the options and neither party will be economically motivated to exercise (as opposed to an embedded forward contract that requires settlement and renders the shares mandatorily redeemable).

**Illustration 5-14: A combination of call and put options with a strike price at fair value embedded in NCI created in a business combination**

On 1 January 20X7, Company P (an SEC registrant) acquires 80% of the outstanding common shares of Target, a private company, from Company Y for cash consideration in a business combination as defined in ASC 805. Company Y retains a 20% noncontrolling interest in Target. As a result of the acquisition, Company P consolidates Target in accordance with ASC 810. In connection with the acquisition, Company P and Company Y enter into an agreement that permits Company P to purchase the remaining 20% interest from Company Y at fair value on 1 January 20X9 and permits Company Y to sell its remaining 20% interest to Company P under those same terms. The call and put options are non-transferrable and will terminate if Company P purchases the shares or Company Y sells the shares.

At the acquisition date, the fair value of the NCI is $500. Target's earnings for 20X7 are $200.

**Analysis**

*Are the call and put options embedded in the NCI?*

Yes. For purposes of this step, Company P's call option and Company Y's put option are evaluated separately to determine whether the features are embedded in or freestanding from the 20% NCI. The call and put options are not legally detachable from the NCI because they are non-transferrable. Further, they are not separately exercisable because the NCI terminates upon exercise of the options. As a result, the call and put options would be considered embedded in the underlying NCI.

*Is the NCI (including the embedded feature) within the scope of ASC 480?*

No. Unlike in Illustration 5-13, the NCI (including the embedded feature) is not subject to ASC 480-10-55-59 through 55-62, which applies only to situations in which the embedded put and call options have the same (or similar) fixed exercise price and exercise date. In addition, the combination of the call and put options does not cause the NCI to be considered mandatorily redeemable because it is possible that neither party will exercise. Therefore, the redemption is not unconditional.

*Do the call and put options require bifurcation under ASC 815?*

No. Company P considered the guidance in ASC 815-15 and determined the nature of the host contract to be more akin to equity. While the combination of a purchased call option and written put option with the same strike price and exercise date embedded in NCI is economically similar to a forward purchase obligation, generally resulting in the determination of a debt host, the nature of the host contract in this example is determined to be more akin to equity because the strike price is the fair value of the non-controlling shares on the exercise date, which reflects the risk and return characteristics of an equity holder.

Although a redemption feature in an equity host is generally not considered to be clearly and closely related to the host contract, the call and put options do not meet the definition of a derivative (as they require gross physical settlement and the shares of Target are not publicly traded — i.e., not readily convertible to cash). Therefore, the call and put options do not require bifurcation under ASC 815.

*Do the call and put options cause the NCI to be redeemable under ASC 480-10-S99-3A?*

Yes. Because the put option permits Company Y to sell its equity interest to Company P for cash, the NCI is considered to be redeemable equity under ASC 480-10-S99-3A. Therefore, the NCI (including the embedded options) is classified as "mezzanine" (between liabilities and equity) in Company P's balance sheet.

At the acquisition date, the cash consideration transferred plus the fair value of the NCI would be used to determine the amount of goodwill in accordance with ASC 805. The NCI balance of $500 would be classified as "mezzanine." After the acquisition date, the amount presented as "mezzanine" would be determined first by applying the guidance in ASC 810 and attributing the earnings of Target to the controlling and noncontrolling interests. Therefore, at 31 December 20X7, before applying the guidance in ASC 480-10-S99-3A, the carrying amount of the NCI would be $540 ((20% x $200) + $500).

While the NCI is not currently redeemable, it will become redeemable only with the passage of time (i.e., on 1 January 20X9). As discussed above, ASC 480-10-S99-3A permits two methods of adjusting the carrying amount of the redeemable security. For purposes of this illustration, assume that Company P elects to adjust the carrying amount of the NCI to what the redemption amount would be if the NCI was redeemable at 31 December 20X7. Assume that the redemption amount (fair value) is $590 at 31 December 20X7.

Accordingly, Company P adjusts the carrying amount of its redeemable NCI to its redemption value of $590 with a $50 credit to the NCI and a corresponding debit to retained earnings (or if there were no retained earnings, to additional paid-in capital). Unlike in Illustration 5-10, because the redemption amount is at fair value, the adjustment to the carrying amount of the redeemable NCI in the form of common stock does not affect EPS.

**Illustration 5-15: Freestanding written put option in a business combination**

Company Y owns 85% of the outstanding common shares of Target, an SEC registrant, with public shareholders holding the remaining 15% of the outstanding common shares. On 1 January 20X7, Company P acquires 80% of the outstanding common shares of Target from Company Y for cash consideration. Company Y retains a 5% noncontrolling interest in Target, with the public shareholders continuing to hold the remaining 15% interest. In connection with the acquisition, Company P and Company Y enter into an agreement that permits Company Y to sell its retained 5% interest in Target to Company P on or after 1 January 20X9 for $100 in cash. The put option is transferable without restriction, and Company Y can use any shares of Target (e.g., shares it currently owns or shares it subsequently acquires in the public market) to satisfy the put option.

At the acquisition date, the fair value of the NCI, representing 20% of Target, is $500. Target's earnings for 20X7 are $75.

**Analysis**

*Is the put option embedded in the NCI?*

No. The put option is legally detachable from the NCI because it is transferrable. Further, because the NCI will not necessarily terminate upon the settlement of the put option (because Company Y could purchase shares in the open market to satisfy the put option), it is separately exercisable. As a result, the put option would not be considered embedded in the underlying NCI (5% interest held by Company Y), but would be considered a freestanding financial instrument and accounted for separately from the 5% NCI held by Company Y.

*Does the freestanding written put option require liability classification under ASC 480?*

Yes. The written put option is classified as a liability under ASC 480 and measured initially at fair value. Pursuant to ASC 480-10-25-8, any financial instrument, other than an outstanding share, is classified as a liability if it (1) embodies an obligation to repurchase the issuer's equity shares, or is indexed to such and obligation, and (2) requires or may require the issuer to settle the obligation by transferring assets. At the acquisition date, the cash consideration plus the fair value of the NCI plus the fair value of the put option liability forms the total consideration transferred to acquire Target for purposes of determining the amount of goodwill to be recorded.

Because the put option is freestanding from the 5% NCI held by Company Y, the NCI would continue to be classified in equity and subsequently accounted for in accordance with ASC 810. Therefore, at 31 December 20X7, the carrying amount of the NCI would be $515 ((20% x $75) + $500). The freestanding written put option would be classified as a liability and marked to fair value through earnings at each subsequent reporting date.

## 5.11 Registration rights agreements

### 5.11.1 Overview and background

Concurrent with many financing transactions (e.g., the issuance of equity shares, warrants, debt instruments), issuers may enter into a registration payment arrangement (or registration rights agreement) under which the issuer agrees to one or more of the following:

- A registration statement must be filed for the resale of specified financial instruments or for the resale of equity shares that are issuable upon exercise or conversion of those financial instruments. The registration statement must be declared effective by the SEC (or other applicable securities regulator if the registration statement will be filed in a foreign jurisdiction) within a specified grace period.
- The effectiveness of the registration statement must be maintained for a specified period of time (or in perpetuity).

Those arrangements frequently specify that the issuer must use its best efforts or apply commercially reasonable efforts to undertake those actions. If the registration statement is not declared effective within the grace period or its effectiveness is not maintained for the specified period, the issuer must transfer consideration to the investors. That consideration may be payable in a lump sum or periodically (i.e., as additional interest). The form of the consideration may vary but is typically in cash (and cannot be in the form of an adjustment to a conversion ratio to be in the scope of ASC 825-20, *Financial Instruments — Registration Payment Arrangements*).

**Illustration 5-16: Registration rights agreement**

Assume that in connection with an issuance of convertible notes, Company A enters into a registration rights agreement. Under that agreement, for the benefit of the holders of the convertible notes issued, Company A agrees to use its reasonable best efforts to file with the SEC within 90 days after the issuance of the notes, and cause to become effective within 120 days after that filing deadline, a shelf registration statement with respect to the resale of the underlying common stock issuable upon conversion of the notes. The stated interest on the notes may be increased by 0.50% per annum if Company A fails to comply with its obligations under the registration rights agreement. The increased rate continues until Company A complies with its registration obligations. Alternatively, the registration rights agreement may specify a 0.50% "liquidated damages" payment (rather than expressing it as incremental interest on the convertible notes).

## 5.11.2 Analysis

ASC 825-20 addresses an issuer's accounting for registration payment arrangements.

Registration payment arrangements, as defined in ASC 825-20, include most registration rights agreements in security issuances and certain contingent interest features in debt instruments. Also included are arrangements that require the issuer to obtain and/or maintain a listing on a stock exchange if the remaining characteristics in the guidance are met. Importantly, the guidance is not applicable by analogy to the accounting for contracts that are not registration payment arrangements based on the criteria (e.g., contingent interest payable if an issuer fails to timely file a Form 10-Q or 10-K, which is not the same as maintaining the effectiveness of a registration statement).

ASC 825-20 specifies that the contingent obligation to make future payments or otherwise transfer consideration under a registration payment arrangement, whether issued as a separate agreement or included as a provision of a financial instrument or other agreement, should be separately recognized and measured in accordance with ASC 450-20, *Contingencies — Loss Contingencies*. Pursuant to ASC 450-20, a liability for the contingent obligation under the registration rights agreement is recognized at inception if it is probable that a payment under the registration rights agreement would be required and the amount of payment can be reasonably estimated. That contingent liability is included in the allocation of proceeds from the related financing transaction.

If the transfer of consideration under a registration payment arrangement was not probable or could not be reasonably estimated at inception but becomes probable and reasonably estimable in a subsequent period, or if the measurement of a previously recognized contingent liability increases or decreases in a subsequent period, the new contingent liability or the change in the measurement of the previously recognized contingent liability (in accordance with ASC 450-20) is recognized in earnings. Further, a registration rights agreement is provided a specific exception from derivative accounting pursuant to ASC 815-10-15-82.

The registration payment arrangement guidance further clarifies that a financial instrument subject to a registration payment arrangement should be accounted for pursuant to other applicable US GAAP without regard to the contingent obligation to transfer consideration pursuant to the registration payment arrangement (e.g., convertible debt instruments are evaluated pursuant to the guidance in ASC 470-20).

ASC 825-20 does not apply to arrangements that require registration or listing of convertible debt instruments or convertible preferred stock if the form of consideration that would be transferred to the counterparty is an adjustment to the conversion ratio. For example, the guidance does not apply if the consideration to be transferred upon the issuer's failure to obtain an effective registration statement is an increase in the conversion ratio (e.g., by 3%). In this case, the indexation guidance in ASC 815-40-15 (refer to section B.3) should be considered for the contingently adjustable conversion ratio.

The accounting also does not apply to arrangements in which the amount of consideration transferred is determined by reference to (1) an observable market other than the market for the issuer's stock or (2) an observable index. For example, an arrangement would not be in the scope of ASC 825-20 if the consideration to be transferred is determined by reference to the price of a commodity (e.g., gold) if the issuer is unable to obtain an effective registration statement. Additionally, ASC 825-20 does not apply to arrangements in which the financial instrument subject to the arrangement is settled at the same time that the consideration is transferred. For example, it would not apply to a warrant that is contingently puttable if an effective registration statement for the resale of the equity shares that are issuable upon exercise of the warrant is not declared effective by the SEC within a specified grace period.

## 5.12 Overallotment provisions (or 'greenshoes')

### 5.12.1 Overview and background

Many public debt and equity securities offerings contain features that provide the underwriter with the option to obtain more of the securities being sold (i.e., a written call option). These provisions permit the underwriter to fill orders slightly in excess of the planned amount of an offering to promote market efficiencies. These options are commonly referred to as "overallotment provisions" or "greenshoes," after the Green Shoe Manufacturing Company, which was the first company to include this type of feature in a public equity offering. Those features may be found in both equity and debt offerings.

Overallotment provisions have historically been used to accommodate potential investor demand in excess of the base offering amount, which may not be known until the issuance date. Therefore, the greenshoe provision permits the issuer to issue more securities without the time and expense of an additional filing. For example, an issuer may hope to issue $100 million of securities but discovers at the issuance date that there is additional demand in the marketplace for the instruments. An overallotment provision permits additional securities to be sold at issuance.

The underwriter or initial investors often are also permitted to purchase additional securities at the offering price for a defined period subsequent to the closing date of the initial offering. The underwriter uses the greenshoe provision as a mechanism to facilitate market stabilization activities.

For example, if $100 million of securities are sold into the market, the underwriter will often reserve the right with the issuer (or in some cases may commit) to enter into market transactions to buy and sell the securities to stabilize the market price for a period of time thereafter (typically 30 days). If the underwriter sells an additional $10 million of securities (short position) and buys $7 million (long position) during that period, the underwriter will exercise its overallotment provision at its expiration date to cover its net $3 million short position in the underlying securities.

Entities will sometimes include greenshoe provisions that permit the issuance manager (in some cases, an investment manager or large initial investor in a private offering) to obtain additional shares for its own purposes at a favorable price if the market price rises subsequent to the initial issuance. This approach has sometimes been referred to as a "manager's option." The exercise period for a manager's option may be longer (45 or more days) than that of a more traditional greenshoe (usually 30 days or less).

The following are examples of the mechanics of the arrangements typically found in the marketplace:

- A traditional overallotment option permits the underwriter to purchase up to a specified amount of the securities issued within a specific time frame (typically 30 days) after the original offering. The underwriter shorts the notional amount of the greenshoe in order for the option to become exercisable later. The notional amount is permanently reduced by any short position that is covered by the underwriter's purchases in the open market. For example, if the greenshoe notional amount is $15 million, representing 150,000 shares at an offering price of $100 per share (which is shorted at issuance), and the underwriter subsequently repurchases 70,000 shares in the market during the stabilization period, then the notional amount of the greenshoe is permanently reduced to 80,000 shares.
- A reload overallotment option permits the underwriter to purchase up to a specified amount of the securities issued within a specific time frame (typically 30 days) after the original offering. The notional amount of the greenshoe is shorted at issuance in order for the option to become exercisable later. The notional amount is reduced by any short that is covered by open market transactions, but it is increased if those securities are resold during that same stabilization period. For example, if the greenshoe notional amount is $15 million, representing 150,000 shares at an offering price of $100 per share (which is shorted at issuance), and the underwriter repurchases 70,000 shares in the market to cover its short because the market price of the securities has declined, the notional amount is temporarily reduced to 80,000 shares. Subsequently, if the underwriter resells an additional 30,000 shares because the market price of the securities has increased, the greenshoe notional amount is adjusted to 110,000 shares.
- A manager's option permits the underwriter to purchase up to a specified amount of the securities issued within a specific time frame (typically 30 to 60 days, but it can be longer) after the original offering. The notional amount of the greenshoe is not required to be shorted at issuance in order for the option to become exercisable later and is not affected by any short that is covered by open market transactions. A manager's option is not found in registered offerings, because the exercise of the option would violate the securities law. Those instruments are essentially written options for additional securities. The options may be held by the underwriter at issuance or transferred to the initial investors.

## 5.12.2 Analysis

### 5.12.2.1 Freestanding or embedded

Manager's options may be freestanding or embedded in the related securities. The option is freestanding if it can be transferred separately from the related securities. For example, if the underwriter holds the option, while the ultimate investors receive the securities, the option would be freestanding. Similarly, if an investor receives both the option and the security yet could sell or transfer the option and the security separately, the option would be considered a freestanding financial instrument. Conversely, if the manager's option and related securities cannot be separated it would be considered an embedded feature in the initial securities issued.

Unlike manager's options, the traditional overallotment and reload overallotment options are considered freestanding because they remain with the underwriter when the securities are sold to the ultimate investor.

If a greenshoe is considered a feature embedded in the securities initially issued, that embedded feature should be analyzed to determine whether it should be bifurcated from the host instrument. That determination will involve evaluating the hybrid instrument (the security and embedded greenshoe feature) in accordance with ASC 815-15 (refer to section 3 of our FRD publication, ***Derivatives and hedging***, for additional information on embedded derivatives). Generally, the greenshoe option would not be bifurcated from the host instrument because the economic characteristics and risks of the embedded written call option are considered to be clearly and closely related to the economic characteristics and risks

of the host contract. The underlying to the greenshoe option is the same security as the host instrument. The following discussion focuses on the accounting considerations for a greenshoe option that is determined to be a freestanding financial instrument.

### 5.12.2.2 Evaluating greenshoes as ASC 480 liabilities

If greenshoes involve equity shares of the issuer, the issuer should evaluate the options in accordance with ASC 480. A greenshoe option is likely an ASC 480 liability if it was part of an issuance of redeemable equity instruments, such as mandatorily redeemable preferred shares or preferred shares that are redeemable at the option of the holder or otherwise outside the control of the issuer. The evaluation would be similar to that for warrants on redeemable equity shares, which are usually determined to be liabilities in accordance with ASC 480.

If the greenshoe is deemed a liability in accordance with ASC 480, it should be evaluated based on whether it should be allocated proceeds from the offering (if it was passed on to the investors) or accounted for as a separate instrument issued for no proceeds (with the offset to expense or deferred equity issuance cost) considering the facts and circumstances.

### 5.12.2.3 Evaluating greenshoes as derivatives

If the greenshoe is not an ASC 480 liability, it should be evaluated as a potential derivative in accordance with ASC 815. If it is a derivative, it should be further evaluated to determine whether it meets any of the conditions to be exempt from derivative accounting.

The underlying of a greenshoe is the price of the underlying securities, as with any option. However, some believe the greenshoe does not have a notional amount, which has resulted in diversity in practice.

ASC 815-10-55-6 through 55-7 provides guidance for determining the notional amount of a contract. The guidance states that when the terms of the contract call for a maximum amount, the notional amount cannot be more than that maximum amount. The guidance also specifies that when a minimum greater than zero exists, the contract has a notional amount of at least that minimum amount. The guidance further explains that penalties for nonperformance and other terms should be considered to determine the notional amount. The conclusion that a notional amount exists can be reached only if a reliable means to determine such a quantity exists (e.g., this would be the case if a notional amount can be determined based on the provisions within a contract or within agreements contemporaneous to the contract).

We generally believe the traditional overallotment options and reload overallotment options do not have a notional amount in accordance with ASC 815 because the underwriter can purchase up to a specified amount (a maximum) within a specified period following the offering, but the actual amount that may be permitted is not known because the final amount is based on subsequent issuance and stabilization activities. Therefore, a notional amount is not readily determinable, since the notional amount of greenshoes can be between zero and the maximum.

In addition, we understand that securities law prevents the exercise of the option unless it is to cover the short position, so the underwriter is not able to economically exercise the overallotment to its benefit (i.e., the underwriter cannot exercise the option to purchase the underlying securities to benefit its proprietary trading activities).

However, the manager's option would have a notional amount equal to the maximum amount because the notional amount is not affected by the underwriter's subsequent activities in the open market. The manager's option functions like any other option contract where a rational holder will exercise the option to its fullest extent if it is in the money at the expiration date.

To the extent that a manager's option is deemed to have a notional amount (some believe it is the contractual maximum), the remaining characteristics of a derivative should be evaluated. Typically, greenshoe options meet the little or no initial net investment criteria, similar to other options. Because the overallotment option is issued together with other securities, its initial investment is considered to be the fair value of the option. The net settlement characteristic may be satisfied because the securities that are delivered upon exercise of the option are themselves readily convertible to cash by virtue of the market in which they are offered (publicly traded or immediately eligible for a Rule 144A transaction). For a private company, consideration of the net settlement characteristic may require additional analysis.

#### 5.12.2.4 Exceptions available for greenshoes meeting the definition of a derivative

There are several potential exceptions from derivative accounting in accordance with ASC 815 that are available if an issuer concludes a greenshoe meets the definition of a derivative.

While some believe a traditional overallotment option for either debt or equity securities that expires on the issuance date may not be subject to derivative accounting because of a specific exemption for regular-way security transactions in ASC 815-10-15-15, we do not believe this is the preferable view.

Greenshoes for equity securities deemed to be derivatives may qualify for the scope exception in ASC 815-10-15-74(a) for issuers because the options are settled in the issuer's underlying equity security. They would be classified as equity if they are both (1) indexed to its own stock and (2) classified in stockholders' equity in its statement of financial position in accordance with ASC 815-40.

For the debt securities of public companies, a greenshoe that is deemed to be a derivative and can be exercised over a period of time does not have any available exceptions from derivative accounting.

A traditional overallotment option that is short term and has an at-the-money strike price at the issuance date may have minimal value, but changes in the volatility of the stock or the stock price, will affect the value of the option over its life.

#### 5.12.2.5 Accounting for greenshoes determined to be derivatives

Similar to greenshoes that are classified as a liability in accordance with ASC 480, greenshoes determined to be derivatives are accounted for at fair value at issuance and subsequently adjusted to fair value through earnings. Judgment is required in determining whether the issuer should (1) allocate a portion of the gross issuance proceeds to the greenshoe or (2) deem the greenshoe to be issued for no proceeds and record an immediate expense (or perhaps an issuance cost) as the other side of the entry to recognize the instrument. The facts and circumstances should be considered in making this determination.

The allocation of proceeds to the greenshoe would be appropriate when a derivative greenshoe and securities are issued to the same party (e.g., investors), and the greenshoe is freestanding. However, a greenshoe is typically issued as a separate instrument to the underwriter, while the securities are purchased by the investors through the underwriter. In this case, allocating a portion of those proceeds to the greenshoe would not be necessary.

Any portion of the initial proceeds allocated to the derivative would affect the initial carrying amount of the securities, which can have further accounting implications depending on the security issued. For example, if the issued securities are debt securities (or preferred stock) and some of the proceeds are allocated to the greenshoe, the initial carrying amount may include a discount to be reflected as a yield adjustment over the security's life. Refer to section 1.2.7 for further discussion on the allocation of proceeds.

#### 5.12.2.6 Application of the SEC staff's longstanding view on written options

While the SEC staff has a longstanding position that written options that don't qualify for equity classification should be recorded at fair value and marked to fair value through earnings,[56] we are not aware that the SEC staff has applied this view to greenshoes.

## 5.13 Pre-funded ('penny') warrants

Pre-funded warrants, commonly known as "penny" warrants, are a type of warrant that allows the holders to acquire a specified number of the issuer's shares at a nominal exercise price (typically $0.01). Pre-funded warrants allow the issuers to receive, as part of the warrant's purchase price, the exercise price that would be due for a traditional warrant, except for the nominal exercise price, at the time of the warrant's issuance.

One of the purposes of issuing pre-funded warrants is to accommodate the needs of the investor who may be subject to ownership restrictions in the issuer's shares. For example, an investor may be subject to a designated ownership threshold of 9.99% or 19.99% in the issuing entity. A pre-funded warrant provides the investor flexibility in acquiring additional beneficial ownership interest when it is ready to do so without exceeding the designated ownership threshold.

Although the payoff of a penny warrant is essentially the same as actually holding the underlying share, we generally believe that a penny warrant should be accounted for as an equity contract. That's because the warrant contains all of the characteristics of an equity option as described in section 4.1.1.1 and usually lacks the other legal characteristics of a share (such as the ability to vote). An issuer should evaluate the equity contract guidance discussed in section 4 in determining the accounting for penny warrants, including the considerations of ASC 480, ASC 815 and ASC 815-40.

Specifically, a penny warrant should be evaluated to determine whether it is a derivative in its entirety under ASC 815. To be a derivative, an instrument must contain (1) one or more underlyings, (2) one or more notional amounts or payment provisions or both (that together with the change in the underlying, determine the settlement amount), (3) no (or little) initial net investment and (4) allows for net settlement.

A penny warrant will likely not meet the "no or little initial net investment" criterion because the initial investment by the investor generally equals the price of the underlying shares. That is, the initial net investment is equal to the amount that would be exchanged to acquire the asset related to the underlying.

If a penny warrant does not meet the definition of a derivative, the entire instrument is considered a hybrid instrument that contains an embedded written call option. The hybrid instrument is analyzed pursuant to ASC 815-15-25-1 to determine whether the embedded written call option requires bifurcation and separate accounting. Specifically, the embedded option (assume it meets the definition of a derivative) is evaluated under ASC 815-40 to determine whether it qualifies for equity classification if it were freestanding. If the embedded written call option meets the requirements of ASC 815-40, separate accounting as a derivative would not be required. Conversely, if it fails to meet the requirements of ASC 815-40, derivative accounting would be required.

There is no specific guidance on the classification of the hybrid instrument. In practice, issuers classify the hybrid instrument as either a liability or equity based on whether the instrument, through the embedded written option, meets the requirements of ASC 815-40. That is, if the instrument contains a feature that potentially fails to meet the requirements of ASC 815-40 for equity classification, the entire instrument would be accounted for as a liability.

Any conclusion on the accounting for a penny warrant should be based on the individual facts and circumstances.

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[56] ASC 815-10-S99-4

## 5.14 Preferred equity certificates, convertible preferred equity certificates

In some jurisdictions, instruments may be issued with characteristics of both debt and equity. If an instrument is legal form equity, it is evaluated pursuant to ASC 480 to determine whether it should be classified as debt for financial reporting purposes. However, US GAAP does not contemplate that legal form debt would be classified in equity. Several concepts in the guidance indicate that legal form debt, and instruments that provide creditor rights, are not considered equity. For example, shares analyzed pursuant to ASC 480 are limited to those that are not liabilities in form under the definition of a "share." As another example, ASC 470-10-S99-2 states that subordinated debt must not be presented as a component of equity. Therefore, we believe that legal form debt instruments should be classified as liabilities.

A common example of an instrument with characteristics of both debt and equity is a preferred equity certificate (PEC) and related instruments (e.g., convertible preferred equity certificate (CPEC) and various others) issued by entities (often financing subsidiaries) in Luxembourg. Those instruments are perpetual, usually without any optional or mandatory redemption dates and are nominally titled as equity instruments. However, we understand that these instruments provide creditor rights to the holder in certain events, the dividends are tax deductible as interest expense, and, most importantly, historically the instruments have generally been considered legal form debt in that country. As a result, these instruments would not be deemed legal form equity instrument eligible for equity classification, but rather legal form debt, unless appropriate support was provided that the instruments were equity in legal form in the jurisdiction in which they are issued.

The accounting evaluation for a debt instrument differs from the considerations for an equity instrument. Refer to section 2 and section 3 for detailed discussions on each instrument.

## 5.15 Liabilities with an inseparable third-party credit enhancement

### 5.15.1 Overview and background

Liabilities are often issued with credit enhancements obtained from a third party. The most common example is credit-enhanced debt. In those issuances, the issuer purchases a guarantee from a third party (usually a monoline insurer or other financial guarantor) that requires the third party to make payments on the issuer's behalf in the event the issuer fails to meet its payment obligations. To the extent the guarantor is required to make payments, the issuer becomes obligated to the guarantor for the payments (i.e., the guarantor becomes the creditor). As a result, investors typically evaluate the credit risk of the instrument based on the third-party guarantor's creditworthiness (rather than the issuer's) assuming that the guarantor's credit rating exceeds that of the issuer. This credit enhancement usually will enable the issuer to more easily market the debt instrument.

When permitted under other US GAAP, issuers of debt with an inseparable third-party credit enhancement may elect to subsequently measure the debt at fair value. For those issuers, the "Liabilities Issued with an Inseparable Third-Party Credit Enhancement" subsection of ASC 825 (the "credit-enhanced liability guidance") requires that the measurement of those liabilities at fair value on a recurring basis exclude the effect of the credit enhancement for accounting purposes. This guidance is also applicable for credit-enhanced liabilities that are not subsequently measured at fair value but are disclosed at fair value.

### 5.15.2 Analysis

#### 5.15.2.1 Scope

The credit-enhanced liability guidance applies to liabilities measured at fair value on a recurring basis, either under a fair value election or some other US GAAP such as ASC 815. For example, derivatives accounted for at fair value pursuant to ASC 815 for which the entity obtained a guarantee from a third party for its potential liability to the counterparty under the derivative instruments would be within the scope.

This guidance does not apply to credit enhancements provided by a government or government agency (e.g., those provided by the FDIC) and credit enhancements provided to a parent or a subsidiary or between entities under common control.

This guidance is applicable only to the issuer of a liability with an inseparable third-party credit enhancement. It does not apply to the holder of the issuer's credit-enhanced liability. That is, the investor is not required to account for two components: the liability from the issuer and the guarantee from the third-party guarantor.

### 5.15.2.2 Measuring liabilities with third-party credit enhancement

Pursuant to ASC 820-10-35-18A, an issuer considers its own credit standing, and not that of the third-party guarantor, in measuring the fair value of a liability with a third-party guarantee, regardless of whether the fair value measurement is used for recognition or solely for disclosure purposes. In other words, the unit of accounting for the liability measured or disclosed at fair value does not include the third-party credit enhancement.

Because the credit enhancement is obtained for the benefit of the holder of the issuer's liability, the guarantee does not represent an asset of the issuer. Any payments made by the guarantor to the creditor or holder of the liability result in a transfer of the issuer's obligation from the creditor to the guarantor. However, the amount of the issuer's obligation is not affected in the event of guarantor's payments. The only change is that the guarantor now stands to collect from the issuer. Therefore, the fair value of that liability should reflect the issuer's creditworthiness.

Proceeds received for the issuance of liabilities with a third-party credit enhancement represent consideration for both the liability issued and the guarantee purchased on the investor's behalf. Because the unit of accounting for the liability does not include the guarantee, the proceeds from the issuance should be allocated between the premium for the guarantee and the liability based on their respective fair values. The following example illustrates this concept, and contrasts the accounting for a credit-enhanced liability under a fair value model with that of a credit-enhanced liability under an amortized cost model.

**Illustration 5-17: Debt with an inseparable third-party credit enhancement**

The assumptions are as follows:

- Borrow Co., whose credit rating is BB, raised $1,000 on 1 January 20X0 by issuing notes that included a third-party guarantee issued by Bond Company whose credit rating is AA
- The notes bear a fixed interest rate of 7% payable annually in arrears on 31 December, with that rate based largely on the higher credit rating of the bond insurer
- The notes mature on 31 December 20X4 (five years after issuance)

At the issuance date:

- The market interest rate for similar five-year debt without a third-party guarantee is 9% based on Borrow Co.'s credit standing
- The premium paid to the guarantor for its guarantee was $75
- Other debt issuance costs (e.g., attorney's fees, rating agency fees), excluding the guarantee premium, were $25

**Initial recognition and measurement — amortized cost accounting**

Assuming the debt is not accounted for at fair value on a recurring basis (i.e., a fair value election has not been made), Borrow Co. would follow traditional amortized cost accounting, wherein a liability is initially measured based on the proceeds received. The total debt issuance costs incurred (the premium paid and the other debt issuance costs) are deferred and amortized over the term of the debt. Thus, Borrow Co. would record the following journal entries at issuance:

| | | | | |
|---|---|---|---|---|
| Deferred debt issuance costs (guarantee premium) | $ | 75 | | |
| Cash | | | $ | 75 |

To record cash paid to bond insurer for guarantee on debt to be issued

| | | | | |
|---|---|---|---|---|
| Deferred debt issuance costs (attorney's fees and other) | $ | 25 | | |
| Cash | | | $ | 25 |

To record cash paid for external costs related to the debt

| | | | | |
|---|---|---|---|---|
| Cash | $ | 1,000 | | |
| Debt | | | $ | 1,000 |

To record proceeds received upon issuance of debt

**Initial recognition and initial measurement — fair value accounting**

Now assume Borrow Co. elected, upon issuance of the debt, to apply the fair value option, and accounts for the debt at fair value as determined pursuant to ASC 820 on a recurring basis. Also, assume the fair value of the debt upon issuance was $925, computed by excluding the effect of the credit enhancement and using Borrow Co.'s own credit standing. Thus, Borrow Co. would record the following journal entries at issuance:

| | | | | |
|---|---|---|---|---|
| Prepaid asset (guarantee premium) | $ | 75 | | |
| Cash | | | $ | 75 |

To record cash paid to bond insurer for guarantee asset on debt to be transferred to the investor

| | | | | |
|---|---|---|---|---|
| Expense (attorney's fees and other) | $ | 25 | | |
| Cash | | | $ | 25 |

To record cash paid for debt issuance costs, which are charged to expense under the fair value model

| | | | | |
|---|---|---|---|---|
| Cash | $ | 1,000 | | |
| Prepaid asset (guarantee premium) | | | $ | 75 |
| Debt | | | | 925 |

To record proceeds on issuance of debt, including allocation of proceeds to guarantee asset transferred to investors

The net effect of those entries is to recognize the debt at its fair value of $925 and recognize as expense debt issuance costs. The guarantee has been transferred to the investor, as Borrow Co. purchased it for the investor's benefit and paid for by the investor with a portion of the issuance proceeds. In this example, the fair value of the guarantee premium exactly equals the difference between the fair value of the debt and the gross proceeds received upon issuance of the debt. In reality, there may be some difference (generally insignificant) between (1) the gross proceeds of issuance of the debt and (2) the sum of the fair value of the debt and the guarantee premium. That difference could result in recognizing a small gain or loss upon the issuance of the debt.

**Subsequent measurement — amortized cost accounting**

If the debt is not accounted for at fair value on a recurring basis, Borrow Co. would record the following cumulative journal entry for the first year (31 December 20X0) to record interest expense and amortize the debt issuance costs:

| | | | | |
|---|---|---|---|---|
| Interest expense | $ | 90 | | |
| Cash | | | $ | 70 |
| Deferred debt issuance costs | | | | 20 |

To record interest expense on debt (assuming straight-line amortization approximates the effective interest method)

This entry results in an effective interest rate in excess of 9%.

**Subsequent measurement — fair value accounting**

If the debt is accounted for at fair value on a recurring basis, Borrow Co. would record the following cumulative journal entry for the first year (31 December 20X0)) to record interest expense and remeasure the debt at fair value (assumed to be $875 as Borrow Co.'s creditworthiness has declined):

| | | | | |
|---|---|---|---|---|
| Interest expense | $ | 70 | | |
| Debt | | 50 | | |
| Cash | | | $ | 70 |
| Other comprehensive income (remeasurement at fair value)[1] | | | | 50 |

To record interest expense on debt and remeasure the debt to fair value under the fair value option

This entry results in the recognition of interest expense equal to the cash interest paid (based on the stated rate in the debt) and the carrying amount of the debt at its current fair value.

Note that if Borrow Co. repays the debt pursuant to its terms, the ultimate expense recognized will be the same under the amortized cost and fair value models. That is, under both methods, the carrying amount at maturity will equal the par amount of the debt ($1,000 in this example). Under the fair value method, Borrow Co. recognized debt issuance costs of $25 as an expense immediately. Although the carrying amount of the debt could increase or decrease in any given reporting period, at maturity, the initial $75 difference between the par and allocated proceeds would ultimately have been recognized in earnings, bringing the cumulative charge in earnings to $100. Under the amortized-cost method, Borrow Co. would amortize the $100 of debt issuance costs, including the guarantee premium, over the term of the debt.

**Disclosure at year end 20X0**

Regardless of whether Borrow Co. subsequently measures the debt at amortized cost or fair value, it would disclose the fair value of the debt in the 31 December 20X0 financial statements as $875, which incorporates the issuer's creditworthiness. This fair value would likely be different than any quoted fair value of the bond, which would look to the creditworthiness of Bond Company (if it were higher than Borrow Co.'s).

[1] Assume that the entire change in fair value of the debt was caused by a change in instrument-specific credit risk (own credit risk).

# 5.16 Convertible debt with call spread

## 5.16.1 Overview and background

A popular financing structure in recent years has been convertible debt with a freestanding call spread. In a typical call spread transaction, the issuer purchases a call option (also referred to as the "bond hedge" or "low strike call option") from the underwriter (an investment bank), with an exercise price and notional number of shares equal to the conversion price and potential conversion shares of its convertible debt. The payoff on the call option economically offsets the conversion option in the debt because it has the same strike price. The issuer also writes a call option to the underwriter at a higher strike price to partially finance the purchased call option (also referred to as the "high strike call option"). The combined economics of the convertible debt and the call spread is a synthetic increase of the strike price of the financing. In certain cases, the issuer can integrate the proceeds from the issued debt with the cost of the low strike call option for tax purposes, providing an original issue discount on the debt from a tax perspective.

A call spread can either be documented as two separate instruments (the purchased call and the written call) or as a single, integrated call spread (i.e., a capped call option). A capped call is a call option purchased by the issuer with a strike price equal to the conversion price but the settlement price is capped at an amount equal to what would be the strike price of the separate high strike call option. This mirrors the economics of the two separate instruments. The benefit of using a capped call option is that the issuer generally would not be subject to the dilution effect of the written call option as the purchased option is generally antidilutive overall and thus not considered for EPS purposes.

## 5.16.2 Analysis

### 5.16.2.1 Unit of account

When documented in two separate instruments, the purchased call and written call option are viewed as separate freestanding financial instruments from the convertible debt (not embedded features) because there are separate counterparties to the contracts. The counterparty to the options is the investment bank, which acts as the underwriter or placement agent for the debt but generally does not hold the convertible debt. The counterparties to the debt are the individual convertible debt investors. ASC 815-15-25-2 states that the notion of an embedded derivative in a hybrid instrument refers to provisions incorporated into a single contract, and not to provisions in separate contracts between different counterparties.

In addition, ASC 480 defines a freestanding financial instrument to be a financial instrument that is (1) entered into separately and apart from any of the entity's other financial instruments or equity transactions or (2) entered into in conjunction with some other transaction and is legally detachable and separately exercisable. Because the exercise of either the purchased call option or the written call option does not automatically result in the redemption of the convertible debt, the two options are considered separately exercisable, which is a factor that points to them being considered freestanding from the debt.

ASC 815-10-15-9 states that two or more freestanding financial instruments should be viewed as a unit (and not accounted for separately) based on certain indicators. Those indicators should be evaluated to determine whether the convertible debt should be considered with the call spread structure as one unit of account. While an analysis should be based on the individual facts and circumstances, following are general considerations:

- There is a substantive business reason to have the convertible debt and call spread executed separately. Convertible debt investors prefer a lower conversion price while issuers prefer a higher conversion price. The call spread economically transforms a lower conversion price convertible debt to a higher conversion price convertible debt, as the separately purchased call option economically offsets the embedded written conversion option.

- The convertible debt and call spread do not have the same counterparties. The convertible debt is issued to investors while the underwriters are the counterparties to the call spread.
- The instruments do not relate to the same risk. Convertible debt contains both interest and equity risks but the call spread has only the equity risk of the issuer. Also, the convertible debt and written call option (as part of the call spread) have different maturities, as their settlement dates are usually intentionally different.

Based on this evaluation, we generally believe the options should not be combined with the convertible debt for accounting purposes.

In addition, the two options should be evaluated for potential combination provided neither is in the scope of ASC 480. The options (documented in different contracts) are generally considered two separate freestanding financial instruments because they intentionally have expiration dates that are sufficiently separated (the purchased call option settles at each conversion of the debt and the written call option settles at some period of time after the maturity of the debt) and are settled separately. However, the options could be combined if the settlement dates are aligned as the factors for combination pursuant to ASC 815-10-15-9 would be present.

When the call spread is executed in a form of capped call option, the analysis is similar. The capped call option is generally not combined with the convertible debt for the reasons discussed above. Because it is documented in a single contract, the capped call is considered a single financial instrument.

### 5.16.2.2 Classification

The issuer should evaluate and determine whether the conversion option in the convertible debt requires bifurcation as a derivative or whether the convertible debt is subject to the substantial premium model pursuant to ASC 470-20. Refer to section 2 for further discussion.

The two options, which represent separate freestanding financial instruments on the issuer's own shares, should be analyzed individually to determine the accounting (if structured as a single capped call, it would be analyzed as a single instrument under the same literature).

ASC 480 applies only to freestanding financial instruments that embody obligations of the issuer. The purchased call option would not be a liability pursuant to that guidance because it does not embody an obligation of the issuer. It permits, but does not require, the issuer to buy its own shares.

In contrast, the written call option embodies an obligation to the issuer to deliver shares or transfer assets upon the counterparty's exercise. Pursuant to ASC 480-10-25-8 through 25-13, if a financial instrument, other than outstanding shares, embodies an obligation of the issuer to transfer assets, the instrument would be a liability. Typically, the written call option does not embody an obligation by the issuer to repurchase its equity shares, as its terms entitle the counterparty the right to acquire shares from the issuer. However, additional consideration is necessary when the written call option involves shares that are themselves redeemable or the written option embeds a written put feature that permits the underwriter to put the option back to the issuer for cash. In those cases, the written call option would be a liability pursuant to ASC 480. Refer to sections 5.7 and A.6.1.4 for further guidance.

ASC 480-10-25-14 should also be considered for the written call option if it involves variable shares. Pursuant to that guidance, liability classification would be required if at inception, the monetary amount of the obligation to deliver variable shares is based solely or predominantly on any one of the following conditions:

- Has a fixed value
- Derives its value predominantly from some underlying other than the fair value of the issuer's shares
- Has a value to the counterparty that moves in the opposite direction as the issuer's shares

Generally, the written call option requires the issuer to deliver a fixed number of shares if the counterparty exercises. However, if the written call option involves a variable number of shares, it generally does not meet any one of the three conditions described in ASC 480-10-25-14. Options that the issuer determines are not liabilities under ASC 480 are then evaluated under the guidance in ASC 815-40 to determine their classification.

These options are frequently executed in a standard ISDA form. In those circumstances, additional consideration should be given to evaluate early termination, adjustment and settlement provisions in the ISDA agreements and side letters, if applicable, to determine their effects on meeting the requirements of ASC 815-40 to make sure equity classification is appropriate. Refer to sections 4.2.2.2 and 4.2.3.1 for further guidance on equity contracts executed in ISDA forms. Refer to section 5.16.3 below for a discussion of call spread transactions with side letters that include a "flat volatility input" provision.

Additional consideration should be given to call spread transactions in debt issuances that involve a greenshoe (or overallotment provision). In those transactions, the issuer provides the underwriter with the option to obtain more of the convertible debt being sold (refer to section 5.12 for additional discussion). The call spread likely considers any overallotment option on the convertible debt, with an automatic adjustment to the number of shares underlying the call spread if the size of the debt offering increases to maintain the appropriate alignment of debt to call spread. As an example, the written call option frequently includes a provision that states (with a similar provision in the purchased call option):

> *If the Initial Purchasers exercise their right to receive additional Convertible Notes as set forth in the Purchase Agreement, then on the Additional Premium Payment Date, the Number of Warrants will be automatically increased by additional Warrants in proportion to such Additional Convertible Notes and an additional premium shall be paid by Bank to the issuer on the closing date for the purchase and sale of the Additional Convertible Notes.*

Because the number of shares increases upon an event that is not an input to a fixed-for-fixed equity option or forward valuation model (the underwriter exercising its overallotment option), the options would fail the indexation guidance in ASC 815-40-15 and therefore, would not be considered indexed to the issuer's own stock at inception. Equity classification would be precluded for the options at issuance.

However, the adjustment provision expires upon the underwriter's exercise of the overallotment option or upon its expiration, and typically the period is for only up to 30 days. In practice, the underwriter frequently exercises the option within an even shorter time frame (e.g., one or two weeks after the issuance). Once the adjustment provision is triggered or expired, the number of shares will be adjusted (or cease being adjustable) and become fixed. Subsequently, the call spread would be considered indexed to the issuer's own equity, provided that there are no other adjustment provisions that would violate the indexation guidance.

#### 5.16.2.3 Allocation of proceeds

Allocation of proceeds is usually unnecessary in a convertible debt with call spread structure as each instrument is exchanged for its fair value. If fair value were not exchanged, an allocation method should be considered for the transactions between the same counterparties (i.e., the call spread instruments). Refer to section 1.2.7 for guidance on the allocation of proceeds.

### 5.16.3 Call spread with a flat volatility input (added September 2024)

#### 5.16.3.1 Overview

An issuer that enters into a call spread executed in a standard ISDA form may execute a side letter with the counterparty to amend or replace certain terms in the standard ISDA agreements. The standard ISDA agreements generally stipulate that terminated transactions are settled at their fair market value at the time of a termination event, which is determined by the calculation agent (as named in the ISDA agreements) in a commercially reasonable manner.

In general, a settlement amount that represents the fair value of an equity contract at the time of settlement would not preclude the instrument from being considered indexed to the issuer's own stock under the indexation guidance in ASC 815-40-15. A side letter that modifies such a settlement provision calls into question whether the settlement amount upon a termination event would still be considered indexed to the issuer's own stock.

One such example is a side letter that prescribes the volatility input to be used by the calculation agent in determining the settlement amount of an integrated call spread (i.e., a capped call option) upon specified termination events. Generally, the calculation agent is required to determine and use an amount that approximates the fair value of the capped call option at the time of early settlement to close out the transaction. Market inputs (e.g., stock price, volatilities) at the time of settlement are generally used.

However, the side letter may stipulate that the volatility input used in the option pricing model for the purchased call within the capped call option will be equal to the volatility input used for the written call within the capped call option (referred to as a flat volatility input). As discussed in section 5.16.1, the strike price of the purchase call option is lower than the strike price of the written call option. Because these options have different terms, the market volatilities used in the option pricing model for determining their fair values are generally not the same.

As an example, the side letter may state:

> *"Each of Dealer and Counterparty hereby agrees with respect to the Capped Call Transaction that upon the occurrence of (i) a Merger Event to which Cancellation and Payment is applicable or (ii) a Repurchase Event, in each case under the terms of the Confirmation, then, notwithstanding anything in the Confirmation to the contrary, the volatility input to be used by the Calculation Agent in its option pricing model to determine the amount payable by Dealer pursuant to Section 6 of the Agreement for valuations of Options with a strike price equal to the Strike Price shall be equal to the volatility input to be used for valuations of Options with a strike price equal to the Cap Price."*[57]

#### 5.16.3.2 Analysis

An issuer of a capped call spread that includes a flat volatility input needs to evaluate the provision under the indexation guidance in ASC 815-40-15 to determine whether the instrument would be precluded from being considered indexed to the issuer's own stock. Specifically, the flat volatility input provision should be assessed under Step 2 of the indexation guidance.

Under the indexation guidance, an instrument is considered indexed to an entity's own stock if its settlement amount equals the difference between (1) the fair value of a fixed number of the entity's equity shares and (2) a fixed monetary amount or a fixed amount of a debt instrument issued by the entity. Further, ASC 815-40-15-7D provides that if an instrument's strike price or the number of underlying shares is not fixed, the instrument should still be considered indexed to an entity's own stock if the only variables that could affect the settlement amount would be inputs to the fair value of a fixed-for-fixed forward or option on equity shares. ASC 815-40-15-7E provides a list of such fair value inputs, including stock price volatility, and states that "Determinations and adjustments related to the settlement amount (including the determination of the ability to maintain a standard hedge position) shall be commercially reasonable." ASC 815-40-25-17 defines the term "commercially reasonable" as "sufficiently objective from a legal perspective to prevent a counterparty from producing an unrealistic value that would then compel an entity to net cash settle the contract."

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[57] "Options with a strike price equal to the Strike Price" represent the low strike call options and "Options with a strike price equal to the Cap Price" represent the high strike call options.

The issuer should consider the intent and design of a flat volatility input provision and evaluate whether a flat volatility input would be considered a fair value input to a fixed-for-fixed forward or option on equity shares within the framework of ASC 815-40-15-7E and whether the use of the flat volatility input would be "commercially reasonable" as required under that guidance. The issuer may also consider whether a market participant would view a flat volatility input to be within a reasonable range of volatilities to be used in determining the fair value measurement of a capped call option pursuant to ASC 820. In addition, the issuer should determine whether the use of a flat volatility input would introduce a leverage factor. This assessment will depend on facts and circumstances and requires judgment. In general, we believe entities may apply one of the following two interpretations of the indexation guidance for a flat volatility input.

Under one view, if the volatility input for the written call is within a commercially reasonable range of volatilities that can be used for pricing the purchased call within the capped call option, and that the design of the provision is to achieve a "commercially reasonable" approximation of the fair value for the purchased call, the capped call option would not be precluded from being considered "indexed" under Step 2 of the indexation guidance. Based on discussions with the SEC staff, they emphasized the importance of considering the specific facts and circumstances surrounding the transaction, including the pricing of the transaction, in determining whether a flat volatility input would be considered "commercially reasonable." Such an assessment may require consultation with valuation specialists.

Under the second view, the use of a flat volatility input would not be considered appropriate because the market inputs used for pricing the purchased call within the capped call option should not be based on the market inputs for another instrument (the written call). Therefore, the capped call option fails under Step 2 of the indexation guidance and is precluded from equity classification.

We generally believe both approaches are acceptable, but the approach selected should be consistently applied.

## 5.17 Prepaid written put option

### 5.17.1 Overview and background

A prepaid written put option is a written put option on the issuer's own shares in which the issuer has prepaid the strike price of the option at inception of the transaction. Some refer to this instrument by its original commercial product names of "Dragon" (due to the shape of the payoff diagram) or "CAESAR" (cash enhanced share repurchase).

In a typical transaction, often executed in a form of European option, the issuer (the option writer) makes an up-front payment to the counterparty (an investment bank, also the option purchaser) in an amount equal to the strike price of the option (generally the spot price on trade date) less the option premium the issuer is entitled to receive from the counterparty (the option purchaser). At maturity, the put option will be automatically exercised and settled in one of the following two ways:

- If the share price on the settlement date is below the strike price, the counterparty will deliver to the issuer the specified number of shares underlying the option. No cash is paid by the issuer as the strike was prepaid at inception.
- If the share price on the settlement date finishes above the strike price, the issuer will receive from the counterparty a payment equal to the option strike price (i.e., a return of the prepaid strike price). The payment can be settled in the form of cash or a number of the issuer's shares equal to the amount due, at the issuer's option.

Economically, a prepaid written put option is equivalent to a combination of a purchased call option with a $0 strike price (such that it is always in the money) and written call option with a strike price that is normally the price of the issuer's shares at inception of the contract. Each contract is for the same number of underlying shares. The initial prepayment reflects the premium to be paid for the deep in-the-money purchased call option less the premium to be received for the written call option. Any share price above zero will result in the issuer exercising the purchased call and repurchasing the shares. At any price above the higher strike of the written call option, both parties will exercise their options.

With the written call option, the issuer receives cash equal to that strike price from the counterparty and delivers the shares. Under the purchased call with a $0 strike, the issuer simply receives its own shares at the same time. The shares to be received and the shares to be delivered are usually netted such that the issuer simply receives cash. The issuer's return in that case is the difference between the cash paid at the inception of the contract for the $0 strike call and the cash received at exercise for the written call option.

In summary, the issuer will either (1) retire its shares if the stock price goes below the share price at inception or (2) receive a return on its investment if the share price goes up. Companies often use a prepaid put option to lower the overall cost of their repurchase programs. In certain cases, the prepaid put option is structured such that option premium received by the issuer upon settlement is not taxable.

Consider the following example of a prepaid written put option that is documented in the form of a combination of a purchased call and a written call:

**Illustration 5-18: Prepaid written put option structured as a combination of a purchased call and a written call**

Company A enters into an equity-linked contract that is indexed to its own common stock with an investment bank. The contract consists of a purchased call option on 100,000 shares of Company A's common stock with a strike price of $0 and a written call option on 100,000 shares of Company A with a strike price of $10 (current share price at inception of the contract). Under the terms of the agreement, Company A pays the investment bank $800,000 upon execution of the contract, which reflects the fair value of the purchased call option, net of the fair value of the written option. Upon settlement in one year, either of the two scenarios will take place:

- If Company A's stock price is greater than $10 per share, Company A will deliver 100,000 shares of its common stock in exchange for $10 per share pursuant to the written call and the counterparty will deliver 100,000 shares to Company A for $0 pursuant to the purchased option. As the obligations by the counterparties to deliver shares of common stock are offsetting, the net result of the instrument is that the company will receive $1 million in cash from the investment bank.
- If Company A's stock price is less than or equal to $10 per share, Company A will receive 100,000 shares of its common stock from the investment bank pursuant to the purchased option; the out-of-the-money written option expires without exercise.

In summary, if the stock is greater than $10 per share, Company A has received a return of $200,000 on its original $800,000 investment. If the stock is less than or equal to $10 per share, Company A has effectively purchased its shares for a per share cost of $8 ($800,000/100,000 shares), which compares favorably with the $10 per share price at inception of the contract.

The following example illustrates a single prepaid written put option that is frequently executed by issuers:

**Illustration 5-19: Prepaid written put option structured as a single instrument**

Company A writes a put option on its own stock to an investment bank. The put option permits the bank to sell 100,000 shares of Company A's common stock to the company at a strike price of $10, which is the current share price at inception of the contract. Under the terms of the agreement, Company A pays the investment bank $800,000 upon execution of the contract, which represents the net amount of the strike price ($10 x 100,000) less the option premium ($200,000). Upon maturity in six months, the option will be automatically exercised and either of the two scenarios will take place:

- If Company A's stock price is greater than $10 per share, the company will receive $1 million in cash or in shares, at the company's option, from the investment bank.
- If Company A's stock price is less than or equal to $10 per share, Company A will receive 100,000 shares of its common stock from the investment bank.

The net effect of this single written put option is the same as the effect of a combined purchased call and written call as illustrated above.

## 5.17.2 Analysis

Each of the above structures is an equity-linked contract that is indexed to an issuer's own stock. While the individual facts and circumstances should be considered, the combination of call options would generally meet the criteria to be combined as a single contract for accounting purposes. The equity contract guidance discussed in section 4 should be considered. The following analysis highlights considerations specific to prepaid written put options.

### 5.17.2.1 ASC 480 considerations

ASC 480 applies only to freestanding financial instruments that embody obligations of the issuer. Generally, a written put option is a liability pursuant to ASC 480 because it embodies an obligation by the issuer to purchase its shares by transferring assets. However, in a prepaid written put option, because the issuer prepays the strike price of the option up-front, the contract no longer embodies any obligation on the part of the issuer to transfer assets or to issue shares after the inception of the transaction (the issuer either receives shares or receives cash). Therefore, the prepaid put option is not subject to ASC 480.

### 5.17.2.2 Definition of a derivative

The prepaid put option is also assessed to determine whether it is a derivative instrument in its entirety, or a hybrid instrument that contains embedded features requiring analysis for bifurcation pursuant to ASC 815. To be a derivative, all of the following criteria should be met:

- A notional amount and an underlying
- No or little initial net investment
- Net settlement

Generally, the prepaid written put option has a notional amount and an underlying (a number of equity shares and the market price of those equity shares). Although it requires physical settlement, the underlying (i.e., the issuer's equity shares) is in many cases considered readily convertible to cash. (There may be cases where the underlying equity shares are not readily convertible to cash because the shares are not publicly traded or there is not an active market that can rapidly absorb the quantity underlying the contract, etc.) Therefore, the net settlement criterion is also met.

However, the issuer's prepayment of the option strike price (or most of it) raises the question of whether the instrument meets the initial net investment criterion and whether that large initial prepayment is less, by more than a nominal amount, than the amount that would be exchanged to acquire the underlying shares at the inception of the contract. If not a derivative, the prepaid written put option would be viewed as a hybrid instrument (e.g., receivable for the prepaid option strike price) containing an embedded equity-linked feature (i.e., written put option) requiring potential bifurcation.

In evaluating the initial net investment criterion, ASC 815-10-15-96 states that:

> If the initial net investment in the contract (after adjustment for the time value of money) is less, by more than a nominal amount, than the initial net investment that would be commensurate with the amount that would be exchanged either to acquire the asset related to the underlying or to incur the obligation related to the underlying, the characteristic in paragraph 815-10-15-83(b) is met. The amount of that asset acquired or liability incurred should be comparable to the effective notional amount of the contract. This does not imply that a slightly off-market contract cannot be a derivative instrument in its entirety. That determination is a matter of facts and circumstances and shall be evaluated on a case-by-case basis.

ASC 815-10-15-97 further elaborates this concept by providing:

> A contract that requires an initial net investment in the contract that is in excess of the amount determined by applying the effective notional amount to the underlying is not a derivative instrument in its entirety.

Diversity exists in practice as to whether a prepaid written put option in its entirety meets the initial net investment criterion in ASC 815-10-15-83(b). Some believe the contract has little initial net investment because the initial payment ($800,000) is less, by more than a nominal amount, than the initial net investment that would be commensurate with the amount that would be exchanged to acquire the number of underlying equity shares at inception ($1 million). Under this view, the contract would be a derivative.

Others believe the prepaid written put option has an initial net investment (and is not a derivative) because the prepayment at inception is equal to the notional amount of the underlying equity shares at the inception adjusted by the time value of money and the premium for the value of the embedded written option. That is, the $800,000 prepayment represents the $1 million notional amount adjusted for the time value of money and the premium for the value of the embedded written option. Therefore, under this view, the prepaid written put option does not meet the definition of a derivative in its entirety pursuant to ASC 815. We generally support this view.

If the prepaid written put option is considered to be a derivative because it meets all the characteristics of a derivative, the entire instrument would be assessed to determine whether it qualifies for equity classification pursuant to ASC 815-40. Generally, the instrument is structured to meet the requirements of ASC 815-40 and classified in equity. In the example, if Company A's stock finishes above the strike price of $10 at maturity, the investment bank would be required to make a payment of $1 million to the company. Company A can choose to settle the $1 million in either cash or shares. If cash settlement is the only settlement option, equity classification would be precluded.

Alternatively, if the prepaid written put option does not meet the definition of a derivative, the entire instrument is considered a hybrid instrument that contains an embedded written put option. The hybrid instrument is analyzed pursuant to ASC 815-15-25-1 to determine whether the embedded option requires bifurcation and separate accounting. Generally, the embedded put option meets the requirements to be classified as an equity instrument if it were freestanding. Therefore, separate accounting would not be required. The entire instrument would be accounted for as either an asset or equity on the balance sheet. Any conclusion on the accounting for the instrument should be based on the individual facts and circumstances.

#### 5.17.2.3 Classification of the hybrid instrument

ASC 815-10-55-73 through 55-76 illustrates an example of a prepaid forward contract (albeit to purchase shares of another entity) and concludes that the prepaid forward contract is a hybrid instrument that is composed of a debt instrument as the host contract and an embedded derivative based on equity prices. (The host contract is a debt instrument because the holder has none of the rights of a shareholder, such as the ability to vote the **shares** and receive distributions to shareholders.)

The concept may equally apply to a prepaid written put option on an issuer's own shares. However, we generally believe that equity classification is appropriate for the hybrid instrument because the contract's economic substance is a capital stock transaction that requires physical settlement in equity shares and generally does not require the counterparty to return any portion of the prepayment to the issuer.

## 5.18 Advanced bond refunding

### 5.18.1 Overview and background

In advanced bond refunding (also referred to as "defeasance"), an issuer deposits cash or permitted financial assets into an irrevocable trust[58] sufficient to enable the issuer to discharge fully its obligations under the indenture. Health care organizations commonly extinguish debt through this process whereby they issue new bonds prior to the first call date of the existing debt and remit the proceeds (or a portion of the proceeds) to an irrevocable trust in an amount that is sufficient to meet the existing debt's service requirements. The existing debt agreement provides that the trust assumes the obligation to service the debt from the proceeds it has received, and the creditor agrees to release the issuer as the primary obligor and to look to the trust for repayment of the debt. Generally, the trustee uses the proceeds received to purchase US Treasury or other government securities.

### 5.18.2 Analysis

To extinguish the existing debt, the issuer must be legally released from being the primary obligor. In addition, pursuant to ASC 860, the transfer of financial assets must be evaluated to determine whether they may be derecognized.

#### 5.18.2.1 Legal defeasance of the issuer

For liabilities in the scope of ASC 405, ASC 405-20-40-1 permits a liability to be derecognized only when the debtor (1) pays the creditor and is relieved of its obligation for the liability or (2) is legally released from being the primary obligor under the liability, either judicially or by the creditor. In an advanced bond refunding, because the issuer has not paid the creditor in satisfaction of the liability, to derecognize the obligation, the issuer must be legally released from being the primary obligor. Whether the issuer is legally released from its obligation is a matter of law. Generally, a legal opinion should be obtained to determine whether the issuer has been legally released.

While there is no direct guidance as to the form and content of a typical legal letter governing legal defeasance, the principles outlined in AICPA Professional Standards Section AU 9336, *The Use of Legal Interpretations As Evidential Matter to Support Management's Assertion That a Transfer of Financial Assets Has Met the Isolation Criterion in Paragraph 9(a) of Financial Accounting Standards Board Statement No. 140*, could be considered. The legal analysis should consider under what circumstances the issuer would continue to remain liable for the outstanding obligation (e.g., failure of the bond trustee to perform its obligations under the terms of the original bond indenture). We generally believe that an attorney's basis for concluding that the issuer is released as the primary obligor should be based on the provisions in the indenture that explicitly or implicitly provide for legal defeasance.

[58] A trust that cannot be modified or terminated without the permission of the beneficiary (in this case, the beneficiary is the creditor).

There are situations where the debt may be novated in that a new debtor takes the place of the existing debtor and is accepted by the creditor, who agrees to discharge the existing debtor from the obligation. A legal opinion for a novation should indicate that the original debtor has been discharged by the creditor from the original liability in order for the debt to be derecognized by the original debtor.

If the issuer remains secondarily liable, the provisions of ASC 460, should be applied through recognition of a guarantee liability that is initially measured at fair value.

#### 5.18.2.2 Transfer of cash to the trust

Although a transfer of cash is outside the scope of ASC 860, we generally believe the substance of the transfer is that the bond trustee is acting as agent for the issuer (based on the conditions in ASC 470-50-55-7) when it purchases the US Treasury securities or other high credit quality assets using the cash transferred by the issuer. As a result, it should generally be assumed that the issuer purchased the US Treasury securities or other high credit quality assets and transferred those securities to the bond trustee, thus making the transfer subject to ASC 860's derecognition criteria.

Under those criteria, derecognition of transferred financial assets is appropriate only if the available evidence provides reasonable assurance that the transferred financial assets are legally isolated from the transferor (refer to ASC 860-10-40-5(a) and 40-7 through 40-14). Because the determination of whether the legal isolation criterion is met is largely a matter of law, a legal opinion may be required to support the assertion for derecognition of the transferred financial assets. However, a legal opinion may not be necessary in all cases, and an entity should consider the facts and circumstances of each transaction to determine whether a legal opinion is needed. For example, a legal opinion may not be necessary to support legal isolation when the transferor (the debtor) has no continuing involvement with the transferred financial assets). Each of ASC 860's criteria should be evaluated to determine whether the transferor should derecognize the transferred financial assets.

## 5.19 Classification and disclosure of certain trade accounts payable transactions involving an intermediary (updated August 2023)

### 5.19.1 Overview and background

Companies looking for ways to maximize working capital sometimes negotiate extended payment terms with suppliers and enter into supplier financing programs (also referred to as structured payable arrangements, reverse factoring or payables financing) with third-party intermediaries, such as banks or other financial institutions.

While the terms of these arrangements vary, a supplier finance program generally involves a finance provider or intermediary (e.g., a bank) processing a company's payments for purchases from suppliers. The program typically allows a company to pay its invoices when due (under the extended terms negotiated with a supplier) and gives the supplier the option to accelerate collection through a separate factoring arrangement it negotiates with the third-party intermediary. Under the separate factoring arrangement, the supplier sells its receivables (i.e., invoices) from the company to the intermediary typically at a discount. The company is then legally obligated to pay the intermediary in full (i.e., the amount specified in the original invoice) since the intermediary is now the legal owner of the receivables. Such an arrangement may better enable a supplier to monetize the receivable that has extended payment terms.

Supplier finance programs raise questions about whether a company can continue to classify the liability related to the supplier's invoice as a trade payable or whether it must reclassify the liability as debt. In general, trade payables may need to be reclassified as debt if the nature of the payables changes after a company enters into the supplier finance program.

## 5.19.2 Analysis

### 5.19.2.1 Balance sheet classification (updated August 2023)

**Excerpt from SEC Rules**

**Regulation S-X, Article 5 Commercial and industrial companies**

**Rule 5-02, Balance Sheets**

19. Accounts and notes payable.

    (a) State separately amounts payable to

        (1) banks for borrowing;

        (2) factoring or other financial institutions for borrowing;

        (3) holders of commercial paper;

        (4) trade creditors;

        (5) related parties (see § 210.4-08(k));

        (6) underwriters, promoters, and employees (other than related parties); and

        (7) others.

    Amounts applicable to (1), (2) and (3) may be stated separately in the balance sheet or in a note thereto.

Rule 5-02 of Regulation S-X requires certain items to be classified separately on the balance sheet, including but not limited to, borrowings and trade payables. Because terms vary, a thorough analysis of the terms of an arrangement must be performed to determine the appropriate classification of the liability.

While there is no specific guidance that addresses how to evaluate the accounting implications of a supplier finance program, an SEC staff member[59] discussed the classification and disclosure of certain trade payable transactions involving an intermediary in two speeches.

The SEC staff member's remarks in both cases involved an arrangement in which a bank paid amounts due to a supplier within the time period necessary to secure the supplier's normal trade discount (e.g., 2/10, net 30). The company was then obligated to pay the intermediary on more favorable terms than the original invoice (i.e., an amount less than the invoice or on a date later than the due date of the invoice).

While acknowledging that a thorough analysis of all of the facts and circumstances specific to the transaction must be considered, the SEC staff objected to the continued classification of amounts due to the intermediary as a trade payable in this case. Because the company ultimately settled the invoice under terms different from the original invoice (either at a later date than the due date of the invoice or at a lower amount), the SEC staff understood that the substance of the transaction was a secured financing from the intermediary to pay suppliers.

In evaluating a structured payable arrangement, the SEC staff member stated that companies should determine the classification based on the substance of the transaction in its totality. This includes an evaluation of responses to the following questions about the arrangement:

- What are the roles, responsibilities and relationships of each party (i.e., the company, intermediary and supplier) involved in the structured payable arrangement?

[59] Robert J. Comerford, 2003 and 2004 — Refer to the SEC website at **https://www.sec.gov/news/speech/spch121103rjc.htm** and **https://www.sec.gov/news/speech/spch120604rjc.htm**.

- Have any discounts or rebates been received by the company that would not have otherwise been received without the intermediary's involvement?
- Has the intermediary reduced the amount due from the company, such that the amount due is less than the amount the company would have had to pay to the vendor on the original payable due date?
- Has the intermediary extended the date on which payment is due from the company beyond the invoice's original due date?

The SEC staff member's analysis focused on whether the terms of the payable change as a result of the involvement of the intermediary. If the payment terms do not change (i.e., the company must pay the intermediary according to the original terms of the invoice), the characteristics of the payable may not have changed and would not reflect a financing. If the terms of the payable have changed as a result of the intermediary's involvement, the characteristics of the liability have changed, and it may no longer be appropriate to classify the liability as a trade payable. If an entity has a supplier financing program involving an intermediary, it should carefully evaluate the terms of the program to determine whether they have altered the nature of the trade payable in a way that necessitates classifying the amount payable as debt. This analysis generally requires considerable judgment and an understanding of both the program and all other relevant facts and circumstances.

The following table lists items a company may consider in the analysis. It is important to note that no individual factor is determinative. When conducting the evaluation, all relevant evidence should be considered, including arrangements between the company and its suppliers, those between the company and the intermediary, and any additional agreements (e.g., side letters) made between the company and its suppliers. Due to the subjective nature of the evaluation and the absence of specific guidance, diversity in views may exist.

| Supplier participation | | |
|---|---|---|
| **Considerations** | **Debt-like** | **Trade payable-like** |
| Who can participate in the program? | The program is offered to only certain suppliers (e.g., only those with whom payment terms have been extended can participate in the program). | The program is offered to a broad base of suppliers across many jurisdictions and with varying payment terms and provisions. Some suppliers participate, and others choose to forgo involvement. |
| Is there an obligation to participate in the program? | Participation in the program is mandated, or lack of participation will cause payment terms to not be extended. | Participation in the program is voluntary, and lack of participation will not impact the relationship or existing payment terms. |

| Roles and responsibilities | | |
|---|---|---|
| **Considerations** | **Debt-like** | **Trade payable-like** |
| Is the company involved in negotiations of the contractual arrangement between the supplier and the intermediary? | The company is directly involved in negotiations between the supplier and the intermediary. | The supplier and intermediary negotiate independently and the company is not involved in the negotiations. |
| Is the company a party to the contract between the supplier and intermediary? | All parties involved, including the company, the intermediary and the supplier, have collectively negotiated and agreed upon the terms, rights and obligations, which are documented in a single tri-party agreement or a combination of agreements to accomplish the intended objective. | Separate agreements exist between the company and the intermediary, as well as between the intermediary and the supplier. For instance, a payable processing agreement is established between the company and the intermediary, while a factoring agreement is entered into between the intermediary and the supplier. |

| Payment terms | | |
|---|---|---|
| **Considerations** | **Debt-like** | **Trade payable-like** |
| Are payment terms or amounts due under the original invoice being modified in conjunction with implementing the supplier finance program? | Terms of the payable between the company and the supplier have changed (e.g., the due date is extended if the supplier chooses to participate in the program and factor its receivables with the intermediary, or the supplier is reimbursed by the company for a portion of the difference between the invoice amount and the factored amount it receives from the intermediary). | No changes were made to the invoice or payment terms, or, in cases where payment terms were modified, these changes were implemented uniformly across all suppliers, regardless of whether the supplier opts to participate in the program and factor its receivable with the intermediary. |
| Are the payment terms with the suppliers consistent with industry standards, peer companies and/or company standards? | Payment terms are either (1) not consistent with industry standards, (2) different from those used by peer companies or (3) outside of company standards. | Payment terms are consistent with industry and company standards and those used by peer companies. |
| How are fees calculated for the company's use of the intermediary to process payments? | Fees are variable, based on factors such as the number of suppliers that participate in the program or the dollar amount of receivables that are factored in a period. | There is a fixed fee paid for the company's use of the intermediary to process payments. |
| Can the company remit payment to the intermediary on a date later than the original due date of the invoice? | The company has the ability to remit payment to the intermediary after the original due date of the invoice, which provides a benefit to the company that it would not have received without the intermediary's involvement | Payment must be remitted to the intermediary by the original due date of the invoice, providing no benefit to the company. |

| Credits and discounts | | |
|---|---|---|
| **Considerations** | **Debt-like** | **Trade payable-like** |
| Does the company receive a fee, commission, refund or discount from the intermediary? | The company receives a fee, commission, refund, discount or other type of consideration from the intermediary that relates to its trade payables factored by its supplier. | The company does not receive any fees, commissions, refunds, discounts or other type of consideration from the intermediary. |
| Does the company still have access to early pay discounts (e.g., 2/10 net 30)? | The company loses the ability to take advantage of early pay discounts associated with factored invoices. | The company retains the right to early pay discounts. |
| What are the company's rights if there are returns or defective product? | The company does not have the right to negotiate returns of damaged goods with the supplier or is not able to withhold payment related to the disputed invoice as it would otherwise be able to in the normal course of business. | The company retains all of its rights, including the right to offset credits against payables related to the disputed invoice or negotiate directly with the supplier returns of damaged goods. |

| Legal rights | | |
|---|---|---|
| **Considerations** | **Debt-like** | **Trade payable-like** |
| Are the intermediary's rights to collection of the payable from the company the same as the supplier's rights to collection of the original invoice? | The intermediary's rights to collection of the original invoice are senior to those of the supplier's in the normal course of business (e.g., collateral must be posted by the company). | The intermediary's rights to collection of the original invoice are the same as those of the supplier's in the normal course of business. |
| Have additional guarantees or other credit enhancements been introduced? | The parent or another subsidiary guarantees the payable and provides protective rights to the intermediary or is jointly and severally liable for the company's obligation. Such guarantees are generally not provided for the company's trade payables in the normal course of business. | No additional guarantees or other credit enhancements have been introduced for the payables factored to the intermediary. |

Other factors to be considered include:

- Whether the company is obligated to maintain cash balances or whether there are credit facilities or other borrowing arrangements with the intermediary outside of the supplier finance program that the intermediary can draw upon in the event of non-collection of the invoice from the company
- Whether the intermediary can determine which invoices to pay or has the ability to prioritize which invoices to pay based on available funds
- Whether the terms of the supplier finance program require the company to pay interest on the payable to the intermediary
- More generally, which classification most accurately reflects the future obligation of the company to transfer assets

It is important to understand the role each party plays in the overall arrangement. Typically, a company negotiates the terms of its purchases from suppliers directly with those suppliers, and the intermediary has no involvement. Also, under a traditional factoring arrangement, the intermediary and the supplier negotiate independently of the company.

To continue classifying the liability as a trade payable, the company must remain liable to the supplier under the original terms of the invoice, and the intermediary must have assumed only the rights to the receivable it purchased.

Under normal circumstances, a factoring arrangement between a company's supplier and an intermediary does not benefit the company. That's why it is important to understand whether the company receives any benefit as a result of the structured payable arrangement. For example, an intermediary may purchase a supplier's receivables in a factoring arrangement at 95% of its face amount. However, rather than collect the full amount payable from the company, the intermediary may require the company to pay only 98% of that amount. In this case, the company has received a benefit that it would not have received without the intermediary's involvement, indicating that the liability may be more akin to a financing arrangement.

Some supplier finance programs require that, as a condition for the intermediary to accept an invoice from a supplier (i.e., the receivable) for factoring, a company must separately promise the intermediary that it will pay the invoice regardless of any disputes that might arise over goods that are damaged or don't conform with agreed-upon specifications. In the event of a dispute, a company that agrees to such a condition would need to seek recourse through other means, such as adjustments on future purchases.

This provision is typical in supplier finance programs since it provides greater certainty of payment to the intermediary. However, this provision may indicate that the economic substance of the trade payable has been altered to reflect that of a financing.

It is important to consider the substance of any such condition in the context of the company's normal practices. For a company that buys enough from a supplier to routinely apply credits for returns against payments on future invoices, this condition might not be viewed as a significant change to existing practice. Similarly, this provision may not be viewed as resulting in a significant change to the terms of the original trade payable if failure by the company to pay on the invoice due date does not entitle the intermediary to any recourse or remuneration beyond what is stipulated in the terms of the invoice.

In some factoring arrangements, the intermediary may require that the company maintain collateral or other credit facilities with the intermediary. These requirements aren't typical in factoring arrangements and may indicate that the economic substance of the liability has changed to be more akin to a financing arrangement, especially if a company's failure to maintain an appropriate cash balance would trigger cross-collateralization events on the company's other debt instruments held by the intermediary. However, if an existing credit facility with the intermediary provides overdraft protection as part of a company's broader relationship with the intermediary, the credit facility may not affect the substance of the liability until the overdraft protection triggers. For the liability to be considered a trade payable, the intermediary generally can collect the amount owed by the company only through its rights as owner of the receivable it purchased from the supplier.

We have also observed that in practice, companies sometimes enter into side agreements with their suppliers to incentivize them to participate in a factoring program established by the intermediaries. Terms of the side agreements may include the reimbursement of finance charges incurred by the supplier (through its factoring arrangement with the intermediary) or a change in payment terms (e.g., from 90 days to 30 days) if the arrangement between the supplier and the intermediary terminates. We generally believe terms such as those indicate that the nature of the supplier finance program has changed and is now more akin to a financing arrangement. Companies should consider the terms included in these side agreements when evaluating the classification of the supplier finance programs.

### 5.19.2.2 Statement of cash flow presentation

There are other possible financial reporting implications to consider, including the impact on the company's statement of cash flows. For example, if a trade payable is required to be reclassified to borrowings (because the intermediary remitted payment to the supplier in an arrangement that is deemed more akin to a financing arrangement), the company should report an operating cash outflow for the reduction in the trade payable balance and a financing cash inflow for the financing being provided by the financial institution. The subsequent payment of the invoice to the intermediary should be reported as a financing cash outflow. This approach is consistent with the SEC staff's view as discussed at the 2005 AICPA National Conference on Current SEC and PCAOB Developments as follows:[60]

> "The situation addressed by the staff dealt with a transaction similar to the purchase of non-[company X] products financed through [company X]. For example, say a dealer purchases [company Y and company Z products] financed under a floor-plan arrangement with [company X]. [Company X] pays the supplier directly and then is repaid later by the dealer. In this case, the financing arrangement is not with the supplier, as it was when the dealer purchased [company X] products; therefore, it does not represent a trade loan. It represents a third-party financing arrangement. Not a big deal, except that the inventory purchase, an operating activity, has taken place without the dealer physically delivering the cash. Based on the view that the financing entity effectively has acted as the dealer's

[60] Joel Levine, 2005 — Refer to the SEC website at **https://www.sec.gov/news/speech/spch120605jl.htm.**

agent, we concluded that upon purchase of the inventory, the dealer should report the increase in the third-party loan in substance as a financing cash inflow, with a corresponding operating cash outflow for the increase in inventory. Upon repayment, the cash outflow would be reported as a financing activity. Here, the cash flows statement would depict the substance of the transactions — with the end result being similar to the previous example where the net effect on operating cash flows is the amount of gross profit generated."

Refer to section 5.2.4 of our FRD publication, ***Statement of cash flows***, for further discussion on classification of cash flows related to similar financing structures.

### 5.19.2.3 Disclosure considerations

#### *5.19.2.3.1 Disclosure about supplier finance program obligations (after the adoption of ASU 2022-04[61]) (added August 2023)*

##### *5.19.2.3.1.1 Overview*

The FASB issued ASU 2022-04 to require entities to disclose the key terms of supplier finance programs they use in connection with the purchase of goods and services along with information about their obligations under these programs, including a rollforward of those obligations.

The guidance, as codified in ASC 405-50, does not affect the recognition, measurement or financial statement presentation of supplier finance program obligations by the buyer, which are classified as either trade payables or bank debt, depending on the terms of the program (refer to section 5.19.2.1 for further discussion on the balance sheet classification). The guidance also does not affect the accounting or disclosures by suppliers or third-party intermediaries involved in such programs.

##### *5.19.2.3.1.2 Scope*

The guidance applies to all entities that use supplier finance programs in connection with the purchase of goods and services. ASC 405-50-15-2 describes a supplier finance program that is subject to the disclosure requirements as an arrangement with the following characteristics:

- The buyer enters into an agreement with a finance provider or intermediary
- The buyer confirms supplier invoices as valid to the finance provider or intermediary
- The supplier has the option to request early payment from a party other than the buyer for the invoices the buyer has confirmed as valid

In the Background Information and Basis for Conclusions of ASU 2022-04, the Board said this confirmation can be either positive or negative. That is, a buyer can confirm an invoice by saying it is valid or by not responding to the request for confirmation.

To determine whether a supplier finance program has been established and is in the scope of the disclosure requirements, the guidance requires an entity to consider all available evidence, including arrangements between the entity and both (1) the finance provider or intermediary and (2) suppliers whose invoices have been confirmed as valid. Under the guidance, a buyer's commitment to pay a party other than the supplier for confirmed invoices "without offset, deduction or any other defenses to payment" is an indicator that the entity may have a supplier finance program, but it would not be determinative.

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[61] ASU 2022-04, *Liabilities — Supplier Finance Programs (Subtopic 405-50): Disclosure of Supplier Finance Program Obligations*.

In the Basis for Conclusions of ASU 2022-04, the Board said that the guidance does not extend to credit card, payment processing and normal factoring arrangements.

#### *5.19.2.3.1.3 Disclosures*

The guidance in ASC 405-50-50-3 through 50-4 requires an entity that uses supplier finance programs to disclose the following information in the annual financial statements to help users understand the nature of the program, activity during the period, changes from period to period and the potential magnitude of the programs:

- The key terms of the programs, including (1) a description of the payment terms, such as payment timing and the basis for its determination, and (2) assets pledged as security or other forms of guarantees provided for the committed payment to the finance provider or intermediary
- The amount of the obligations outstanding at the end of the reporting period that the entity has confirmed as valid to the finance provider or intermediary (i.e., the amount of obligations that the buyer has confirmed as valid that remains unpaid by the buyer), where those obligations are presented in the balance sheet and the amounts presented in each line item in the balance sheet if they are presented in more than one line item
- A rollforward of those obligations presenting, at a minimum, the amount outstanding at the beginning of the reporting period, the amount added to the program during the reporting period, the amount settled during the reporting period and the amount outstanding at the end of the reporting period

If an entity has more than one program, it can aggregate the disclosures, as long as useful information is not obfuscated.

In interim periods, the guidance requires entities to provide the amount of the obligations outstanding at the end of the reporting period that the entity has confirmed as valid to the finance provider or intermediary (i.e., the amount of obligations that the buyer has confirmed as valid that remains unpaid by the buyer).

#### *5.19.2.3.1.4 Effective date and transition*

ASU 2022-04 is currently effective for all entities, except for the rollforward requirement, which is effective for fiscal years beginning after 15 December 2023.

During the fiscal year of adoption, entities are required to disclose in each interim period the key terms of the programs and the balance sheet presentation of the program obligations. Entities apply the guidance retrospectively to all periods in which a balance sheet is presented, except for the rollforward requirement, which is applied prospectively.

### *5.19.2.3.2 SEC staff disclosure guidance on supplier finance programs*

The SEC staff has commented about the increased use of supplier finance programs and the lack of transparency on an entity's use of these arrangements. At the 2019 AICPA Conference on Current SEC and PCAOB Developments, a member of the SEC staff noted that while the use of these programs frequently improved companies' liquidity and operating cash flows, companies did not always disclose their use of this strategy.

At the 2021 AICPA & CIMA Conference, a member of the SEC staff reminded the audience that the staff had mentioned the use of supplier finance programs in its guidance[62] on making robust and transparent disclosures about financing activities companies were undertaking in response to COVID-19. This

[62] SEC Division of Corporation Finance CF Disclosure Guidance: **Topic 9A, *Coronavirus (COVID-19) — Disclosure Considerations Regarding Operations, Liquidity, and Capital Resources*.**

guidance states that if a company is relying on supplier finance programs that have a material impact on the company's balance sheet, statements of cash flows or short-term and long-term liquidity, the following questions should be considered when determining the appropriate disclosures to include in MD&A:

- How are these arrangements impacting the balance sheet, statement of cash flows or short-term and long-term liquidity?
- What are the material terms of the arrangement?
- Are there guarantees provided (either by the company or a subsidiary) related to the arrangement?
- Is there material risk if a party to the arrangement terminates it?
- What amounts payable at the end of the period related to these arrangements and what portion of these amounts has an intermediary already settled on behalf of the company?

At the 2023 AICPA & CIMA Conference, an SEC staff member noted that the staff continues to review MD&A disclosures related to supplier finance programs and encouraged registrants to revisit this guidance when preparing disclosures about these programs.

When determining the appropriate disclosures, the facts and circumstances specific to the company should be considered, and judgment is generally required.

### 5.19.3 Purchasing cards

There are other programs that require considerations similar to those for supplier finance programs. For example, reporting entities often use purchasing cards, or P-cards, to make payments for goods and services. P-cards are a form of corporate charge card. They allow companies to make electronic payments for business expenses, without using the onerous and expensive traditional purchasing process (e.g., issuing purchase orders). The cards sometimes may also be used to pay invoices issued by vendors.

Because P-cards are generally issued by a bank, when a reporting entity uses a P-card to purchase goods or services from its vendor, it is legally obligated to make payment to the bank (rather than its vendor). Accordingly, reporting entities generally should classify obligations arising from the use of P-cards as debt, rather than vendor payable, on their statement of financial position. In limited circumstances, classification of an obligation arising from the use of a P-card as vendor payable may be appropriate if an entity only uses the P-card as a convenience to pay for incidental expenses (e.g., travel expenses, meals, entertainment) that arose from normal operating purchases and must make full payment of the outstanding balance on the P-card at the end of each billing cycle pursuant to the terms of the P-card (generally within one month).

## 5.20 Joint and several liabilities

### 5.20.1 Overview and background

An entity may enter into borrowing arrangements under which it is identified as a co-borrower and is jointly and severally liable for the entire amount of the borrowing. Under a joint and several liability arrangement, the lender can demand payment for the full amount of the outstanding borrowings from any one, or a combination, of the co-borrowers. This raises the question of whether a co-borrower in a joint and several liability arrangement should recognize all outstanding borrowings under the arrangement as a liability or instead some other amount (e.g., under a contingent liability accounting model). Joint and several liability arrangements may be executed between entities that are under common control or between unrelated parties.

## 5.20.2 Scope

ASC 405-40 provides guidance on the recognition, measurement, and disclosure of obligations resulting from joint and several liability arrangements. The guidance applies to obligations resulting from joint and several liability arrangements for which the total amount under the arrangement is fixed at the reporting date. As clarified in ASC 405-40-15-2, the obligation that must be fixed from the joint and several liability arrangement is the total amount of the obligation, not the entity's portion of the obligation.

The following obligations are outside of the scope of ASC 405-40 and accounted for under other topics:

- Asset Retirement and Environmental Obligations (ASC 410)
- Contingencies (ASC 450)
- Guarantees (ASC 460)
- Compensation–Retirement Benefits (ASC 715)
- Income Taxes (ASC 740)

For the total amount of an obligation under an arrangement to be considered fixed at the reporting date, there can be no measurement uncertainty at the reporting date relating to the total amount of the obligation under the arrangement. However, the total amount under the arrangement may change subsequently due to factors that are unrelated to measurement uncertainty (e.g., the amount was fixed at the reporting date but may change because an additional amount was borrowed or the interest rate changed).

Liabilities subject to a measurement uncertainty are excluded from the scope of ASC 405-40 and should continue to be accounted for under the guidance in ASC 450 or other US GAAP.

Examples of obligations that could be within the scope of this guidance include debt arrangements, other contractual obligations, and settled litigation and judicial rulings.

## 5.20.3 Recognition and measurement

Obligations resulting from joint and several liability arrangements included in the scope of ASC 405-40 are initially and subsequently measured at the sum of:

a. The amount the reporting entity agreed to pay on the basis of its arrangement among its co-obligors

b. Any additional amount the reporting entity expects to pay on behalf of its co-obligors

In measuring any additional amount an entity expects to pay on behalf of its co-borrowers, the entity should record its best estimate of that amount. If a range of additional amounts is developed, and one amount in the range is a better estimate than any other amount within the range, that amount should be the additional amount included in the measurement of the obligation. If no amount within the range is a better estimate than any other amount, then the minimum amount in the range is the additional amount included in the measurement of the obligation.

Under this guidance, a reporting entity is not required to record the full amount of the obligation as a liability, unless the reporting entity expects to pay the full amount of the obligation on behalf of its co-borrowers. At a minimum, the entity should record the portion of the joint and several liability arrangement it agreed to pay based on the arrangement among the co-borrowers, even if it does not expect to pay.

ASC 405-40 does not include specific guidance about the corresponding entry or entries when recognizing and measuring a liability resulting from a joint and several liability arrangement. Rather, the corresponding entry (or entries) depends on the facts and circumstances of the arrangement. Following are examples of entries included in ASC 405-40:

- Cash for proceeds from a debt arrangement

- An expense for a legal settlement
- A receivable (that is assessed for impairment) for a contractual arrangement
- An equity transaction with an entity under common control

In instances in which a legal or contractual arrangement exists to recover amounts funded under a joint and several obligation from the co-obligors, a receivable could be recognized at the time the corresponding liability is established and then subsequently assessed for impairment. However, when no such legal or contractual arrangement exists to recover amounts from co-obligors, an entity should consider all relevant facts and circumstances to determine whether the gain contingency guidance in ASC 450-30 or other guidance would apply in recognizing a receivable for potential recoveries.

### 5.20.4 Disclosures

ASC 405-40-50 requires certain disclosures for obligations resulting from joint and several liability arrangements, including:

- The nature of the arrangement, including how the liability arose, the relationship with other co-borrowers, and the terms and conditions of the arrangement.
- The total amount outstanding under the arrangement, which should not be reduced by the effect of any amounts that may be recoverable from other entities.
- The carrying amount, if any, for an entity's liability and the carrying amount of a receivable recognized, if any.
- The nature of any recourse provision that would enable recovery from other entities of the amounts paid, including any limitations on the amounts that might be recovered.
- In the period the liability is initially recognized and measured or in a period the measurement changes significantly, the corresponding entry and where it was recorded in the financial statements.

## 5.21 Breakage for certain prepaid stored-value products

Prepaid stored-value products are products in physical and digital forms with stored monetary values that are issued for the purpose of being commonly accepted as payment for goods or services. These products generally include prepaid gift cards issued on a specific payment network and redeemable at network-accepting merchant locations, prepaid telecommunication cards and traveler's checks, among other things. When an entity sells this type of prepaid stored-value product, it recognizes a liability for its stand-ready obligation to provide payment to the third party when the consumer redeems the product for goods, services, or cash. However, these products may result in breakage, which represents the value that is not redeemed by consumers (because, for example, the remaining amount is negligible or the product has been lost).

ASC 405-20-40-4 provides guidance on the accounting for breakage (i.e., derecognize the liability) related to prepaid stored-value products (in physical and digital forms) with stored monetary values that are redeemable for goods, services or cash at third-party merchants. It does not apply to prepaid stored-value products that can only be redeemed for cash (e.g., nonrecourse debt, bearer bonds, trade payables). Further, the derecognition guidance in ASC 405-20-40-4 does not apply to liabilities related to prepaid stored-value products that are subject to unclaimed property (or escheatment) laws or those that are attached to a segregated bank account (e.g., debit cards). It also does not apply to customer loyalty programs, which do not meet the definition of a prepaid stored-value product, and to transactions within the scope of other topics in the Codification (e.g., the derecognition guidance for gaming chips in ASC 924-405).

## 5.21.1 Recognition and measurement

Entities must recognize liabilities related to the sale of prepaid stored-value products that are within the scope of ASC 405-20 as financial liabilities. ASC 405-20-40-4 requires breakage to be recognized for these liabilities in a way that is consistent with how gift card breakage is recognized under the revenue guidance in ASC 606.

Under the derecognition guidance, an entity that expects to be entitled to a breakage amount for a liability resulting from the sale of a prepaid stored-value product within the scope of the guidance has to derecognize the liability related to expected breakage in proportion to the pattern of rights expected to be exercised by the consumer only if it is probable that a significant reversal of the recognized breakage amount will not occur. If an entity does not expect to be entitled to a breakage amount, it has to derecognize the related liability when the likelihood of consumer exercising its remaining rights becomes remote.

**Illustration 5-20: Expectation of breakage**

Card Issuer ABC (ABC) sells a prepaid gift card with a load value of $500 that the cardholder can only use at Content Provider XYZ (XYZ). The card is not subject to unclaimed property laws and is not attached to a segregated bank account. ABC is required to remit the card's load value to XYZ if and when the cardholder uses the card. Otherwise, the load value remains with ABC in perpetuity. To simplify this example, we are ignoring fees and commissions ABC and other parties would earn.

By analyzing historical redemption rates and determining how those rates may change, given current facts and circumstances, ABC estimates that 10% of the load value for this card will go unredeemed. Further, ABC has objective evidence to support that its prepaid cards are typically redeemed on a pro-rata basis over a 24-month period. Assuming a significant reversal of the recognized breakage amount is not probable, ABC would recognize the estimated breakage amount of $50 ratably over the 24-month redemption period (i.e., approximately $2 of the liability per month).

**Illustration 5-21: No expectation of breakage**

Assume the same fact pattern as above except that virtually all of ABC's cardholders have historically redeemed 100% of the load value of their cards. ABC has the same objective evidence to support that its prepaid cards are typically redeemed on a pro-rata basis over a 24-month period.

Also assume that, after 24 months, $8 of the $500 load value remains on a prepaid card and the cardholder has not used the prepaid card in the last 14 months. As a result, ABC determines that the likelihood of the cardholder using the remaining $8 is remote. ABC would therefore derecognize the remaining balance of $8 at that time.

At the end of each reporting period, an entity is required to update the estimated breakage amount to reflect circumstances present at the end of the period and any changes during the period. Changes to an entity's estimated breakage amount must be accounted for as a change in accounting estimate in accordance with ASC 250-10-45-17 through 45-20.

## 5.21.2 Disclosures

An entity is required under ASC 405-20-50 to disclose the methodology and significant judgments used to recognize breakage for prepaid stored-value products. These liabilities are not subject to the disclosure requirements for financial liabilities (e.g., those required by ASC 825).

## 5.22 Credit facilities issued with warrants

### 5.22.1 Overview and background

Many early-stage entities obtain credit facilities to meet their liquidity needs. In some cases, a credit facility is structured as a term loan (or a series of term loans), plus a warrant (or a series of warrants) that gives the lender the right to buy the borrower's shares. The warrant provides the lender with the potential for enhanced returns and reduces the borrower's coupon rate on the term loan. There is generally a "draw period" during which the borrower may draw or borrow from the facility. Upon each draw, the borrower issues debt (i.e., the term loan) and a warrant in exchange for cash.

The term loans typically have maturities of three to five years and may have interest-only periods. The warrants, which expire seven to 10 years after issuance, typically give the lender the option to make an investment in the equity of the borrower equal to a percentage of the loan amount drawn (i.e., warrant coverage). The number of common or preferred shares the lender can purchase under the warrant is usually determined by dividing the warrant coverage amount by the warrant exercise price. The exercise price of each warrant is usually based on the price of the underlying shares at the time the warrant is issued (i.e., the warrant is issued at the money).

For example, consider a $10 million credit facility that provides 5% warrant coverage. When the borrower draws $10 million, it is required to issue a warrant that is exercisable into a number of shares determined by dividing $500,000 ($10 million x 5%) by the contractually specified exercise price.

When a borrower draws a portion of the available facility at the initial closing (i.e., upon entering the credit facility), three instruments are issued: (1) a term loan, (2) a warrant based on the warrant coverage and (3) the financial commitment asset (FCA), which is the right the borrower has to borrow subsequent tranches under the facility by issuing additional debt and warrants.[63]

The following illustration provides an example of a typical credit facility issued with warrants.

**Illustration 5-22: Credit facility issued with warrants**

An entity raised $20 million by issuing Preferred Series A shares a year ago. Based on projected cash-burn, the entity has approximately 11 months of cash on hand before it will need to raise its next round of equity financing. To extend its cash runway, the entity enters into a credit facility with a bank (the lender) on 30 June 20X2. The facility will provide the entity with additional time to achieve milestones, which increases its chances of raising its next round of equity financing at a higher valuation. The facility has the following terms:

- The entity may draw up to $6.5 million during the draw period, which expires on 30 June 20X3 subject to customary default provisions.
- Term loans issued upon each draw will have a stated interest rate of the bank's prime rate plus 3.50%, payable quarterly.
- The term loans mature four years from the draw date.
- The bank receives warrant coverage of 8%, with the exercise price of each warrant equal to the fair value of the underlying common shares on each warrant's issuance date.
- The warrants are exercisable for seven years.

[63] In limited cases, the issuer may be required to draw an amount under the facility and issue additional debt and warrants either on a fixed or determinable date or upon reaching a milestone.

On 30 June 20X2, the entity drew $2.5 million. On that date, its common stock price is $5 a share. Based on the terms of the credit facility, the following components exist at initial closing:

- Term loan of $2.5 million at the bank's prime rate plus 3.50% maturing on 30 June 20X6
- Warrant for 40,000 common shares [ ($2.5M x 8%) / $5 ] exercisable at $5 per share for seven years
- The entity's right to draw an additional $4 million under the facility over the 12-month draw period by issuing additional term loans and warrants (i.e., the FCA)

## 5.22.2 Analysis

Entities that enter into credit facilities with warrants should first determine the appropriate unit of account by determining which components are freestanding financial instruments (e.g., whether the warrant and/or FCA is embedded in the term loan). Then, the accounting analysis should be based on the contractual terms of each freestanding financial instrument. The following table summarizes the relevant accounting considerations for applying this two-step approach:

| | **Accounting considerations** |
|---|---|
| Step 1: Identify the freestanding financial instruments (section 5.22.2.1) | ▸ Is the warrant freestanding or embedded in the term loan?<br>▸ Is the FCA freestanding or embedded in the term loan?<br>▸ If neither the warrant nor the FCA is embedded in the term loan, are the warrant and FCA attached to each other? |
| Step 2: Analyze each freestanding financial instrument based on its contractual terms (section 5.22.2.2) | ▸ An entity should follow the analysis in section 2.2 to initially account for the term loan. If the warrant is considered embedded in the term loan, the entity should follow the guidance on accounting for conversion options embedded in debt hosts in section 2.2.4. If the FCA is considered embedded in the term loan, the entity should follow the analysis in section 5.22.2.2.1 below (and section 5.22.2.2.3, as applicable).<br>▸ If the warrant is considered freestanding (i.e., it is not embedded in the term loan), the entity should follow the analysis in section 4.2 on the initial accounting for freestanding equity contracts.<br>▸ If the FCA is considered freestanding (i.e., it is not embedded in the term loan), the entity should follow the analysis in section 5.22.2.2.2 below (and section 5.22.2.2.3, as applicable). |

Entities should be aware that the terms of credit facilities issued with warrants vary. For example, instead of issuing a warrant at each draw, the borrower may issue a warrant (or warrants) up-front in exchange for the lender's commitment to provide funds during the draw period. In these cases, entities will need to consider the facts and circumstances when determining the appropriate accounting for credit facilities issued with warrants.

### 5.22.2.1 Identify the freestanding financial instruments (step 1)

As discussed in section 1.2.1, when companies issue multiple instruments to the same counterparty in a single transaction, the first step is to identify all freestanding financial instruments. ASC 480 defines a freestanding financial instrument as a financial instrument that is entered into either (1) separately and apart from any of the entity's other financial instruments or equity transactions or (2) in conjunction with some other transaction and is legally detachable and separately exercisable. An instrument or feature that does not meet these conditions is generally considered a feature embedded in another instrument.

The credit facility in Illustration 5-22 involves multiple financial instruments issued contemporaneously at inception: the initial term loan, the initial warrant and the FCA. Because the three instruments are issued in conjunction with one another, the second condition of the definition of a freestanding financial instrument (above) applies. Accordingly, the borrower must determine whether the warrants and/or FCA are both legally detachable and separately exercisable from the initial term loan. The analysis of whether a financial instrument is a freestanding instrument or an embedded feature should consider all relevant facts and circumstances. Once that determination is made, the accounting for the freestanding instruments or embedded features is based on the contractual terms of the three financial instruments.

**Warrant — freestanding or embedded in the term loan?**

Although the facts and circumstances of each transaction may differ, the initial warrant is often considered freestanding from the term loan because it generally can be (1) transferred separately to another party and (2) exercised without terminating the term loan. In fact, the warrant could continue to be outstanding after the term loan matures. That's because the typical maturity of a term loan in these credit facilities is three to five years, while the warrant issued with the term loan typically expires seven to 10 years after issuance.

However, if the warrants cannot be transferred to another party separately from the term loan, or if the warrants can only be exercised by surrendering the term loan, the warrants would be considered embedded in the debt instrument.

**FCA — freestanding or embedded in the term loan?**

The issuer's analysis of whether the FCA is a freestanding instrument can be more challenging. Because the initial warrant is often considered freestanding from the term loan and FCA, the analysis of the FCA generally focuses on whether it is considered freestanding or embedded in the initial term loan.

Generally, two instruments issued together are considered legally detachable from one another if they can be legally separated and transferred to a third party. For example, if the lender can sell the term loan without also transferring its obligation under the FCA to make future advances, the FCA is considered legally detachable from the term loan. In this analysis, it does not matter which instrument the lender can transfer. For example, if the lender can transfer the term loan but contractually cannot transfer the FCA, the FCA is still legally detachable from the term loan. The same would be true if the lender had to retain the term loan but could transfer the FCA.

A careful analysis of the terms of the agreements must be performed, and the company's legal counsel may need to be involved in determining whether the FCA can be transferred separately from the initial term loan. Because performance on the FCA (i.e., the funding of future advances) is affected by the creditworthiness of the lender, the issuer may (and often does) restrict the ability of the lender to transfer its obligation under the FCA. In those cases, as long as the lender can sell the initial term loan while remaining the counterparty to the FCA (or vice versa), the FCA is legally detachable. Alternatively, if the lender cannot transfer the term loan to a third party without that party also becoming the counterparty to the FCA, the FCA would not be considered legally detachable from the term loan.

Exercising the FCA generally does not result in the termination of the initial term loan. In these circumstances the FCA would be viewed as being separately exercisable.

**FCA and warrant — attached to each other?**

If the FCA and warrant are both freestanding from term loan, the same analysis as discussed above should be performed to determine whether the FCA is legally detachable from the warrant. If the lender is able to separately transfer these instruments, they are generally considered legally detachable.

Although the facts and circumstances of each transaction may differ, the FCA is often considered freestanding from the warrant because the warrant generally can be (1) transferred separately to another party and (2) exercised without terminating the FCA (and vice versa).

### 5.22.2.2 Analyze each freestanding financial instrument (step 2)

Entities should evaluate the accounting for credit facilities issued with warrants by analyzing each freestanding financial instrument based on its contractual terms.

The accounting for the term loan generally should follow the analysis for an issuer's initial accounting for debt instruments, as described in section 2.2. If the issuer determines that the warrant is embedded in the term loan (based on the analysis in section 5.22.2.1), it will need to consider the guidance on evaluating conversion options embedded in debt hosts in section 2.2.4 to account for the combined instrument. Alternatively, if the issuer determines that the warrant is freestanding from the term loan, it should consider the guidance in section 4.2 on an issuer's initial accounting for equity contracts to account for the warrant.

Accounting for the FCA may be more challenging because of the lack of specific guidance. The accounting will depend on whether the FCA is considered freestanding, embedded in the term loan or attached to the warrant, as well as an evaluation of the substance of the FCA as a loan commitment. We discuss the accounting for an FCA that is considered embedded in the term loan in section 5.22.2.2.1 and an FCA that is considered a freestanding financial instrument in 5.22.2.2.2 as these fact patterns are the most common in practice. Additionally, we discuss the accounting for FCAs (freestanding and embedded) that are considered loan commitments in section 5.22.2.2.3.

Although infrequent, there may be scenarios where the warrant and FCA are freestanding from the term loan but attached to each other (as a combined instrument). In these cases, judgment will be required to determine the appropriate accounting, however we expect that the analysis discussed in 5.22.2.2.2 should generally be followed for the combined instrument. That is, the combined instrument should be first assessed under ASC 480 (see Appendix A). If not in the scope of ASC 480, the combined unit should be analyzed under ASC 815 to determine whether it meets the definition of a derivative (see section 4.2.4) and if not, whether any features embedded in the combined unit require bifurcation. The combined unit is unlikely to meet the criteria for equity classification in ASC 815-40 because the settlement of the FCA includes the issuance of a term loan.

#### *5.22.2.2.1 FCA considered embedded*

If an entity determines that the FCA is a feature embedded in the initial term loan, the entity should evaluate the FCA under ASC 815-15-25-1 to determine whether the embedded FCA requires bifurcation. Under that guidance, embedded features must be separated from their host non-derivative contracts and accounted for as derivative instruments if, and only if, all of the following criteria are met:

- The economic characteristics and risks of the embedded derivative are not "clearly and closely related" to the economic characteristics and risks of the host contract.
- The contract that embodies both the embedded derivative and the host contract is not remeasured at fair value under otherwise applicable US GAAP with changes in fair value reported in earnings as they occur.
- A separate, freestanding instrument with the same terms as the embedded derivative would be a derivative instrument subject to the requirements of ASC 815.

The last criterion is particularly important when considering FCAs. One of the characteristics necessary for a contract to meet the definition of a derivative in ASC 815 is that the terms of the contract require or permit net settlement, it can readily be settled net by means outside the contract or it provides for delivery of an asset that puts the recipient in a position not substantially different from net settlement (i.e., the asset is readily convertible to cash or is itself a derivative instrument).

The FCA in Illustration 5-22 requires delivery of two underlying financial instruments (i.e., subsequent issuance of a term loan and warrant) in exchange for cash from the lender. For the FCA to meet the definition of a derivative, a determination must be made as to whether delivery of the term loan and warrant puts the recipient in a position not substantially different from net settlement. ASC 815-10-15-119 through 15-139 provides guidance on the application of the net settlement criterion when settlement involves the delivery of a derivative instrument or an asset readily convertible to cash. However, it does not provide guidance for circumstances where there are multiple underlyings and one of them is not considered readily convertible to cash while another is a derivative instrument.

With respect to the FCA, a term loan underlying is generally not considered readily convertible to cash because the term loan is a privately issued instrument that usually cannot be transferred to another party. The warrant, on the other hand, often meets the definition of a derivative because the terms of the warrant frequently provide for net settlement (e.g., it either requires physical delivery of shares that are readily convertible to cash or net-cash settlement), and the warrant also has the other characteristics of a derivative instrument (i.e., an underlying, a notional amount and little to no initial net investment).

Judgment is required to determine whether the FCA meets the definition of a derivative. In practice, entities apply one of the following two interpretations of the guidance to determine whether the net settlement criterion is met.

Under one view, the entity focuses on whether *any* underlying of the FCA is a derivative instrument or an asset that is readily convertible to cash. Under this view, if the warrant underlying the FCA is itself a derivative instrument under ASC 815, delivery of the warrant would constitute net settlement of the FCA, even though the settlement of the FCA also includes the delivery of a debt instrument that is not readily convertible to cash.

Under the other view, the entity focuses on whether the *predominant* underlying of the FCA is a derivative instrument or an asset that is readily convertible to cash. Because there is no specific guidance on evaluating the net settlement criteria for an instrument with multiple underlyings, an entity that uses this view analogizes to the guidance in ASC 815-10-15-59 to 15-60 on derivative scope exceptions related to certain contracts that are not traded on an exchange. Under that guidance, when a contract has more than one underlying and some, but not all, of them qualify for the scope exceptions, the contract is evaluated based on its *predominant* characteristics.

The primary underlyings of the FCA generally can be broken down into (1) the risk-free interest rate and the borrower's credit risk for the term loan and (2) the borrower's stock price for the warrant. To determine which underlying is predominant, an issuer may consider how each underlying affects the fair value or cash flows of the FCA under a range of reasonably possible scenarios over the life of the FCA. For example, an issuer might compare its estimates of how the value of the warrant would change due to stock price fluctuations and how the value of the term loan would change due to fluctuations in risk-free interest rates and the credit risk of the borrower. The volatility of each underlying, as well as the relative size of the notional amounts of the term loan and warrants the entity may issue in connection with the FCA should also be considered.

An embedded feature that meets the definition of a derivative in ASC 815 still might not be subject to the requirements of ASC 815 (and, therefore, not meet the third criterion above for bifurcation) if it qualifies for a scope exception. The most relevant scope exceptions for the FCA are the scope exception for contracts indexed to a company's own stock (ASC 815-10-15-74(a) — which considers the guidance in ASC 815-40) and the scope exception for certain loan commitments. With respect to the scope exception for contracts indexed to a company's own stock, the FCA would not be considered indexed to the issuer's own equity because one of the underlyings of the FCA is a debt instrument (i.e., term loan). Consequently, the FCA would not meet that scope exception. See section 5.22.2.2.3 for a discussion of the FCA as a loan commitment.

As a result, an FCA that meets the definition of a derivative and does not meet any scope exception would generally be bifurcated and accounted for separately from the debt host because the FCA would not be considered clearly and closely related to the debt host. This is because the FCA has economic risks and characteristics that are, in part, related to the entity's stock price and not solely to an interest rate index or the borrower's credit risk.

An FCA that does not meet the definition of a derivative in ASC 815 would not be bifurcated and accounted for separately from the debt host.

#### *5.22.2.2.2 FCA considered freestanding*

If the FCA is considered a freestanding instrument, it should first be evaluated under ASC 480-10-25 to determine whether it is classified as a liability. The contractual terms should be carefully considered to determine whether the FCA represents a right or an obligation to issue additional debt and warrants. Generally, the FCA is exercisable at the issuer's sole discretion and, therefore, it is not considered an "obligation" in the scope of ASC 480. However, if the FCA represents a conditional or unconditional obligation in which the issuer must issue the additional debt and warrant either on a fixed or determinable date or upon an event that is outside the control of the issuer, the instrument may require ASC 480 liability classification (or as an asset in some circumstances) if the additional warrant involves the issuance of redeemable shares. Refer to section 5.7 for a discussion on warrants where the shares underlying the warrant are redeemable.

If ASC 480-10-25 does not apply to the FCA, the issuer would apply the guidance in ASC 815-40 to determine whether the FCA should be classified in equity or as a liability (or an asset in some circumstances). Because one of the underlyings of the FCA is a debt instrument, the FCA would not be considered indexed to the issuer's own equity and must be classified as a liability (or an asset in some circumstances).

If the FCA is a liability (or an asset in some circumstances) under ASC 480-10-25, or if it is not in the scope of ASC 480 and doesn't qualify for equity classification under ASC 815-40 (e.g., because it fails the indexation guidance in ASC 815-40-15 to be considered indexed to the issuer's own equity (regardless of whether it meets the definition of a derivative)), it is subsequently measured at fair value through earnings. In that case, the entity allocates proceeds from the issuance of the initial term loan and warrant to the FCA at its fair value as discussed in section 1.2.7. Depending on whether the FCA is an asset or liability, it creates a corresponding premium or discount, respectively, on the debt that would subsequently be amortized as interest.

#### *5.22.2.2.3 FCA considered a loan commitment*

Typically, the purpose of the FCA is to provide additional funds to the borrower on demand (or in some cases, upon the occurrence of certain events), and the warrant is considered an ancillary element of the financing. If the warrant is considered ancillary, an alternative approach to analyze the FCA is to focus on the substance of the FCA as a loan commitment, which is eligible for the scope exception from derivative accounting in ASC 815-10-15-69.

Under this approach, a term loan issued under the facility is recognized only when an amount is drawn. The warrant issued concurrently with the term loan is also recognized only when the related term loan is drawn. The treatment of the warrants is similar to lender fees that are paid when the issuer borrows money. These lender fees are generally not recognized until the liability has been incurred. This approach is also supported by analogy to the guidance in ASC 718-10-25-2C, which requires that share-based payment awards granted to nonemployees that will be issued in exchange for goods or services should be recognized as an asset or expense in the same period and in the same manner as if the entity had paid cash for the goods or services (i.e., they are not recognized until the goods or services are received). Therefore, under this approach, the warrants will not be recognized until the draw occurs and the lender performs the service of lending money to the issuer.

When it draws additional term loans and issues warrants under the facility, the borrower should allocate the proceeds received to the two instruments using a relative fair value or fair value method, depending on whether the warrants are subsequently measured at fair value through earnings. Refer to section 1.2.7 for further discussion of the allocation of proceeds when multiple instruments are issued concurrently.

## 5.23 Bridge loans

### 5.23.1 Overview and background

Private companies commonly use a form of financing referred to as a bridge loan. As suggested by its name, these loans are typically used to "bridge" a gap in liquidity until a more permanent means of financing can be arranged. For example, a company may be planning an initial public offering, the completion of which requires significant effort over an extended period. Accordingly, the company may enter into a bridge loan to make sure that it has sufficient cash flows to maintain its operations in the interim.

Bridge loans are typically short-term loans of as short as a few weeks or months but the term may be longer. Given that bridge loans are generally provided when a company is at risk of meeting its liquidity requirements, an investor may not recover all of its investment in the bridge loans if the company is unable to obtain permanent or longer-term financing. Therefore, interest rates on bridge loans are often established at relatively high rates to compensate investors for greater exposure to credit risk.

In section 2, we discussed the guidance for analyzing settlement features in debt arrangements. The following sections discuss features commonly included in bridge loans, such as fixed and variable share settlement alternatives, and the application of the guidance discussed in section 2.

#### 5.23.1.1 Variable-share settlement

Many contractual terms in a bridge loan are similar to those in other debt instruments. However, one feature often included in a bridge loan is the ability for the issuer to settle its obligation by delivering a variable number of its own shares (i.e., variable-share settlement). Specifically, many bridge loans include a provision that permits (or requires) the borrower to settle the outstanding principal and accrued interest by issuing a variable number of the shares issued in its next round of equity financing, if and when that equity financing occurs.[64]

Although variable-share settlement is often documented in the loan agreement as a "conversion," the feature does not expose the holder to any equity risk of the issuer upon settlement. This is because the number of shares the holder will receive is a function of the price (i.e., fair value) of the shares issued in the financing and the debt's outstanding principal amount (plus accrued interest). The "conversion price" is variable and will always equal the price (or a percentage thereof) of the shares issued in the next round of financing, which results in the issuance of a variable number of shares.

For example, assume a bridge loan's outstanding principal amount is $1,000, which will be settled in shares using the issue price in the next round of equity financing. The following table calculates the number of shares that would be delivered and their fair value, assuming various share issuance prices.

| (A) Principal | (B) Price per share | (A)/(B)=(C) Shares delivered | (C)*(B)=(D) Fair value of shares delivered |
|---|---|---|---|
| $1,000 | $5 | 200 | $1,000 |
| $1,000 | $10 | 100 | $1,000 |
| $1,000 | $20 | 50 | $1,000 |
| $1,000 | $25 | 40 | $1,000 |
| $1,000 | $40 | 25 | $1,000 |

[64] The next round of equity financing may be referred to in loan agreements as a "qualified financing" or a similar term and would be defined. For example, it might be defined as a transaction or series of transactions in which the issuer raises at least a certain dollar amount (e.g., $10 million) in net proceeds. The "next round" may also be defined as the issuer's initial public offering.

As indicated in the last column, regardless of the issuance price of the shares, the aggregate fair value transferred to the lender under variable-share settlement is fixed at the outstanding principal amount of the bridge loan.[65]

A common variation to the variable-share settlement illustrated above incorporates a percentage discount to the issuance price (e.g., 20%) of the shares in the next round of equity financing. This results in the issuer transferring a fixed amount of value upon settlement at an amount that will include a premium in excess of the outstanding principal. For example, assume the bridge loan's outstanding principal amount is $1,000 and it will be settled in shares at 80% of the share issuance price in the next round of equity financing (i.e., 20% discount). The following table illustrates the calculation of the number of shares that would be delivered and their fair value, assuming various share issuance prices.

| (A)<br>Principal | (B)<br>Price per share | (A)/((B)*80%)=(C)<br>Shares delivered | (C)*(B)=(D)<br>Fair value of shares delivered |
|---|---|---|---|
| $1,000 | $5 | 250 | $1,250 |
| $1,000 | $10 | 125 | $1,250 |
| $1,000 | $20 | 62.5 | $1,250 |
| $1,000 | $25 | 50 | $1,250 |
| $1,000 | $40 | 31.25 | $1,250 |

The last column shows that, regardless of the price at which the shares are issued in the next round of equity financing, the aggregate fair value transferred to the lender is fixed to include a premium to the outstanding principal amount of the bridge loan.

### 5.23.1.2 Additional settlement features

#### Fixed-share conversion

Bridge loans may also include fixed-share conversion features. These conversion features typically provide the lender with an option to convert the loan into a class of shares (e.g., common or preferred shares of a particular class) that existed when the bridge loan was issued. The conversion price is often fixed at the fair value of those shares when the bridge loan is issued. Because the number of shares the lender would receive is fixed, this is a true conversion option that exposes the lender to fluctuations in the fair value of the underlying shares.

These conversion features are often exercisable at the option of the lender only if an equity financing does not occur by the stated maturity of the bridge loan. Sometimes, these conversion features are exercised automatically at maturity (even if the lender receives less than the outstanding principal upon conversion).

Regardless of whether the conversion is optional or automatic, settlement of these features under their original terms is accounted for as a conversion of the bridge loan as described in section 2.5.2.

Occasionally, the shares the lender will receive in a conversion do not exist when the bridge loan is issued. Instead, the lender is entitled to receive shares of a new series of preferred stock. In these cases, the bridge loan agreement may specify the terms of the "new preferred" shares. For example, the bridge loan agreement may define the new preferred stock to be pari passu with the most senior series of preferred stock outstanding at the time of conversion and to have all the same terms, rights, privileges and restrictions as these most senior series of preferred stock.

[65] Although settlement often includes any accrued but unpaid interest, it is excluded from this example for simplicity.

#### Combination of fixed and variable share settlement

Bridge loans may include share-settlement features with a combination of a fixed and variable conversion prices upon the next round of equity financing. These share-settlement features provide the lender with an option (or an automatic obligation) to convert the loan into shares issued in the next round of equity financing. The conversion price may be defined as the lesser of (1) a fixed price and (2) the share issuance price in the next round of equity financing (or a percentage thereof). In this case, the lender is only exposed to fluctuations in the fair value of the shares above the fixed price.

As an example, assume the conversion price is the lesser of $10 and the price per share in the next round of equity financing. If the next stock issuance price is at or below $10, settlement will be consistent with the variable-share-settlement discussed above. In that case, the lender receives a variable number of shares but the value it receives will always equal the outstanding principal amount. However, if the price per share in the next round of equity financing is above $10, settlement will be consistent with the fixed-share conversion feature discussed above. The value of the shares the lender receives will fluctuate with changes in the fair value of the shares. In this case, the lender will always receive a settlement with a value at least equal to the principal amount and will receive additional value when the price of the next round of equity financing is above $10.

### 5.23.2 Analysis

The accounting analysis for bridge loans follows the debt roadmap outlined in section 2. The following illustration provides an example of a typical bridge loan issuance. Issuers should carefully consider the different terms and features, as well as all relevant facts and circumstances, when determining the appropriate accounting for bridge loans.

**Illustration 5-23: Bridge loan with variable-share settlement and conversion features**

An entity plans to raise $75 million through an IPO in the next year. To maintain operations and make sure it has adequate funding to cover expenses it expects to incur prior to the IPO, the entity decides to borrow $8 million by issuing a bridge loan with the following terms:

- The maturity is 18 months.
- The stated annual interest rate is 14% payable monthly.
- The principal amount is $8 million.
- If the entity completes an equity financing (including an IPO) that raises at least $20 million in net proceeds ("qualified financing"), the principal and accrued interest outstanding as of that date ("repayment amount") automatically converts into shares of capital stock sold by the entity in the qualified financing:
  - The number of shares of capital stock to be delivered equals the repayment amount divided by the purchase price for each share of capital stock the entity issued in a qualified financing.
- At maturity, if a qualified financing does not occur, the lender has the option to convert the bridge loan into 1,000,000 common shares (i.e., conversion price of $8 per share).

The entity identifies the various features embedded in the bridge loan. It determines that the settlement upon a qualified financing is a variable-share settlement feature as described in section 5.23.1.1. The entity also determines that the optional conversion at maturity is a fixed-share conversion feature as described in 5.23.1.2.

### 5.23.2.1 ASC 480 considerations

Because the legal form of a bridge loan is debt, it would be recognized as a liability. However, because bridge loans frequently contain variable-share settlement features (as described in section 5.23.1.1), an analysis is required to determine whether the bridge loan is within the scope of ASC 480-10-25-14.

ASC 480-10-25-14 requires liability accounting for (1) any financial instrument that embodies an unconditional obligation to transfer a variable number of shares or (2) a financial instrument other than an outstanding share that embodies a conditional obligation to transfer a variable number of shares, provided that, in both cases, the monetary value of the obligation is based solely or predominantly on, among other things, a fixed monetary amount known at inception.

Evaluating whether a financial instrument is an obligation is the starting point in determining the appropriate classification of the instrument under ASC 480. Because the event that may trigger variable-share settlement is the occurrence of the next round of equity financing, which is considered in the issuer's control because the issuer may choose not to proceed with the financing, the issuer would not be considered to have an *obligation* to deliver a variable number of shares. For example, the issuer may begin to generate positive cash flows and, therefore, no longer need the next round of financing, or the issuer may refinance the bridge loan with different lenders.

Alternatively, if the triggering event is determined not to be in the control of the issuer, further consideration under ASC 480-10-25-14 would be required because the variable-share settlement would be considered a conditional obligation of the issuer to deliver a variable number of shares. Issuers should carefully consider all possible settlement outcomes under the bridge loan when evaluating whether the instrument is a conditional obligation to deliver a variable number of the issuer's shares with a monetary value based predominantly on a fixed monetary amount.

If a bridge loan (1) obligates the borrower (either conditionally or unconditionally) to issue a variable number of shares equal to a fixed monetary amount and (2) this obligation is the predominant settlement outcome at inception, the bridge loan would be in the scope of ASC 480. In that case, the instrument is initially recorded at fair value pursuant to ASC 480-10-30-7.

As discussed in section A.6.2.1, we generally believe that some of these obligations are, in substance, "traditional" debt arrangements with the stock of the issuer used as the form of currency for repayment. Therefore, the accounting guidance in ASC 835-30 (i.e., accrue to the redemption amount using the interest method) may be applied unless some other accounting guidance permits or specifies another measurement attribute (e.g., the fair value option is elected pursuant to ASC 825-10-15).

### 5.23.2.2 Embedded derivatives

If the bridge loan is not subsequently measured at fair value, any embedded derivative features should be evaluated for bifurcation pursuant to ASC 815-15.

#### *5.23.2.2.1 Variable-share settlement features*

Although variable-share settlement features are often described as "conversion" features, they generally do not expose the lender to changes in the fair value of the company's shares. Therefore, they should be evaluated as redemption features, not conversion features. The settlement upon a qualified financing in Illustration 5-23 is a variable-share settlement feature.

Accordingly, the guidance in section 2.2.5 should be applied to determine whether such features are clearly and closely related to the debt host contract. If settlement of those features involves a substantial premium or discount, the features are not considered clearly and closely related to the debt host because they are also contingently exercisable (e.g., upon the occurrence of the next round of financing). The lender may receive a substantial premium upon settlement if a discounted share price is used in determining the number of shares to be issued. Additionally, if the bridge loan is issued contemporaneously with another instrument (e.g., a warrant), an allocation of proceeds may create a substantial discount on the debt.

Further, although those features result in the settlement of the bridge loan in shares of a private company that are generally not readily convertible to cash, they will meet the definition of a derivative pursuant to ASC 815-10-15-107 through 15-109. That guidance states that the settlement of the debtor's obligation to the creditor upon exercise of a redemption feature meets the net settlement criterion.

Also, regardless of whether variable-share settlement features are bifurcated, the debt extinguishment guidance in ASC 405-20 should be applied if the features are exercised because they represent redemption features (see section 2.5.1 for more information).

#### *5.23.2.2.2 Fixed-share conversion features*

The bridge loan in Illustration 5-23 permits the lender to convert the bridge loan into common stock at a fixed conversion price of $8 per share, if a qualified financing does not occur prior to maturity. Because this settlement would be a true conversion, this type of feature should be evaluated for bifurcation pursuant to ASC 815.

If the shares that would be received under the conversion option are not readily convertible to cash, as is the case with shares of most private companies, the conversion option would generally not meet the definition of a derivative in ASC 815 (and therefore, bifurcation under ASC 815 would not be required).

#### *5.23.2.2.3 Combination of variable-share and fixed-share settlement features*

Bridge loans may include settlement features that result in the delivery of a number of shares determined based on a combination of fixed and variable conversion prices. For example, the feature may define the "conversion price" as the lesser of (1) a fixed price and (2) the price at which the shares are sold in the next round of financing. Judgment is required in these cases to determine whether the settlement feature should be accounted for as a redemption or a conversion or, if the features are deemed to be separate embedded features, as a redemption and a conversion.

ASC 815 does not explicitly address the unit of account at which an embedded feature should be evaluated. We generally believe the combination of settlement features should be accounted for based on its substance — that is, whether the combination is in substance a conversion feature or a redemption feature as of the issuance date. This determination requires judgment based on the facts and circumstances. For example, a bridge loan may be issued with a combination of settlement features that has a fixed price per share that is extremely high in relation to the fair value of shares on the date of issuance (i.e., "out of the money"). In this case, the issuer may determine that the substance of the combination of settlement features is a redemption feature because it is highly unlikely the share price will appreciate above the fixed price per share during the expected life of the bridge loan. Said differently, it is more likely the combination of settlement features will result in share-settled redemption rather than fixed-share conversion.

However, it is frequently unclear at inception whether settlement as a fixed-share conversion or as a share-settled redemption is more likely. Therefore, we believe one acceptable approach may be to evaluate a combination of settlement features as separate embedded features:

- A variable-share settlement feature that is contingently exercisable if the price at which the shares sold in the next round of equity financing is below the fixed price
- A fixed-share settlement feature that is contingently exercisable if the price at which the shares sold in the next round of financing is at or above the fixed price

# 6 ASU 2020-06 effective dates and transition

## 6.1 Effective

ASU 2020-06 is currently effective for public business entities that meet the definition of an SEC filer, other than smaller reporting companies, as defined by the SEC, as of 5 August 2020. For all other entities, it is effective for fiscal years beginning after 15 December 2023 and interim periods therein.

Early adoption is permitted, but an entity must adopt the guidance as of the beginning of a fiscal year.

## 6.2 Transition

ASU 2020-06 allows entities to use either a modified retrospective or full retrospective transition method. Under the modified retrospective approach, entities will apply the guidance to all financial instruments that are outstanding as of the beginning of the year of adoption, with the cumulative effect recognized as an adjustment to the opening balance of retained earnings. Under the full retrospective method, they will apply it to all financial instruments that are outstanding as of the beginning of the first comparative reporting period for each prior reporting period presented in accordance with the guidance on accounting changes in ASC 250-10-45-5 through 45-10.

When they adopt the new guidance, entities will need to recombine instruments that they previously separated into two units of account if separation is no longer required. That is, a conversion option that was previously accounted for under the cash conversion model or beneficial conversion feature model will be recombined into a single instrument that is classified as a liability for convertible debt (if separation isn't required under the substantial premium model) or as equity for equity-classified preferred stock.

To compute the transition adjustment for a convertible instrument under both the modified retrospective and full retrospective methods, entities need to recompute the basis of that instrument at transition (i.e., the beginning of year of adoption for the modified retrospective method or the beginning of earliest year presented for the full retrospective method) as if the conversion option had not been separated. This requires an entity to determine the amortized cost of the instrument at contact inception and then recalculate the amortization of the discount (or premium) under the effective interest method using the recalculated effective interest rate.

The adjustment to retained earnings will be the difference between the sum of the carrying values of the debt or preferred stock and the conversion feature immediately before transition and the revised amortized cost of the combined convertible instrument under the substantial premium or traditional debt model as of the transition date. Entities will also need to consider the income tax accounting effects when determining the retained earnings adjustment.

Because the substantial premium model will continue to exist after entities adopt the new guidance, entities will be required to assess whether that model applies to any outstanding convertible debt instruments as of the transition date. That's because the substantial premium model was only considered under legacy guidance if the conversion feature was not already separated pursuant to the cash conversion or beneficial conversion feature guidance. With the elimination of those two models, any conversion features previously separated pursuant to those models must be recombined with the debt host as if they had not been separated. That may create a premium that is viewed as substantial.

Entities must also consider any freestanding contracts in an entity's own equity issued with the convertible instrument that were required to be subsequently measured at fair value under legacy guidance but are not required to be subsequently measured that way under ASU 2020-06 or vice versa. That's because this could affect the amount of proceeds that was originally allocated to the convertible instrument when it was initially recognized.

**Examples of the transition effects in ASU 2020-06**

The FASB provided the following table of examples of transition effects for certain instruments in paragraph 129 of the Background Information and Basis for Conclusions of ASU 2020-06:

| Instrument type and current GAAP classification | Effect of guidance (if scope exception currently failed, but passed under the amendments) |
|---|---|
| Freestanding instrument is classified as a liability. | Reclassify to equity and adjust basis of instrument to what would have been the value at initial measurement. |
| Embedded feature is classified as a liability, and the host is classified as a liability. | Recombine instruments into a single liability instrument. Determine what the basis of that instrument would have been originally if the embedded feature had not been bifurcated.<br>This would include a recalculation of the effective interest rate and any amortization of a discount (or premium). |
| Embedded feature is classified as a liability, and the host is classified as equity. | Recombine instruments into a single equity instrument and recalculate basis. Determine what the basis of that instrument would have been originally if the embedded feature had not been bifurcated. |
| Multiple embedded features are bifurcated from the host and classified as liabilities (host is classified as equity). | Recombine instruments into a single equity instrument (except for features not affected by this guidance) and recalculate basis. Determine what the basis of that instrument would have been originally if the embedded feature(s) had not been bifurcated. |
| Multiple embedded features are bifurcated from the host and classified as liabilities (host is classified as a liability). | Recombine instruments into a single liability instrument (except for features not affected by this guidance) and recalculate basis. Determine what the basis of that instrument would have been originally if those embedded features had not been bifurcated. This would include a recalculation of the effective interest rate and any amortization of a discount (or premium). |
| Debt is issued with detachable warrants. | Recalculate Day 1 allocation between the debt and warrants. Reclassify the warrants to equity on the basis of original relative fair value. Recalculate the basis of the debt. This would include a recalculation of the effective interest rate and any amortization of a discount (or premium). |

The effects of the basis adjustments described in the table above would be recognized in accordance with the transition requirements in paragraph 815-40-65-1(b).

### Income tax accounting considerations at transition

Entities with instruments that are recombined at transition (i.e., instruments with beneficial conversion features or cash conversion options) need to consider the tax accounting consequences of the adoption. Recombining previously separated instruments at transition may change the difference between the book and tax bases of the instruments. As a result, entities may need to adjust deferred tax liabilities related to these instruments.

Entities that apply the full retrospective method of adoption need to adjust each previously reported tax provision and deferred tax amounts for purposes of recasting the financial statements of prior reporting periods.

### Changes to valuation allowances

When adopting the new guidance, entities may need to adjust deferred tax liabilities or reevaluate expectations about the timing of future taxable income, which may affect their judgments regarding the realizability of deferred tax assets.

For example, an entity that recorded a deferred tax liability related to an instrument with a beneficial conversion feature may have considered the eventual reversal of the related deferred tax liability as a source of future taxable income when evaluating the realizability of its deferred tax assets. If the amount of the deferred tax liability decreases or is eliminated upon adoption of ASU 2020-06, the entity may conclude that a valuation allowance should be recorded (or an existing valuation allowance should be increased). Therefore, the entity would record the valuation allowance (or the increase of an existing valuation allowance) as part of the cumulative effect adjustment. Changes in the valuation allowance that are not a direct result of adopting the standard are recorded as a component of income tax expense from continuing operations. Careful consideration of the facts and circumstances is necessary to determine whether the change in valuation allowance is a direct effect of adopting ASU 2020-06.

The example below illustrates the transition adjustments, including adjustments for income tax effects, that an entity would record for convertible debt issued a year before it adopts the new guidance.

**Illustration 6-1: Transition adjustments**

On 1 January 20X0, a year before it adopts ASU 2020-06, Company C issues convertible debt with a par amount of $1,000,000, an annual coupon rate of 1% and a maturity in two years. The conversion feature in the convertible debt is exercisable anytime and can only be settled in the company's common stock, which is not publicly traded (i.e., it is not readily convertible into cash). Company C received $900,000 in proceeds. The stated conversion price is $10 per share, and the fair value of each underlying share is $10 at the commitment date.[a]

The effective conversion price is $9 per share ($900,000 proceeds/100,000 shares) and results in a beneficial conversion option with an intrinsic value of $100,000 [100,000 shares × ($10 − $9)].

Because of the additional discount created under the beneficial conversion feature guidance, the debt discount is $200,000 on 1 January 20X0. The company's effective tax rate is 25%, and it does not have a valuation allowance recorded on its deferred tax assets. The journal entry to record the initial issuance is:

| | | | | |
|---|---|---|---|---|
| Cash | $ | 900,000 | | |
| Debt discount — beneficial conversion option | | 100,000 | | |
| Debt discount — issuance | | 100,000 | | |
| Convertible debt | | | $ | 1,000,000 |
| Additional paid-in capital | | | | 100,000 |

The issuance of the convertible debt with a beneficial conversion feature results in a $100,000 difference between the book basis of the instrument (calculated by deducting both the $100,000 conversion option and the $100,000 discount at issuance from the par value of $1,000,000) and the tax basis ($900,000). (For the purpose of this illustration, the tax basis of the debt instrument includes the original issue discount.) The journal entry to record the deferred tax consequence upon issuance of the instrument is as follows:

| | | | | |
|---|---|---|---|---|
| Additional paid-in capital | $ | 25,000 | | |
| Deferred tax liability | | | $ | 25,000 |

On 31 December 20X0, Company C records the following entries (assume that the straight-line method approximates the effective interest method):

| | | | | |
|---|---|---|---|---|
| Interest expense | $ | 110,000 | | |
| Debt discount — beneficial conversion option | | | $ | 50,000 |
| Debt discount — issuance | | | | 50,000 |
| Cash — annual coupon of 1% | | | | 10,000 |

Company C records the following entry to recognize the income tax effects related to the amortization of the debt discount-issuance and debt discount-beneficial conversion option:

| | | | | |
|---|---|---|---|---|
| Current income tax payable (($110,000 − $50,000) * 0.25) | $ | 15,000 | | |
| Deferred tax liability | | 12,500 | | |
| Current income tax benefit | | | $ | 15,000 |
| Deferred income tax benefit | | | | 12,500 |

As of 31 December 20X0, the carrying value of the convertible debt is $900,000 (the initial carrying value of $800,000 plus the amortization of the debt discounts of $100,000 as of the end of the period).

On 1 January 20X1, Company C adopts ASU 2020-06 and elects the modified retrospective approach. Because the beneficial conversion feature is not required to be separated and the debt was issued at a discount, the conversion feature should not be bifurcated under ASC 815 or accounted for under the substantial premium model. Company C computes the transition adjustment as follows:

Under ASU 2020-06, the convertible debt would have been accounted for as a single unit of account. The carrying value as of 31 December 20X0 would have been $950,000 ($900,000 + the amortization of the $100,000 discount over the two-year period, or $50,000). To adjust the carrying value of convertible debt from $900,000 to $950,000, Company C records the following transition entries to the beginning retained earnings and additional paid-in capital as of 1 January 20X1:

| | | | | |
|---|---|---|---|---|
| Additional paid-in capital | $ | 100,000 | | |
| Debt discount — beneficial conversion option | | | $ | 50,000 |
| Retained earnings | | | | 50,000 |

Company C also records the following transition entry to reflect the tax effects of adopting ASU 2020-06 as of 1 January 20X1:

| | | | | |
|---|---|---|---|---|
| Deferred tax liability | $ | 12,500 | | |
| Retained earnings | | 12,500 | | |
| Additional paid-capital | | | $ | 25,000 |

Company C concluded that the adoption of ASU 2020-06 did not change its prior valuation allowance conclusions. If the elimination of the deferred tax liability required the company to increase its valuation allowance solely due to the adoption of ASU 2020-06, the company would have recorded the increase in the valuation allowance as part of the transition adjustment.

[a] Because the net settlement criterion under ASC 815-10 is not met, the conversion feature is not bifurcated under ASC 815. Also, because the conversion feature can only be settled with shares, the cash conversion guidance is not applicable.

### 6.2.1 Optional election

An entity also may irrevocably elect the fair value option in accordance with ASC 825-10 for any liability-classified convertible securities (except for those issued at a substantial premium). For any convertible securities for which the fair value option is elected at transition, the difference between their carrying amount and their fair value will be recorded as a cumulative-effect adjustment to opening retained earnings as of the beginning of the period of adoption.

### 6.2.2 Transition disclosures

When entities adopt the new guidance, they must disclose the following:

- The nature of the change in accounting principle, including an explanation of the newly adopted accounting principle
- The method of applying the change
- The cumulative effect of the change on retained earnings or other components of equity in the statement of financial position as of the beginning of the first period for which ASU 2020-06 is initially applied
- The effect of the change on per-share amounts for the period of adoption if they present EPS

Under the full retrospective method, entities also need to disclose the effect of the change on income from continuing operations, net income, any other affected financial statement line item and per-share amounts for the current period and any prior periods that are adjusted.

For interim reporting purposes, entities are required to provide the applicable transition disclosures in all interim financial statements issued in the year of adoption.

# Appendices

# A Distinguishing liabilities from equity

## A.1 Summary and overview

While ASC 480 does not define an equity instrument or a liability, it does require three types of freestanding instruments to be classified as liabilities (or assets in some cases), including:

- Shares that are mandatorily redeemable (refer to section A.4)
- Financial instruments other than a share that represent or are indexed to obligations to repurchase the issuer's equity shares by transferring assets (refer to section A.5)
- Certain obligations to issue a variable number of shares (refer to section A.6)

ASC 480 addresses only freestanding instruments and is not applied to embedded features in instruments that are not derivatives in their entirety. Embedded features in instruments that are classified as a liability pursuant to ASC 480 should be evaluated for potential embedded derivatives that should be bifurcated pursuant to in ASC 815-15.

Redeemable shares and instruments that are generally related to an issuer's own shares that are not classified as liabilities pursuant to ASC 480 are subject to the following guidance:

- ASC 815-40-15-5 through 15-8 and 55-26 through 55-48 which is referred to throughout this publication as "the indexation guidance." Refer to section B.3 for a discussion of the indexation guidance.
- ASC 815-40-25-1 through 25-38, 35-1 through 35-13, 40-1 and 40-2, and 55-2 through 55-18, which is referred to throughout this publication as "the equity classification guidance." Refer to section B.4 for a discussion of the equity classification guidance.
- ASC 480-10-S99-1 (the Codification reference for the SEC's Accounting Series Release 268, *Redeemable Preferred Stocks)*, and its interpretive guidance in ASC 480-10-S99-3A, which is referred to throughout this publication as "the SEC staff's redeemable equity guidance." Refer to Appendix C for a discussion of the SEC staff's guidance on redeemable instruments.

## A.2 Background and prior accounting

**Excerpt from Accounting Standards Codification**

**Distinguishing Liabilities from Equity — Overall**

*Overview and Background*

*General*

*480-10-05-1*

The Codification contains separate Topics for liabilities and equity, including a separate Topic for debt. The Distinguishing Liabilities from Equity Topic contains only the Overall Subtopic. This Subtopic establishes standards for how an issuer classifies and measures in its statement of financial position certain financial instruments with characteristics of both liabilities and equity. Section 480-10-25 requires that an issuer classify a financial instrument that is within its scope as a liability (or an asset in some circumstances) because that financial instrument embodies an obligation of the issuer.

*480-10-05-2*

All of the following are examples of an obligation:

a. An entity incurs a conditional obligation to transfer assets by issuing (writing) a put option that would, if exercised, require the entity to repurchase its equity shares by physical settlement. (Further, an instrument that requires the issuer to settle its obligation by issuing another instrument [for example, a note payable in cash] ultimately requires settlement by a transfer of assets.)

b. An entity incurs a conditional obligation to transfer assets by issuing a similar contract that requires or could require net cash settlement.

c. An entity incurs a conditional obligation to issue its equity shares by issuing a similar contract that requires net share settlement.

*480-10-05-3*

In contrast, by issuing shares of stock, an entity generally does not incur an obligation to redeem the shares, and, therefore, that entity does not incur an obligation to transfer assets or issue additional equity shares. However, some issuances of stock (for example, mandatorily redeemable preferred stock) do impose obligations requiring the issuer to transfer assets or issue its equity shares.

*480-10-05-4*

For certain financial instruments, Section 480-10-25 requires consideration of whether monetary value would remain fixed or would vary in response to changes in market conditions.

*480-10-05-5*

How the monetary value of a financial instrument varies in response to changes in market conditions depends on the nature of the arrangement, including, in part, the form of settlement.

*480-10-05-6*

For purposes of this Subtopic, three related terms—shares, equity shares, and issuer's equity shares—are used in the particular ways defined in the glossary.

*Objectives*

*General*

*480-10-10-1*

The objective of this Subtopic is to require issuers to classify as liabilities (or assets in some circumstances) three classes of freestanding financial instruments that embody obligations for the issuer.

Prior to the issuance of Statement 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity* (Statement 150, now the guidance in ASC 480), instruments that required the transfer of cash by the issuer upon settlement were inconsistently classified. For example, instruments that are equity in legal form may require the issuer to redeem the instrument in certain circumstances that are outside of the issuer's control (e.g., a mandatory redemption or a contingent redemption). While public companies had to consider the SEC staff's redeemable equity guidance, the instruments were not classified as liabilities. Instead, the redemption amount of those instruments was presented outside of permanent equity (i.e., between liabilities and permanent equity, referred to as "temporary equity" or "mezzanine").

As another example, many freestanding equity contracts that are indexed to, and potentially settled in, the issuer's own shares could have received equity classification pursuant to the then-existing EITF guidance (codified in ASC 815-40), even though the instruments could require cash settlement by the issuer (e.g., if physical settlement required the transfer of cash by the issuer).

Statement 150 addressed the classification of certain instruments, including: (1) mandatorily redeemable shares (2) certain equity contracts that represent obligations or potential obligations to repurchase the issuer's shares (e.g., written put options that permit the counterparty to sell shares to the issuer at a specified price) and (3) obligations that could be settled in shares but with a value that was not indexed to the issuer's shares (e.g., an obligation to deliver shares with a fixed value on the settlement date, sometimes referred to as "stock-settled debt").

## A.3 Scope of ASC 480

**Excerpt from Accounting Standards Codification**

**Distinguishing Liabilities from Equity — Overall**

***Scope and Scope Exceptions***

***480-10-15-1***

The Scope Section of the Overall Subtopic establishes the pervasive scope for the Distinguishing Liabilities from Equity Topic.

***480-10-15-2***

The guidance in the Distinguishing Liabilities from Equity Topic applies to all entities.

***480-10-15-3***

The guidance in the Distinguishing Liabilities from Equity Topic applies to any freestanding financial instrument, including one that has any of the following attributes:

a. Comprises more than one option or forward contract

b. Has characteristics of both a liability and equity and, in some circumstances, also has characteristics of an asset (for example, a forward contract to purchase the issuer's equity shares that is to be net cash settled). Accordingly, this Topic does not address an instrument that has only characteristics of an asset.

***480-10-15-4***

For example, an instrument that consists of a written put option for an issuer's equity shares and a purchased call option and nothing else is a freestanding financial instrument (paragraphs 480-10-55-18 through 55-20 provide examples of such instruments). That freestanding financial instrument embodies an obligation to repurchase the issuer's equity shares and is subject to the requirements of this Topic.

***480-10-15-5***

Because paragraph 480-10-15-3 limits the scope of this Topic to freestanding instruments, this Topic does not apply to a feature embedded in a financial instrument that is not a derivative instrument in its entirety.

***480-10-15-6***

Paragraphs 480-10-55-53 through 55-58 apply to the specific circumstances described by those paragraphs in which a majority owner enters into a transaction in the shares of a consolidated subsidiary and a derivative instrument indexed to the noncontrolling interest in that subsidiary.

***480-10-15-8A***

The guidance in this Topic does not apply to the following instruments:

a. Registration payment arrangements within the scope of Subtopic 825-20.

*Recognition*

*480-10-25-1*

The guidance in this Section shall be applied to a freestanding financial instrument in its entirety. Any nonsubstantive or minimal features shall be disregarded in applying the classification provisions of this Section. Judgment, based on consideration of all the terms of an instrument and other relevant facts and circumstances, is necessary to distinguish substantive, nonminimal features from nonsubstantive or minimal features.

*480-10-25-2*

For purposes of applying paragraph 815-10-15-74(a) in analyzing an embedded feature as though it were a separate instrument, paragraphs 480-10-25-4 through 25-14 shall not be applied to the embedded feature. Embedded features shall be analyzed by applying other applicable guidance.

*Glossary*

*480-10-20*

*Employee Stock Ownership Plan*

An employee stock ownership plan is an employee benefit plan that is described by the Employee Retirement Income Security Act of 1974 and the Internal Revenue Code of 1986 as a stock bonus plan, or combination stock bonus and money purchase pension plan, designed to invest primarily in employer stock. Also called an employee share ownership plan.

*Equity Shares*

Equity shares refers only to shares that are accounted for as equity.

*Financial Instrument*

Cash, evidence of an ownership interest in an entity, or a contract that both:

a. Imposes on one entity a contractual obligation either:
    1. To deliver cash or another financial instrument to a second entity
    2. To exchange other financial instruments on potentially unfavorable terms with the second entity.
b. Conveys to that second entity a contractual right either:
    1. To receive cash or another financial instrument from the first entity
    2. To exchange other financial instruments on potentially favorable terms with the first entity.

The use of the term financial instrument in this definition is recursive (because the term financial instrument is included in it), though it is not circular. The definition requires a chain of contractual obligations that ends with the delivery of cash or an ownership interest in an entity. Any number of obligations to deliver financial instruments can be links in a chain that qualifies a particular contract as a financial instrument.

Contractual rights and contractual obligations encompass both those that are conditioned on the occurrence of a specified event and those that are not. All contractual rights (contractual obligations) that are financial instruments meet the definition of asset (liability) set forth in FASB Concepts Statement No. 6, Elements of Financial Statements, although some may not be recognized as assets (liabilities) in financial statements—that is, they may be off-balance-sheet—because they fail to meet some other criterion for recognition.

For some financial instruments, the right is held by or the obligation is due from (or the obligation is owed to or by) a group of entities rather than a single entity.

*Freestanding Financial Instrument*

A financial instrument that meets either of the following conditions:

a. It is entered into separately and apart from any of the entity's other financial instruments or equity transactions.

b. It is entered into in conjunction with some other transaction and is legally detachable and separately exercisable.

*Issuer*

The entity that issued a financial instrument or may be required under the terms of a financial instrument to issue its equity shares.

*Issuer's Equity Shares*

The equity shares of any entity whose financial statements are included in the consolidated financial statements.

*Obligation*

A conditional or unconditional duty or responsibility to transfer assets or to issue equity shares. Because Topic 480 relates only to financial instruments and not to contracts to provide services and other types of contracts, but includes duties or responsibilities to issue equity shares, this definition of obligation differs from the definition found in FASB Concepts Statement No. 6, Elements of Financial Statements, and is applicable only for items in the scope of that Topic.

*Shares*

Shares includes various forms of ownership that may not take the legal form of securities (for example, partnership interests), as well as other interests, including those that are liabilities in substance but not in form. (Business entities have interest holders that are commonly known by specialized names, such as stockholders, partners, and proprietors, and by more general names, such as investors, but all are encompassed by the descriptive term owners. Equity of business entities is, thus, commonly known by several names, such as owners' equity, stockholders' equity, ownership, equity capital, partners' capital, and proprietorship. Some entities [for example, mutual organizations] do not have stockholders, partners, or proprietors in the usual sense of those terms but do have participants whose interests are essentially ownership interests, residual interests, or both.)

## A.3.1 Obligations

ASC 480 applies only to freestanding financial instruments that embody obligations of the issuer. ASC 480 defines an obligation as "a conditional or unconditional duty or responsibility on the part of the issuer to transfer assets or to issue its equity shares." Accordingly, purchased options do not embody obligations to the purchaser because they permit, but do not require, the purchaser to buy or sell shares (whether on a gross or net basis). As a result, purchased options on their own are not subject to ASC 480.

On the other hand, contracts that require or could require the issuer to purchase or issue its shares (e.g., forward contracts, written options, mandatorily redeemable shares) do represent obligations.

Certain freestanding instruments that include a written option component may also represent obligations. For example, a purchased call option and a written put option on the issuer's shares may be combined in a single instrument. Even though the value of the purchased call option may exceed the value of the written put option at inception (i.e., resulting in a premium being paid for a net purchased option), the written put component of the instrument imposes a conditional obligation on the issuer and is, therefore, within the scope of ASC 480. The investment would be an asset if the fair value of the purchased call option exceeds the fair value of the written put option, and would represent a liability if the opposite were true.

An understanding of the contractual terms is important in determining whether the issuer has an obligation. An obligation does not exist when the obligation is triggered by a future event completely within the issuer's control. The obligation will be evaluated when the issuer takes (or fails to take) action. Determining whether an obligation is triggered by an event within the issuer's control — regardless of probability, is a matter of facts and circumstances.

However, if certain criteria are met (as discussed in section A.4), some obligations in the form of redeemable shares may be classified as equity rather than liabilities.

## A.3.2 Freestanding financial instruments

ASC 480 applies only to freestanding financial instruments. As a result, ASC 480 does not apply to features embedded in debt or equity instruments. However, this scope restriction does not apply to the extent that the debt or equity host is non-substantive or minimal.

Refer to Question 1 in section A.8 — How does the scope of ASC 480 interact with other areas of the financial instrument guidance?

### A.3.2.1 Identifying 'nonsubstantive or minimal' features

While ASC 480 provides little guidance about what constitutes a "nonsubstantive or minimal" host contract, the provision is intended to prevent circumvention of its requirements by embedding what otherwise would be a freestanding instrument into a nominal host. For example, if an entity wanted to write a put option on its own shares but avoid liability accounting for that option, it could embed that option in a share of preferred stock that has minimal value apart from the option. To the extent that the host is relatively inconsequential or has little value when compared to the embedded feature, the host instrument should be ignored and the entire instrument should be accounted for as a liability (a written put option) pursuant to ASC 480.

While the determination of what constitutes a non-substantive or minimal feature included in an instrument will require significant judgment, we believe that the reason for embedding the feature in a host contract should be considered. If there is no apparent business purpose for embedding the feature in a minimal host contract, other than to obtain a specific accounting result, the host instrument should likely be ignored. This determination should be made based on the individual facts and circumstances. Additional guidance on evaluating non-substantive or minimal features is included in section A.4.1.3.

Refer to Question 2 in section A.8 — What is an example of an option to redeem shares embedded in a minimal host?

### A.3.2.2 Determining whether an instrument is freestanding

ASC 480 provides little interpretive guidance on the definition of a "freestanding" financial instrument. We believe that the substance of a transaction should be considered in making this determination.

In this regard, whether an instrument is documented in a separate contract is not necessarily determinative that it is freestanding, particularly when a contract is entered into in conjunction with another transaction. If the transactions are with the same party and involve the same underlying (in this context, the issuer's shares), it is important to assess whether the instruments are (1) legally detachable and (2) separately exercisable. If both conditions are met, the instrument is considered freestanding.

- Legally detachable — Generally, whether two instruments can be legally separated and transferred such that the two instruments may be held by different parties. As long as an investor is somehow able to separate the instruments, they are considered legally detachable. However, if an instrument can be separately transferred only with the consent of the counterparty, we generally believe that the instrument is not legally detachable. On the other hand, the legal detachability criteria may be met if the counterparty cannot unreasonably withhold consent. The determination of whether two instruments can be legally separated and transferred such that the two instruments may be held by different parties is a legal matter that may require advice from legal counsel.
- Separately exercisable — Generally, whether one instrument can be exercised without terminating the other instrument (i.e., through redemption, simultaneous exercise or expiration).

If the exercise of one instrument must result in the termination of the other, the instruments would typically not be considered freestanding pursuant to ASC 480. In contrast, if one instrument can be exercised while the other instrument continues to be outstanding (e.g., if a forward can be satisfied with any outstanding shares of the issuer or can be net settled), provided the instruments are also legally detachable, the instruments would be considered freestanding.

For example, if a parent company enters into a contract with the only minority shareholder of its privately held subsidiary that allows the shareholder to put its shares to the parent at a fixed price (gross settlement), that put option generally would be considered to be embedded in the related shares. As a result, the redeemable equity securities would not be subject to ASC 480 (although if the parent is a public company, the SEC staff's redeemable equity guidance would apply to those redeemable shares). However, if the same parent writes a put option on publicly traded common stock of a different subsidiary, and that put option allows the counterparty to put any common shares of the subsidiary to the parent at a fixed price (e.g., the counterparty could put shares of the subsidiary already owned or buy shares in the public market to exercise the put), that written put option would be considered freestanding and classified as a liability pursuant to ASC 480.

## A.3.3 Definition of issuer's shares (including shares of subsidiaries)

ASC 480 applies to certain financial instruments that are based on variation in the fair value of, or potentially settled in, equity shares (i.e., shares that are accounted for as equity) of the issuer. ASC 480 defines the concept of "issuer's shares" broadly. All forms of ownership interests, including partnership interests and residual interests in mutual enterprises, are considered issuer's equity shares pursuant to ASC 480. Further, instruments deriving value from any form of the issuer's equity shares, regardless of whether those shares take the legal form of securities, are within the scope of this guidance.

ASC 480-10-15 states that instruments issued by members of a consolidated group that are indexed to the equity shares of another member of the consolidated group are within the scope of ASC 480. In other words, for instruments subject to its scope, ASC 480 considers equity shares of any member of a consolidated group to be the issuer's equity shares.

## A.3.4 Prohibition against combining separate contracts

**Excerpt from Accounting Standards Codification**

**Distinguishing Liabilities from Equity — Overall**

*Recognition*

*480-10-25-15*

A freestanding financial instrument that is within the scope of this Subtopic shall not be combined with another freestanding financial instrument in applying paragraphs 480-10-25-4 through 25-14 unless combination is required under the provisions of Topic 815. For example, a freestanding written put option that is classified as a liability under this Subtopic shall not be combined with an outstanding equity share.

ASC 480 prohibits the combination of any freestanding financial instrument within its scope with any other instrument unless ASC 815 requires the combination of those instruments.

In paragraphs B50 and B51 of the Basis for Conclusions of Statement 150, the FASB indicated it precluded combining separate instruments because of ASC 815's prohibition on combining separate instruments (i.e., synthetic accounting). This prohibition also avoids the inadvertent or planned circumvention of the requirements of ASC 480.

Combining an instrument that is a liability within the scope of ASC 480 with another freestanding instrument might (1) cause a freestanding instrument to be outside the scope of ASC 480, (2) change the reported amount of the liability or (3) change the required measurement. For example, although a freestanding written put option would be a liability on its own pursuant to ASC 480, if combined with an equity share, it would be classified in equity with the share unless the embedded derivative guidance required the put to be bifurcated.

We generally believe the decision to combine two instruments that are issued contemporaneously should be made pursuant to the following framework:

- Combine the instruments if required pursuant to ASC 815, then evaluate the combined instrument pursuant to ASC 480 and ASC 815.
- If both (1) ASC 815 does not require the combination of the two instruments and (2) one of the instruments is within the scope of ASC 480, do not combine the two instruments.
- If both (1) ASC 815 does not require the combination of the two instruments and (2) neither of the instruments is within the scope of ASC 480, combine the instruments under the basic concepts around combination if applicable.

Refer to section 1.2.1.1 for a discussion of the concepts of combining financial instruments.

For example, if an issuer writes a put option on its own shares and simultaneously purchases a separate call option on its own shares with the same counterparty, those separate instruments would first be considered pursuant to the guidance in ASC 815 for combination. If not combined pursuant to that guidance, those instruments would not be combined pursuant to ASC 480 because the written put is classified as a liability pursuant to ASC 480. The purchased call would be classified either as an asset or as equity, depending on the specific terms of the instrument, based on the requirements of ASC 815-40.

Refer to Question 3 in section A.8 — What are examples of various combinations of a share, a written put and a purchased call to illustrate the assessment of combinations of instruments?

## A.3.5 Instruments not within the scope of certain classification, measurement and disclosure provisions

**Excerpt from Accounting Standards Codification**

Distinguishing Liabilities from Equity — Overall

*Scope and Scope Exceptions*

*Instruments Not within Scope of Certain Classification, Measurement, and Disclosure Provisions of This Subtopic*

*Certain Mandatorily Redeemable Financial Instruments of Nonpublic Entities*

*480-10-15-7A*

The classification, measurement, and disclosure guidance in this Subtopic does not apply to mandatorily redeemable financial instruments that meet both of the following:

a. They are issued by nonpublic entities that are not Securities and Exchange Commission (SEC) registrants.

b. They are mandatorily redeemable, but not on fixed dates or not for amounts that either are fixed or are determined by reference to an interest rate index, currency index, or another external index.

*480-10-15-7B*

Mandatorily redeemable financial instruments issued by an SEC registrant are not eligible for the scope exception in paragraph 480-10-15-7A, even if the entity meets the definition of a nonpublic entity.

*480-10-15-7C*

Some entities have issued shares that are required to be redeemed under related agreements. If the shares are issued with a redemption agreement and the required redemption relates to those specific underlying shares, the shares are mandatorily redeemable. If an entity with such shares and redemption agreement is a nonpublic entity that is not an SEC registrant, those mandatorily redeemable shares meet the scope exception in paragraph 480-10-15-7A if they meet the conditions specified in that paragraph.

*480-10-15-7D*

Although the disclosure requirements of this Subtopic do not apply for those mandatorily redeemable instruments of certain nonpublic companies that meet the scope exception in paragraph 480-10-15-7A, the requirements of Subtopic 505-10 still apply. In particular, paragraph 505-10-50-3 requires information about the pertinent rights and privileges of the various securities outstanding, which includes mandatory redemption requirements. Paragraph 505-10-50-11 also requires disclosure of the amount of redemption requirements for all issues of stock that are redeemable at fixed or determinable prices on fixed or determinable dates in each of the next five years.

*Certain Mandatorily Redeemable Noncontrolling Interests*

*480-10-15-7E*

The guidance in this Subtopic does not apply to mandatorily redeemable noncontrolling interests (of all entities, public and nonpublic) as follows:

a. The classification and measurement provisions of this Subtopic do not apply to mandatorily redeemable noncontrolling interests that would not have to be classified as liabilities by the subsidiary, under the only upon liquidation exception in paragraphs 480-10-25-4 and 480-10-25-6, but would be classified as liabilities by the parent in consolidated financial statements.

b. The measurement provisions of this Subtopic do not apply to other mandatorily redeemable noncontrolling interests that were issued before November 5, 2003, both for the parent in consolidated financial statements and for the subsidiary that issued the instruments that result in the mandatorily redeemable noncontrolling interest. For those instruments, the measurement guidance for redeemable shares and noncontrolling interests in other predecessor literature (for example, in paragraph 480-10-S99-3A) continues to apply.

*480-10-15-7F*

All public entities as well as nonpublic entities that are SEC registrants with mandatorily redeemable noncontrolling interests subject to the classification and measurement scope exception in paragraph 480-10-15-7E are required to follow the disclosure requirements in paragraphs 480-10-50-1 through 50-3 as well as disclosures required by other applicable guidance.

*Recognition*

*Mandatorily Redeemable Financial Instruments*

*480-10-25-4*

A mandatorily redeemable financial instrument shall be classified as a liability unless the redemption is required to occur only upon the liquidation or termination of the reporting entity.

The following table summarizes the exceptions to the guidance in ASC 480-10 for certain mandatorily redeemable financial instruments. Sections A.3.5.1, A.3.5.2 and A.4.1 provide further discussions on these exceptions.

| | | Does ASC 480-10 apply? | | | |
|---|---|---|---|---|---|
| **Exception** | **Reporting entity** | **Classification** | **Measurement** | **Disclosure** | **Refer to section** |
| Certain mandatorily redeemable financial instruments | Nonpublic entities that are not SEC registrants | No | No | No | A.3.5.1 |
| Mandatorily redeemable NCI that are redeemable only upon the liquidation of the subsidiary | Parent (consolidated financial statements) | No | No | Yes | A.3.5.2 |
| Mandatorily redeemable NCI issued before 5 November 2003 | Parent (consolidated financial statements) and subsidiary | Yes | No | Yes | A.3.5.2 |
| Financial instruments that are mandatorily redeemable only upon the liquidation or termination of the reporting entity | All entities | No | No | No | A.4.1 |

SEC registrants should note that even if they issue instruments that qualify for an exception from ASC 480-10, certain SEC guidance may apply. In a speech[66] at the 2003 AICPA National Conference on Current SEC Developments, an SEC staff member said entities with instruments that qualify for the deferral of certain provisions of ASC 480 (which became scope exceptions that were later codified in ASC 480-10-15-7A through 15-7F) should refer to the SEC staff guidance in ASC 480-10-S99-3A on how to classify and/or measure securities that will not be fully accounted for under ASC 480-10. In the speech, the SEC staff stated:

> "Entities with instruments that qualify for the deferral in FSP FAS 150-3[67] should refer to Topic D-98[68] for guidance related to classification and/or measurement, as applicable, for those securities that … will not be fully accounted for in accordance with Statement 150.[69] In other words, if both the classification and measurement guidance in Statement 150 has been deferred for an instrument, look to Topic D-98 for both classification and measurement guidance. If only the measurement guidance in Statement 150 has been deferred for an instrument, look to Topic D-98 for continued measurement guidance."

Refer to Appendix C for further discussion on the application of ASC 480-10-S99-3A.

### A.3.5.1 Scope exception for certain mandatorily redeemable shares of nonpublic companies

The classification, measurement and disclosure provisions of ASC 480 do not apply to certain mandatorily redeemable financial instruments issued by nonpublic entities that also are not SEC registrants. These financial instruments are mandatorily redeemable, but not on fixed dates or for amounts that either are fixed or determined by reference to an interest rate index, currency index or another external index.

For purposes of this scope exception, SEC registrants are defined as entities, or entities that are controlled by entities, that (1) have issued or will issue debt or equity securities that are traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local or regional markets), (2) are required to file financial statements with the SEC or (3) provide financial statements for the purpose of issuing any class of securities in a public market. The definition of a "nonpublic" entity in the ASC Master Glossary that applies to ASC 480 includes any entity other than one that (1) has equity securities trade in a public market, either on a stock exchange (domestic or foreign) or in the over-the-counter market, including securities quoted only locally or regionally, (2) makes a filing with a regulatory agency in preparation for the sale of any class of equity securities in a public market or (3) is controlled by an entity covered by (1) or (2). As a result, an issuer that is an SEC registrant only by virtue of the fact that it has debt that is registered with the SEC would be considered nonpublic pursuant to ASC 480 but could not apply the scope exception described in this section.

Some nonpublic entities have issued shares that are required to be redeemed pursuant to related agreements (e.g., a forward contract). If the shares are issued with the redemption agreement and the required redemption relates to those specific underlying shares, the shares are mandatorily redeemable (i.e., the forward contract is not considered freestanding). If an entity with such shares and a redemption agreement is a nonpublic entity that is not an SEC registrant, the scope exception in ASC 480-10-15-7A applies to those mandatorily redeemable shares.

Although the disclosure requirements of ASC 480 do not apply to mandatorily redeemable instruments of non-SEC registrants, the requirements of ASC 505-10 still apply. In particular, ASC 505-10-50-3 requires information about the rights and privileges of the various securities outstanding (including mandatory redemption requirements) and ASC 505-10-50-11 requires disclosure of the amounts payable on stock that is redeemable at fixed or determinable prices on fixed or determinable dates in each of the next five years.

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[66] Gregory A. Faucette, 2003 – Refer to SEC website at http://www.sec.gov/news/speech/spch121103gaf.htm.

[67] Codified in ASC 480-10-15-7A through 15-7F

[68] Codified in ASC 480-10-S99-3A

[69] Codified in ASC 480-10

### A.3.5.2 Scope exception for certain mandatorily redeemable noncontrolling interests

ASC 480-10-15-7E provides the following scope exception for mandatorily redeemable NCI for all entities (public and nonpublic):

a. For NCI that are classified as equity in the financial statements of the issuing subsidiary but would be classified as a liability in the parent's financial statements pursuant to ASC 480 (e.g., NCI in limited-life subsidiaries), the application of the classification and measurement guidance in ASC 480 does not apply. However, the disclosure requirements of ASC 480 continue to apply.

b. For mandatorily redeemable NCI that are classified as liabilities in the financial statements of the subsidiary (i.e., NCI that are not subject to the scope exception of ASC 480's classification requirements because they must be redeemed prior to the liquidation of the subsidiary) that were issued before 5 November 2003, the measurement provisions of ASC 480 do not apply, both for the parent in consolidated financial statements and for the subsidiary that issued the instruments that result in the mandatorily redeemable NCI. However, the classification and disclosure requirements of ASC 480 continue to apply.

Refer to the following Questions in section A.8:

- Question 6 — If the NCI of a consolidated limited-life subsidiary is mandatorily redeemable, how does that affect the consolidated financial statements? Are such interests affected by the scope exception in ASC 480?
- Question 9 — How does the scope exception in ASC 480 affect trust preferred securities?
- Question 12 — How should an entity measure and present mandatorily redeemable NCI classified as liabilities that were issued before 5 November 2003?

## A.3.6 Contingent consideration in a business combination

**Excerpt from Accounting Standards Codification**

**Distinguishing Liabilities from Equity**

***Scope and Scope Exceptions***

***480-10-15-9***

Subtopic 805-30 provides guidance on the recognition and initial measurement of consideration issued in a business combination, including contingent consideration.

***480-10-15-10***

However, when recognized, a financial instrument within the scope of this Topic that is issued as consideration (whether contingent or noncontingent) in a business combination shall be classified pursuant to the requirements of this Topic.

***Subsequent Measurement***

***480-10-35-4A***

Contingent consideration issued in a business combination that is classified as a liability in accordance with the requirements of this Topic shall be subsequently measured at fair value in accordance with 805-30-35-1.

The recognition and measurement guidance for contingent consideration in ASC 805 requires an acquirer to recognize contingent consideration at fair value as of the acquisition date as part of the consideration transferred in exchange for the acquired business. ASC 480's provisions should be considered in classifying contingent consideration issued in the form of a financial instrument (and may also indirectly affect its subsequent measurement).

If the contingent consideration arrangement pursuant to ASC 805 requires the transfer of or is indexed to equity instruments of the acquirer, ASC 480 and the indexation and equity classification guidance in ASC 815-40 generally should be considered to determine whether to classify the arrangement in equity or as a liability (or asset). Refer to sections 6.4.3 and 8.3.2 of our FRD publication, ***Business combinations***, for further discussion of the classification and presentation of contingent consideration in a business combination, respectively.[70]

Pursuant to ASC 805-30-35-1(a), if a contingent consideration arrangement meets the criteria to be classified as equity, the carrying amount (i.e., the acquisition date fair value) of the contingent consideration is not subsequently remeasured unless adjustments are made during the measurement period to the provisional initial fair value due to the discovery of additional facts and circumstances that existed as of the acquisition date (i.e., the adjustments qualify as measurement period adjustments, as discussed in section 7.3.3 of our FRD publication, ***Business combinations***).

Pursuant to ASC 805-30-35-1(b), if a contingent consideration arrangement is classified as a liability (or an asset), the carrying amount should be remeasured to fair value at each reporting date. Except for qualifying measurement period adjustments (see above), subsequent changes in the fair value of the liability should be recognized in earnings unless the contingent consideration is designated as a hedging instrument in a qualifying hedge within the scope of ASC 815.

Refer to section 6.4 of our FRD publication, ***Business combinations***, for further discussion of the accounting for contingent consideration.

## A.3.7 Share-based compensation

**Excerpt from Accounting Standards Codification**

**Distinguishing Liabilities from Equity — Overall**

*Scope and Scope Exceptions*

*480-10-15-8*

The guidance in the Distinguishing Liabilities from Equity Topic does not apply to an obligation under share-based compensation arrangements if that obligation is accounted for under Topic 718. For example, employee stock ownership plan shares or freestanding agreements to repurchase those shares are not within the scope of this Topic because those shares are accounted for under Subtopic 718-40 through the point of redemption. However, this Topic does apply to a freestanding financial instrument that was issued under a share-based compensation arrangement but is no longer subject to Topic 718. For example, this Topic applies to a mandatorily redeemable share issued upon a grantee's exercise of a share option. (Topic 718 provides accounting guidance for dividends on allocated shares, redemption of shares, recognition of expense, and computing earnings per share [EPS].) However, employee stock ownership plan shares that are mandatorily redeemable or freestanding agreements to repurchase those shares continue to be subject to other applicable guidance related to Subtopic 718-40.

ASC 480 does not apply to obligations incurred pursuant to stock compensation arrangements accounted for in accordance with ASC 718. However, ASC 480 does apply to a freestanding financial instrument that is issued under a share-based compensation arrangement that is no longer subject to ASC 718. For example, ASC 480 applies to mandatorily redeemable shares issued upon an employee's exercise of an employee stock option.

[70] For the classification of a contingent consideration arrangement settled in or indexed to equity instruments of the acquirer in an asset acquisition, refer to section A.2.3.2 of our FRD publication, ***Business combinations***.

While ASC 480 excludes share-based payments from its scope, certain concepts in ASC 480 apply to share-based payments accounted for under ASC 718. ASC 718 states that share-based payments that would be classified as liabilities under ASC 480 (absent ASC 480's exemption for share-based payments) must be classified as liabilities under ASC 718, unless ASC 718 specifically requires equity classification.

Refer to section 5 of our FRD publication, ***Share-based payment***, for further discussion on the accounting for liability instruments.

## A.4 Mandatorily redeemable financial instruments — recognition and measurement

**Excerpt from Accounting Standards Codification**

**Distinguishing Liabilities from Equity — Overall**

*Recognition*

*480-10-25-4*

A mandatorily redeemable financial instrument shall be classified as a liability unless the redemption is required to occur only upon the liquidation or termination of the reporting entity.

*480-10-25-5*

A financial instrument that embodies a conditional obligation to redeem the instrument by transferring assets upon an event not certain to occur becomes mandatorily redeemable if that event occurs, the condition is resolved, or the event becomes certain to occur.

*480-10-25-6*

In determining if an instrument is mandatorily redeemable, all terms within a redeemable instrument shall be considered. The following items do not affect the classification of a mandatorily redeemable financial instrument as a liability:

a. A term extension option

b. A provision that defers redemption until a specified liquidity level is reached

c. A similar provision that may delay or accelerate the timing of a mandatory redemption.

*480-10-25-7*

If a financial instrument will be redeemed only upon the occurrence of a conditional event, redemption of that instrument is conditional and, therefore, the instrument does not meet the definition of mandatorily redeemable financial instrument in this Subtopic. However, that financial instrument would be assessed at each reporting period to determine whether circumstances have changed such that the instrument now meets the definition of a mandatorily redeemable instrument (that is, the event is no longer conditional). If the event has occurred, the condition is resolved, or the event has become certain to occur, the financial instrument is reclassified as a liability.

*Initial Measurement*

*480-10-30-1*

Mandatorily redeemable financial instruments shall be measured initially at fair value.

*480-10-30-2*

If a conditionally redeemable instrument becomes mandatorily redeemable, upon reclassification the issuer shall measure that liability initially at fair value and reduce equity by the amount of that initial measure, recognizing no gain or loss.

*Subsequent Measurement*

*480-10-35-3*

Forward contracts that require physical settlement by repurchase of a fixed number of the issuer's equity shares in exchange for cash and mandatorily redeemable financial instruments shall be measured subsequently in either of the following ways:

a. If both the amount to be paid and the settlement date are fixed, those instruments shall be measured subsequently at the present value of the amount to be paid at settlement, accruing interest cost using the rate implicit at inception.

b. If either the amount to be paid or the settlement date varies based on specified conditions, those instruments shall be measured subsequently at the amount of cash that would be paid under the conditions specified in the contract if settlement occurred at the reporting date, recognizing the resulting change in that amount from the previous reporting date as interest cost.

*480-10-35-4*

Cash (as that term is used in the preceding paragraph) includes foreign currency, so physically settled forward purchase contracts in exchange for foreign currency shall be measured as provided in the preceding paragraph then remeasured under Topic 830.

*Glossary*

*480-10-20*

*Mandatorily Redeemable Financial Instrument*

Any of various financial instruments issued in the form of shares that embody an unconditional obligation requiring the issuer to redeem the instrument by transferring its assets at a specified or determinable date (or dates) or upon an event that is certain to occur.

*Noncontrolling Interest*

The portion of equity (net assets) in a subsidiary not attributable, directly or indirectly, to a parent. A noncontrolling interest is sometimes called a minority interest.

## A.4.1 General applicability

ASC 480 requires that financial instruments that are issued in the form of shares and are mandatorily redeemable on a specified or determinable date or upon an event certain to occur (e.g., the death of the holder) be classified as liabilities. One exception is if the instrument is required to be redeemed only upon liquidation or termination of the reporting entity. Shares are considered mandatorily redeemable if they are subject to an unconditional obligation to be redeemed by transferring assets (e.g., cash or other assets). That redemption requirement must be applicable to both parties (i.e., the issuer must redeem and the holder must surrender), as opposed to "mandatory to the issuer if the holder decides to redeem."[71] However, if the instruments are redeemable only upon the liquidation or termination of the reporting entity, those instruments are not considered mandatorily redeemable.

The FASB concluded that, regardless of the form of an instrument, an instrument that is mandatorily redeemable requires a nondiscretionary transfer of assets as a result of a past transaction and, therefore, meets the definition of a liability in FASB Concepts Statement No. 6, *Elements of Financial Statements*.

[71] In practice, the use of the terms "puttable," "callable" and "redeemable" is often imprecise and different than how those terms are defined and used in the authoritative accounting guidance. The terminology as defined in the authoritative guidance should be carefully and consistently used to determine an instrument's accounting.

A mandatorily redeemable instrument that contains a provision to defer redemption to a future date, but not indefinitely, may change the timing of redemption but does not remove the obligation to redeem the instrument and, therefore, does not alter the requirement for liability classification.

ASC 480-10-25-6 describes a circumstance in which mandatory redemption is deferred "until a specified liquidity level is reached." In this circumstance, the FASB concluded that the instrument is mandatorily redeemable and must be classified as a liability. It is inferred in the guidance that it is inevitable that the issuer will ultimately have sufficient liquidity to be able to meet its obligations (i.e., the issuer is a going concern) and, therefore, the instrument is mandatorily redeemable rather than contingently redeemable and should be classified as a liability. As a result, provisions that defer redemption until a specified level of liquidity is achieved generally should be viewed differently from other contingencies when applying ASC 480.

The existence of any mechanisms to fund the redemption of mandatorily redeemable shares does not affect their classification. For example, as discussed in paragraph 3(g) of ASC 480-10-S99-3A, the SEC staff has not historically required temporary equity classification of shares subject to repurchase upon the death of the holder if the issuer has acquired insurance on the holder's life sufficient to fund the redemption. However, such mandatorily redeemable shares are liabilities pursuant to ASC 480, notwithstanding the fact that the issuer is reasonably assured of having the funds necessary to satisfy the redemption obligation.

The terms of convertible instruments should be carefully evaluated in determining whether the instrument is mandatorily redeemable. For example, if an instrument has a stated redemption date, but may be converted into an equity instrument (e.g., common stock) at the option of the holder, that instrument is not mandatorily redeemable until that conversion option expires. Rather, if the conversion option is considered substantive, the instrument is considered contingently or optionally redeemable. The accounting for those instruments is discussed further in section A.4.1.1.

Scope exceptions are provided for certain mandatorily redeemable instruments issued by certain entities. Refer to section A.3.5 for further discussion of these scope exceptions.

Refer to the following Questions in section A.8:

- Question 4 — What are examples of various combinations of NCI with (1) a forward contract, (2) a combination of put and call options and (3) a total return swap?
- Question 5 — Does the increasing-rate nature of increasing-rate preferred stock cause it to be considered mandatorily redeemable pursuant to ASC 480?
- Question 6 — If the NCI of a consolidated limited-life subsidiary is mandatorily redeemable, how does that affect the consolidated financial statements? Are such interests affected by the scope exception in ASC 480?

### A.4.1.1 Contingently or optionally redeemable shares

Many instruments that are in the form of shares are characterized as redeemable equity instruments because redemption can be (1) required automatically upon the occurrence of certain contingent events (e.g., an IPO, change in control or an achievement of a performance condition) or (2) at the option of the holder at any time or on the occurrence of a contingent event. Such shares may also be referred to as "contingently redeemable" or "puttable" because they often have triggers that allow the investor to realize its return (e.g., a liquidation preference on preferred shares) prior to the actual liquidation of the issuer.

However, if redemption of the instrument is not certain to occur, the instrument is not required to be classified as a liability pursuant to ASC 480 (although public companies may be required to classify the redemption amount as temporary equity pursuant to the SEC staff's redeemable equity guidance (refer to Appendix C for further discussion)). The convertible redeemable preferred share discussed above in section A.4.1 is an example of a contingently redeemable share as it is contingent on the holder not converting.

Refer to section A.5.1.2 for a discussion of the application of ASC 480 to warrants that are exercisable for contingently redeemable shares.

Refer to the following Questions in section A.8:

- Question 4 — What are examples of various combinations of NCI with (1) a forward contract, (2) a combination of put and call options and (3) a total return swap?
- Question 7 — What are the accounting considerations for contingently redeemable instruments?

### A.4.1.2 Contingently redeemable shares that become mandatorily redeemable

While a share that must be redeemed upon or after an event that is not certain of occurrence is not required to be accounted for as a liability pursuant to ASC 480, once the event becomes certain to occur, that instrument should be reclassified to a liability. The term "certain of occurrence" should not be confused with "probable" or even "highly probable." "Certain" means certain. Often, an event will not be certain of occurrence until it actually occurs.

The assessment of whether a contingently or optionally redeemable share has become mandatorily redeemable should be made throughout the life of the instrument. The amount to be reclassified on the date that the contingent event becomes certain of occurrence is the fair value of the share as of that date. No gain or loss is recognized upon such a reclassification (i.e., the entire fair value is reclassified from equity to a liability).

However, for SEC registrants, the guidance in ASC 260-10-S99-2 that addresses the SEC staff's views on redemptions of preferred stock is also applicable to the reclassification of the instrument. That guidance states that if an equity-classified preferred stock is subsequently reclassified as a liability based on other US GAAP, the equity instrument is considered redeemed through the issuance of a debt instrument. As such, the difference between the carrying amount of the preferred share in equity and the fair value of the preferred share (now a debt instrument) is treated as a dividend for EPS purposes. It is important to note that the scope of this SEC staff's guidance is limited to preferred shares.

Contingently redeemable shares become mandatorily redeemable when the holder notifies the issuer that the holder is exercising its put option, even if the issuer is allowed a specified time period (e.g., 30 days) to satisfy the put. Once the holder has notified the issuer of its put, the instrument is no longer contingently redeemable and should be reclassified to a liability. Mandatorily redeemable shares with a substantive embedded conversion option that expires prior to the mandatory redemption date should be classified to a liability once the conversion option expires.

Refer to Question 8 in section A.8 — What is an example of a contingently redeemable share that is reclassified when it becomes mandatorily redeemable?

### A.4.1.3 Non-substantive or minimal features in otherwise mandatorily redeemable instruments

ASC 480 prohibits circumventing its objectives by including non-substantive or minimal features in the instrument. For example, if a conversion feature were added to an otherwise mandatorily redeemable share and that feature permitted conversion into a small number of shares or the conversion price was extremely high relative to the then-current share price, rendering the likelihood of conversion extremely remote, the conversion option should be viewed as non-substantive and the instrument should be classified as a liability. However, despite being non-substantive, the conversion option would be analyzed for bifurcation as an embedded derivative pursuant to ASC 815.

While determining whether a conversion option is substantive is a matter of facts and circumstances, one consideration is estimating the fair value of the conversion option. If, for example, the value of the conversion option is de minimis, it may be indicative that the conversion option is not substantive.

We believe that the assessment of whether a feature is minimal or non-substantive should be made at the inception of the instrument. If substantive, it should be considered substantive for the life of the instrument (absent any modifications to the instrument). For example, a redeemable instrument initially may include a substantive conversion option that, because of a subsequent significant decline in the issuer's stock price, may have little value later in the life of the instrument. We generally do not believe it is appropriate to reconsider whether the conversion feature is substantive and potentially reclassify the instrument after issuance (although, as discussed above, if the conversion option expires before the instrument must be redeemed, it should be reclassified as a liability at its fair value on that date).

## A.4.2 Recognition and measurement

Mandatorily redeemable instruments are recognized initially at their fair value. In most cases, the fair value of an instrument at its issuance date will be the gross proceeds received upon issuance. We generally believe that issuance costs should be accounted for as a separate deferred charge (refer to section A.4.2.1).

A mandatorily redeemable instrument that has a fixed redemption amount (that exceeds its initial fair value) and a fixed redemption date should be accreted to the redemption amount using the effective interest method, similar to the accounting for debt issued at a discount pursuant to ASC 835-30. If the redemption amount varies (e.g., the redemption amount is based on a formula or is equal to the instrument's fair value) or the redemption date is unknown (e.g., redemption is upon the death of the holder), the instrument should be carried at the amount of cash that would be paid pursuant to the conditions specified in the contract (i.e., the settlement amount) if the shares were repurchased or redeemed at the reporting date. We generally believe that the carrying amount of a mandatorily redeemable instrument should not be adjusted below its initial carrying amount.

Some mandatorily redeemable preferred securities include a feature that allows the issuer to call the security at various times (or the holder to redeem) at an amount that may differ from the fixed mandatory redemption amount. Although this feature could be viewed as resulting in a settlement amount that is not fixed, we generally believe the instrument should still be considered to have a fixed settlement amount based on its fixed mandatory redemption amount. This approach is consistent with the accounting for debt. The call (or put) feature would be separately evaluated for potential bifurcation from the debt host contract.

If the redemption amount is denominated in a currency other than the entity's functional currency, mandatorily redeemable shares should be measured as described above and then remeasured pursuant to ASC 830.

Because mandatorily redeemable instruments are classified as liabilities pursuant to ASC 480, any dividends or accretion on instruments that have a legal form of equity should generally be presented as interest expense.

Refer to the following Questions in section A.8:

- Question 10 — How should an entity account for a stock required to be redeemed upon death of a holder?
- Question 11 — How should an entity measure and present mandatorily redeemable instruments when the entity has no equity-classified instruments?
- Question 12 — How should an entity measure and present mandatorily redeemable NCI classified as liabilities that were issued before 5 November 2003?

### A.4.2.1 Accounting for costs to issue mandatorily redeemable shares

ASC 480 does not explicitly address the accounting for costs incurred that are directly related to issuing mandatorily redeemable shares. Because the accounting for those instruments pursuant to ASC 480 generally is the same as for debt instruments, we generally believe that direct and incremental issuance costs should be accounted for in a manner similar to debt issuance costs. That is, if the fair value option is not elected, costs should be deferred and amortized using the interest method, by analogy to ASC 835-30.

Under that guidance, entities are required to present debt issuance costs related to a recognized liability on the balance sheet as a direct deduction from that liability rather than as an asset, consistent with the presentation of a debt discount.

### A.4.2.2 Accounting for modifications or exchanges of mandatorily redeemable shares

ASC 480 does not address the accounting for modifications or exchanges of mandatorily redeemable shares. Because the accounting for mandatorily redeemable shares under ASC 480 generally is similar to the accounting for debt instruments, we believe entities should apply the guidance in ASC 470-60 and 470-50 to account for modifications or exchanges of mandatorily redeemable shares. Refer to section 2.6 for further guidance on debt modifications or exchanges.

## A.5 Obligations to repurchase an entity's own shares by transferring assets — recognition and measurement

**Excerpt from Accounting Standards Codification**

**Distinguishing Liabilities from Equity — Overall**

*Recognition*

*480-10-25-8*

An entity shall classify as a liability (or an asset in some circumstances) any financial instrument, other than an outstanding share, that, at inception, has both of the following characteristics:

a. It embodies an obligation to repurchase the issuer's equity shares, or is indexed to such an obligation.

b. It requires or may require the issuer to settle the obligation by transferring assets.

*480-10-25-9*

In this Subtopic, *indexed to* is used interchangeably with *based on variations in the fair value of*. The phrase *requires or may require* encompasses instruments that either conditionally or unconditionally obligate the issuer to transfer assets. If the obligation is conditional, the number of conditions leading up to the transfer of assets is irrelevant.

*480-10-25-10*

Examples of financial instruments that meet the criteria in paragraph 480-10-25-8 include forward purchase contracts or written put options on the issuer's equity shares that are to be physically settled or net cash settled.

*480-10-25-11*

All obligations that permit the holder to require the issuer to transfer assets result in liabilities, regardless of whether the settlement alternatives have the potential to differ.

*480-10-25-12*

Certain financial instruments that embody obligations that are liabilities within the scope of this Subtopic also may contain characteristics of assets but be reported as single items. Some examples include the following:

a. Net-cash-settled or net-share-settled forward purchase contracts

b. Certain combined options to repurchase the issuer's shares.

Those instruments are classified as assets or liabilities initially or subsequently depending on the instrument's fair value on the reporting date.

*480-10-25-13*

An instrument that requires the issuer to settle its obligation by issuing another instrument (for example, a note payable in cash) ultimately requires settlement by a transfer of assets, accordingly:

a. When applying paragraphs 480-10-25-8 through 25-12, this also would apply for an instrument settled with another instrument that ultimately may require settlement by a transfer of assets (warrants for puttable shares).

b. It is clear that a warrant for mandatorily redeemable shares would be a liability under this Subtopic.

*Initial Measurement*

*Certain Physically Settled Forward Purchase Contracts*

*480-10-30-3*

Forward contracts that require physical settlement by repurchase of a fixed number of the issuer's equity shares in exchange for cash shall be measured initially at the fair value of the shares at inception, adjusted for any consideration or unstated rights or privileges.

*480-10-30-4*

Two ways to obtain the adjusted fair value include:

a. Determining the amount of cash that would be paid under the conditions specified in the contract if the shares were repurchased immediately

b. Discounting the settlement amount, at the rate implicit at inception after taking into account any consideration or unstated rights or privileges that may have affected the terms of the transaction.

*480-10-30-5*

Equity shall be reduced by an amount equal to the fair value of the shares at inception.

*480-10-30-6*

Cash (as that term is used in paragraph 480-10-30-3) includes foreign currency, so physically settled forward purchase contracts in exchange for foreign currency shall be measured as provided in paragraphs 480-10-30-3 through 30-5 and 480-10-35-3, then remeasured under Topic 830.

*All Other Financial Instruments*

*480-10-30-7*

All other financial instruments recognized under the guidance in Section 480-10-25 shall be measured initially at fair value.

*Subsequent Measurement*

*Certain Physically Settled Forward Purchase Contracts and Mandatorily Redeemable Financial Instruments*

*480-10-35-3*

Forward contracts that require physical settlement by repurchase of a fixed number of the issuer's equity shares in exchange for cash and mandatorily redeemable financial instruments shall be measured subsequently in either of the following ways:

a. If both the amount to be paid and the settlement date are fixed, those instruments shall be measured subsequently at the present value of the amount to be paid at settlement, accruing interest cost using the rate implicit at inception.

b. If either the amount to be paid or the settlement date varies based on specified conditions, those instruments shall be measured subsequently at the amount of cash that would be paid under the conditions specified in the contract if settlement occurred at the reporting date, recognizing the resulting change in that amount from the previous reporting date as interest cost.

*480-10-35-4*

Cash (as that term is used in the preceding paragraph) includes foreign currency, so physically settled forward purchase contracts in exchange for foreign currency shall be measured as provided in the preceding paragraph then remeasured under Topic 830.

*All Other Financial Instruments*

*480-10-35-5*

All other financial instruments recognized under the guidance in Section 480-10-25 shall be measured subsequently at fair value with changes in fair value recognized in earnings, unless either this Subtopic or another Subtopic specifies another measurement attribute.

*Implementation Guidance and Illustrations*

*Freestanding Warrants and Other Similar Instruments on Shares that Are Redeemable*

*480-10-55-33*

A warrant for puttable shares conditionally obligates the issuer to ultimately transfer assets—the obligation is conditioned on the warrant's being exercised and the shares obtained by the warrant being put back to the issuer for cash or other assets. Similarly, a warrant for mandatorily redeemable shares also conditionally obligates the issuer to ultimately transfer assets—the obligation is conditioned only on the warrant's being exercised because the shares will be redeemed. Thus, warrants for both puttable and mandatorily redeemable shares are analyzed the same way and are liabilities under paragraphs 480-10-25-8 through 25-12, even though the number of conditions leading up to the possible transfer of assets differs for those warrants. The warrants are liabilities even if the share repurchase feature is conditional on a defined contingency.

*Glossary*

*480-10-20*

*Net Cash Settlement*

A form of settling a financial instrument under which the entity with a loss delivers to the entity with a gain cash equal to the gain.

*Net Share Settlement*

A form of settling a financial instrument under which the entity with a loss delivers to the entity with a gain shares of stock with a current fair value equal to the gain.

*Physical Settlement*

A form of settling a financial instrument under which both of the following conditions are met:

a. The party designated in the contract as the buyer delivers the full stated amount of cash or other financial instruments to the seller.

b. The seller delivers the full stated number of shares of stock or other financial instruments or nonfinancial instruments to the buyer.

## A.5.1 General applicability

ASC 480-10-25-8 through 25-10 and 25-12 require liability classification for a financial instrument, other than an outstanding share, that embodies, or is indexed to, a conditional or unconditional obligation to repurchase an issuer's equity shares that requires or could require settlement by the transfer of assets. Related implementation guidance in ASC 480-10-55 requires the issuer look closely at all elements of the instrument, including instruments underlying the instrument (e.g., shares underlying a warrant) to determine whether they embody an obligation.

Examples of instruments addressed by this guidance include:

- Forward contracts that require the issuer to purchase its shares (forward purchases), written options that obligate the issuer to buy its shares at the election of the counterparty (written puts) and that require physical or net cash settlement
- Puttable warrants that permit the counterparty to require the issuer to pay cash to settle the warrant or to purchase the shares obtained upon exercise of the warrant, freestanding warrants and other similar instruments on shares that are redeemable

As a limited exception, we believe that an instrument that requires or may require an entity to transfer assets only upon a deemed liquidation event is not precluded from equity classification under this guidance if all of the holders of equally and more subordinated equity instruments of the entity would always be entitled to also receive the same form of consideration. This view is analogous to ASC 480-10-S99-3A-3(f). Refer to section C.2.10 for further guidance on determining whether an event is considered a deemed liquidation event.

### A.5.1.1 Freestanding financial instruments composed of more than one option or forward contract embodying obligations to transfer assets

ASC 480 provides specific guidance on freestanding financial instruments that are composed of more than one option or forward contract embodying obligations that may require settlement by transfer of assets. This guidance is primarily found in ASC 480-10-55-18 through 55-20, ASC 480-10-55-29 through 55-33 and ASC 480-10-55-36 through 55-40.

Examples of those instruments include puttable warrants (or forwards) and equity collars where the obligation requires or may require the transfer of assets:

- A puttable warrant is a written call option that entitles the holder to buy the issuer's shares and a written put option that entitles the holder to put the warrants (or the underlying shares) back to the issuer at a specified price. Similarly, a forward sale contract on puttable shares obligates the holder to buy and the issuer to sell a number of shares at a specified price and contains a written put option that entitles the holder to put the shares obtained upon the settlement of the forward back to the issuer at a specified price.
- An equity collar is a combination of a purchased option and a written option. Although containing two options, an equity collar is legally one freestanding instrument because the two option components are not legally detachable and separately exercisable. Generally, if a financial instrument is composed of more than one component and any component obligates the issuer to repurchase shares (or is indexed to such an obligation) and may require a transfer of assets, the presence of this obligation would require the entire financial instrument be classified as a liability (or an asset in some circumstances). For example, a puttable warrant is a liability pursuant to ASC 480-10-25-8 through 25-13 because the put option component embodies an obligation that is indexed to repurchasing the issuer's shares and may require a transfer of assets.

Refer to Question 14 in section A.8 — What are examples of instruments composed of more than one option or forward contract?

### A.5.1.2 Freestanding warrants and other similar instruments on shares that are redeemable

ASC 480-10-25-9, 25-13 and 55-33 clarify that the "obligation to repurchase" guidance applies to freestanding warrants and other similar instruments on shares that are either puttable or mandatorily redeemable, regardless of the timing of the redemption feature or the redemption price because those instruments embody obligations to transfer assets.

Therefore, the "obligation to repurchase" guidance applies to warrants on shares (including preferred shares) that are redeemable immediately after exercise of the warrants and also to those that are redeemable at some date in the future. The phrase "requires or may require" in ASC 480-10-25-8(b) encompasses instruments that either conditionally or unconditionally obligate the issuer to transfer assets. If the obligation is conditional, the number of conditions leading up to the transfer of assets is irrelevant.

The SEC staff's redeemable equity guidance in ASC 480-10-S99-3A (refer to Appendix C for further discussion) may be used to determine whether shares may be redeemable outside the control of the issuer and therefore whether a warrant on such shares may embody an obligation to transfer assets. A warrant for those redeemable shares is generally classified as a liability pursuant to ASC 480. Similarly, warrants issued by a private issuer on redeemable shares should also be classified as liabilities. The individual facts and circumstances should be considered to evaluate whether the warrants embody or indexed to an obligation to repurchase shares.

Refer to section 5.7 for additional discussion of warrants for redeemable shares.

## A.5.2 Recognition and measurement

ASC 480 provides guidance on initial and subsequent measurement of instruments included within its scope.

### A.5.2.1 Physically settled forward contracts to purchase shares

Forward contracts that require physical settlement by repurchasing a fixed number of the issuer's shares for cash are initially measured and recognized at the fair value of the shares at the inception of the contract, adjusted for any consideration or unstated rights or privileges. The offsetting charge is to shareholders' equity (or NCI if the shares in question are shares of a consolidated subsidiary).

ASC 480 suggests there are two ways to derive the initial carrying amount:

- Discount the settlement amount at the rate implicit at inception after taking into account any consideration or unstated rights or privileges that may have affected the terms of the transaction
- Determine the amount of cash that would be paid under the conditions specified in the contract if the shares were repurchased immediately

In the Basis for Conclusions to Statement 150 the Board noted (in paragraph B61) that these methods were commonly used for initially measuring fixed-rate and floating-rate borrowings, respectively. As a result, it would appear that it is most appropriate to use the first method for forward contracts with a fixed settlement amount and date, and the second method for forward contracts with a variable settlement amount or date.

The requirement described above to "take into account any unstated rights and privileges" is similar to language used in ASC 835-30-25-6 that discusses the need to consider unstated rights and privileges as follows:

> A note issued solely for cash equal to its face amount is presumed to earn the stated rate of interest. However, in some cases the parties may also exchange unstated (or stated) rights or privileges, which are given accounting recognition by establishing a note discount or premium account. In such instances, the effective interest rate differs from the stated rate. For example, an entity may lend a supplier cash that is to be repaid five years hence with no stated interest. Such a noninterest bearing loan may be partial consideration under a purchase contract for supplier products at lower than the

prevailing market prices. In this circumstance, the difference between the present value of the receivable and the cash loaned to the supplier is appropriately regarded as an addition to the cost of products purchased during the contract term. The note discount is amortized as interest income over the five-year life of the note, as required by ASC 835-30-35.

Notwithstanding the two methods above, if there is not any consideration or unstated rights or privileges, we generally believe the fair value of the underlying shares at the inception of the contract will provide a reasonable measurement basis for the initial recognition of the forward contract.

For subsequent measurement, a forward contract with a fixed settlement amount and date is measured at the present value of the amount to be paid at settlement, accruing interest cost using the rate implicit at inception. However, a forward contract with either a variable settlement date or amount is measured subsequently at the amount of cash that would be paid under the conditions specified in the contract if settlement occurred at the reporting date. In both cases, changes in the carrying amount are reflected as interest cost.

As a result, a physically settled forward contract with a fixed settlement amount and date would follow a measurement model similar to debt instruments.

In contrast, a physically settled forward contract subject to a variable redemption amount or settlement date would initially be recognized at the amount of cash to be paid under the specified conditions if the exchange occurred immediately (which may equal the fair value of the shares at inception depending on the facts and circumstances). Subsequently, the carrying amount would be accrued to equal the settlement amount due on the reporting date. For example, a variable-rate forward contract may specify a settlement price that varies based on a short-term interest rate index (e.g., three-month Term SOFR). In that circumstance, the initial carrying amount of the liability would be accrued based on the index rate(s) in effect during the reporting period, with any resulting accretion recognized as interest expense.

Refer to Question 16 in section A.8 — What are examples of physically settled forward contracts to purchase shares?

#### *A.5.2.1.1 Forward contracts on noncontrolling interest*

ASC 480 does not specifically address the accounting for NCI. However, a physically settled forward contract that requires the purchase of the shares of the consolidated subsidiary from the NCI holders should be considered under this guidance.

Forward contracts related to NCI can be issued in a variety of situations (e.g., either at the time of the transaction creating the NCI or subsequent to such a transaction), can be either freestanding or embedded in the shares representing the NCI and can include different pricing mechanisms (i.e., at a fixed price, at a formulaic price or at fair value). Each of the variations can affect the accounting for the forward contract. Refer to section 5.10 for further discussion of equity contracts on NCI.

### A.5.2.2 Other contracts embodying obligations to repurchase an entity's own shares

Contracts that embody an obligation to repurchase an entity's own shares (other than physically settled forward contracts) are initially and subsequently measured at fair value with changes in fair value recognized in earnings. Some instruments subject to that measurement guidance include:

- Net cash settled forward contracts to purchase shares
- Forward contracts to purchase shares that include a physical settlement option in addition to a net cash settlement option, regardless of which party to the contract controls the selection of the settlement option
- Physically settled or net cash settled written put options

- Warrants for redeemable shares
- Warrants that permit or may permit (based on a contingency outside the control of the issuer) the counterparty to require the issuer to purchase the warrant by paying cash (i.e., a puttable warrant)

Forward purchase contracts and written put options that are net share settled will also be classified as liabilities and accounted for at fair value, as further discussed in section A.6.1.3.

### A.5.2.3 Reassessment of contracts

The guidance in ASC 480-10-25-8 requires a financial instrument (other than an outstanding share) to be classified as a liability (or an asset in some circumstances) based on whether, at inception, it embodies an obligation to repurchase the issuer's shares by transferring assets. Once an instrument is initially recognized as a liability pursuant to ASC 480-10-25-8 through 25-13, ASC 480 does not explicitly permit or require a reassessment of that classification.

In limited circumstances, a contract that is initially recognized as a liability (or an asset in some circumstances) pursuant to ASC 480-10-25-8 may no longer embody any obligation of the issuer to transfer assets in the future. For example, a puttable warrant may be exercisable for a seven-year period, but it may only permit the holder to require the issuer to purchase the warrant for cash during the first four years. In this case, the put feature on the warrant that conditionally obligates the issuer to transfer assets expires before the warrant's maturity.

Paragraph B33 of Statement 150 states that "Identifying whether a financial instrument embodies an obligation is the starting point in determining the appropriate classification of that instrument. … A financial instrument that does not embody an obligation cannot be a liability under the current Concepts Statement 6 definition. The Board concluded in the Exposure Draft that the existence of an obligation should continue to be an essential characteristic of a liability."

In accordance with this paragraph, if an instrument no longer embodies an obligation to transfer assets, it cannot be a liability. Therefore, in these cases, we believe that it may be appropriate for an entity to reassess the classification of the instrument under ASC 480.

Judgment should be applied to determine whether it is appropriate to reassess the classification of a contract in the scope of ASC 480. We generally believe an entity may make an accounting policy election to reassess instruments' classifications if they no longer obligate the issuer to transfer assets.

## A.6 Certain share-settled obligations — recognition and measurement

**Excerpt from Accounting Standards Codification**

***Distinguishing Liabilities from Equity — Overall***

***Recognition***

***480-10-25-14***

A financial instrument that embodies an unconditional obligation, or a financial instrument other than an outstanding share that embodies a conditional obligation, that the issuer must or may settle by issuing a variable number of its equity shares shall be classified as a liability (or an asset in some circumstances) if, at inception, the monetary value of the obligation is based solely or predominantly on any one of the following:

a. A fixed monetary amount known at inception (for example, a payable settleable with a variable number of the issuer's equity shares)

b. Variations in something other than the fair value of the issuer's equity shares (for example, a financial instrument indexed to the Standard and Poor's S&P 500 Index and settleable with a variable number of the issuer's equity shares)

c. Variations inversely related to changes in the fair value of the issuer's equity shares (for example, a written put option that could be net share settled).

See paragraph 480-10-55-21 for related implementation guidance.

*Initial Measurement*

*480-10-30-7*

All other financial instruments recognized under the guidance in Section 480-10-25 shall be measured initially at fair value.

*Subsequent Measurement*

*480-10-35-1*

Financial instruments within the scope of Topic 815 shall be measured subsequently as required by the provisions of that Topic.

*480-10-35-5*

All other financial instruments recognized under the guidance in Section 480-10-25 shall be measured subsequently at fair value with changes in fair value recognized in earnings, unless either this Subtopic or another Subtopic specifies another measurement attribute.

*Glossary*

*480-10-20*

*Monetary Value*

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.

## A.6.1 General applicability

ASC 480-10-25-14 requires liability accounting for (1) any financial instrument that embodies an unconditional obligation to transfer a variable number of shares or (2) a financial instrument other than an outstanding share that embodies a conditional obligation to transfer a variable number of shares, provided that the monetary value of the obligation is based solely or predominantly on any of the following:

- A fixed monetary amount known at inception (e.g., stock settled debt)
- Variations in something other than the fair value of the issuer's equity shares (e.g., a preferred share that will be settled in a variable number of common shares with its monetary value tied to a commodity price)
- Variations in the fair value of the issuer's equity shares, but the monetary value to the counterparty moves inversely to the value of the issuer's shares (e.g., net share settled written put options, net share settled forward purchase contracts)

Notwithstanding the fact that the above instruments can be settled in shares, the FASB concluded that equity classification is not appropriate because instruments with those characteristics do not expose the counterparty to risks and rewards similar to those of an owner and, therefore, do not create a shareholder relationship. The issuer is instead using its shares as the currency to settle its obligations.

Refer to Question 17 in section A.8 — What is the monetary value of a contract?

### A.6.1.1 Monetary value does not change

The instruments described in (1) above do not create a shareholder relationship because the monetary value does not change. For example, assume an issuer agrees to issue $1,000,000 of its own stock in one year in exchange for $950,000 today. The obligation may be legal form debt, mandatorily convertible preferred stock or an equity contract (e.g., a prepaid forward sales contract). The number of shares that will be delivered upon settlement is based on their fair value on the settlement date. Accordingly, if the share price one year from the date of the agreement is $20, the issuer will issue 50,000 shares. If the share price is $10, the issuer will issue 100,000 shares. The agreement represents a loan that the issuer will repay with its shares used as the currency.

As indicated above, the monetary value need only be predominantly fixed, not completely fixed. ASC 480-10-55-22 includes an example in which the number of shares to be delivered is based on a fixed dollar amount and a 30-day average trading price rather than the trading price on the settlement date. In that circumstance, even though the fair value of the shares delivered upon settlement is not completely fixed, the FASB concluded that the monetary value is predominantly fixed and therefore the financial instrument should be classified as a liability.

Shares that are optionally convertible into another class of shares with a fixed value are not subject to this accounting. Essentially, those shares are optionally redeemable and, like shares that are redeemable for cash or other assets, are not in the scope of ASC 480, and therefore subject to the redeemable equity guidance.

Refer to Question 18 in section A.8 — What are examples of monetary values that do not change and are settled in a variable number of shares that the issuer must or may settle by issuing a variable number of shares?

### A.6.1.2 Monetary value is based on something other than the issuer's equity shares

The instruments described in (2) in section A.6.1 do not create a shareholder relationship because the counterparty's risks and rewards are not similar to those of a holder of the issuer's own equity shares. For example, in exchange for a premium received at inception, assume that an issuer agreed to issue a variable number of its shares of common stock in the future equal in value to the fair value of 100 ounces of platinum. The monetary value of the obligation to deliver the issuer's shares is not fixed, but rather varies solely based on the price of platinum. Because the contract's monetary value does not vary with changes in value of the issuer's equity shares, it should be classified as a liability.

While it may appear straightforward to determine if the monetary value at settlement varies with something other than the issuer's share price, consider a contingently exercisable instrument and whether its settlement varies with something other than the value of the issuer's shares. For example, assume that an issuer has issued a warrant (a written call option) allowing the holder to purchase 100 shares of its common stock for $10 per share if the issuer has revenues of $1 million in the next 12 months. Assume the option requires net share settlement on exercise, such that the holder will receive the intrinsic value of the option in a variable number of shares.

Under one view, the settlement obligation to issue a number of shares has a monetary value (the intrinsic value of the option) that varies directly with the fair value of the issuer's shares. Alternatively, the settlement obligation could be viewed as not solely varying with the issuer's equity shares because the option could be worthless at the end of 12 months if the revenue target is not met. In other words, the settlement amount also varies with a contingency in that either the option will settle for a monetary value equal to the intrinsic value or will settle for zero if the revenue target is not met.

The first view considers the contingency as merely an "on-off switch" that does not affect the settlement amount, where the settlement amount will vary only with changes in the share price when/if exercise occurs. Under that view, the expiration of the contract without meeting the contingency means the contract is not actually settled as contemplated in ASC 480 because no consideration is delivered. Under that first view, the instrument is outside the scope of ASC 480.

The second view considers the relief from the obligation to perform a form of settlement and further acknowledges that zero could be considered a monetary amount. Under that second view, the contract would have to be further evaluated to determine if it is within the scope of ASC 480 (i.e., if the contingency were deemed to be the predominant factor in the monetary value).

We generally believe either approach could be acceptable based on the facts and circumstances and generally should be applied as an accounting policy. We understand that the FASB staff believes that either view could be appropriate. We generally believe the indexation guidance in ASC 815-40 should not be used to inform a conclusion on whether the monetary value varies with the fair value of the issuer's stock.[72] ASC 815-40 provides guidance on what is deemed to be "indexed to an entity's own stock" by considering (1) the existence of one or more defined exercise contingencies and (2) how the settlement amount of the instrument is determined. However, we generally believe that the concept of being "indexed to" the issuer's stock is different from the concept of "variations in … the fair value of the issuer's equity shares." In fact, in the pre-Codification illustrative application examples provided pursuant to Exhibit 07-5A of EITF 07-5, *Determining Whether an Instrument (or Embedded Feature) Is Indexed to an Entity's Own Stock*, the introduction paragraph stated, "These examples also do not address whether the instrument is within the scope of other accounting literature such as Statement 150."

An instrument with a settlement amount that looks to an input that is other than the fair value of the issuer's underlying equity shares would be considered to vary with something other than the fair value of the issuer's equity shares and thus potentially be an instrument in the scope of ASC 480. The determination of whether that instrument would be in the scope of ASC 480-10-25-14(b) would consider whether the monetary value of the obligation was based solely or predominantly on that non-fair value input.

The determination of whether an instrument's monetary value is derived solely or predominantly on something other than the fair value of the issuer's shares pursuant to (b) above will depend on the specific facts and circumstances. Pursuant to ASC 480-10-55-25, a contract that is indexed in part to the issuer's shares and in part (but not predominantly) to something other than the issuer's shares (commonly called a dual-indexed obligation) is not within the scope of the Subtopic. Therefore, an instrument with more than one significant underlying cannot be considered solely or predominately indexed to an underlying other than the fair value of the issuer's shares and thus is not in the scope of ASC 480.

Refer to Question 19 in section A.8 — What are examples of what it means to vary with something other than changes in the fair value of the issuer's equity shares?

### A.6.1.3 Monetary value moves in the opposite direction as value of the issuer's shares

The instruments addressed in the third bullet point in section A.6.1 are economically equivalent to the net cash and physically settled forward purchase contracts and written put options addressed in the "obligations to repurchase" guidance in ASC 480-10-25-8 through 25-10, and 25-12 as discussed in section A.5. Even though those instruments do not require a transfer of cash, they are classified as liabilities because they do not establish a shareholder relationship with the counterparty. The monetary value of the obligation to deliver a variable number of shares varies inversely in relation to changes in the fair value of the issuer's equity shares. That is, the monetary value of the issuer's obligation pursuant to those contracts increases when the issuer's share price decreases.

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[72] As a result, an instrument could potentially be deemed to be based "solely or predominantly on … variations in something other than the fair value of the issuer's equity shares" under ASC 480 yet could be considered to be "indexed to an entity's own stock" under the indexation guidance in ASC 815-40 if that guidance were applicable.

Accordingly, given the combined effect of the "obligations to repurchase" guidance and the "certain share-settled obligations" guidance in ASC 480-10-25-14, all forward purchase contracts and written put options on an entity's own shares are required to be classified outside of equity, regardless of the settlement method. Note, however, that the initial and subsequent measurement of forward purchase contracts will differ depending on which guidance in ASC 480 resulted in their being classified as an asset or liability.

Refer to Question 20 in section A.8 — What are examples of what it means to have a monetary value move in the opposite direction as the value of the issuer's equity shares?

### A.6.1.4 Freestanding instruments with more than one option or forward contract embodying an obligation

ASC 480 provides specific guidance on freestanding financial instruments that are composed of more than one option or forward contract embodying obligations that may require settlement by a variable number of shares. This guidance in primarily found in ASC 480-10-55-18 through 55-20 and ASC 480-10-55-42 through 55-52.

ASC 480-10-55-43 summarizes a two-step approach to evaluating instruments where one component may require the delivery of a variable number of shares. The approach is different than that for the contract that requires or may require a transfer of assets.

An issuer should first identify all component obligations. Each component obligation should be evaluated to determine whether that component potentially requires the delivery of a variable number of shares and, if freestanding, would be a liability pursuant to the three conditions outlined in ASC 480-10-25-14, as discussed in section 4.2.1.

If any component(s) potentially requiring delivery of a variable number of shares meets one of the conditions in ASC 480-10-25-14, the issuer should next determine whether the monetary value of that component obligation(s), is (collectively) predominant over the collective monetary value of all other component obligation(s) identified. If so, the entire instrument would be classified as a liability (or an asset in some circumstances). Otherwise, the equity contract is not in the scope of ASC 480 and other guidance should be considered.

Refer to Question 14 in section A.8 — What are examples of instruments composed of more than one option or forward contract?

### A.6.1.5 Determining predominance

While not defined in ASC 480, the concept of predominance is discussed briefly in ASC 480-10-55-44 and is illustrated in following examples:

- A guarantor's obligation to an investor is measured based on the difference between the fair value of the investment and a guaranteed value "plus .005 times the change in fair value of the guarantor's shares." Given the negligible effect of the indexation to equity shares, it is clear in this example that the monetary value of the instrument is based predominantly on the value of the investment.
- A share-settled obligation requires that a variable number of shares be issued based on an average market price for the shares over the last 30 days, instead of the fair value of the issuer's equity shares on the date of settlement. ASC 480 indicates that while the monetary value of the obligation is not entirely fixed at inception and is based, in small part, on variations in the fair value of the issuer's equity instruments, the monetary value of the obligation is predominantly based on a fixed monetary amount known at inception.

We generally believe the determination of whether a component(s) is predominant is based on the likelihood the equity contract will settle in accordance with that particular component(s), compared to the likelihood of settling under the other component obligation(s). The issuer should analyze an equity contract at inception and consider all possible outcomes to evaluate which component obligation(s) is predominant. The information to be considered includes the issuer's current stock price and volatility, the strike price of the instrument and other factors.

Consider a collar arrangement that is comprised of a purchased call option and a written put option that requires net share settlement. The written put option component, if freestanding, would be within the scope of ASC 480 because its value moves in the opposite direction as the fair value of the issuer's shares, pursuant to ASC 480-10-25-14(c). Once identified, the monetary value of this component obligation is assessed to determine whether it is predominant over the monetary value of the other component obligation. In this case, because the collar does not contain any other obligations (the purchased call option does not embody any obligation and therefore does not affect the classification of the entire instrument), the net settled written put component obligation governs the classification of the instrument. As such, the collar in its entirety should be classified as a liability (or asset) and recognized at fair value with changes in fair value recognized in earnings.

Even though the value of the purchased call option may exceed the value of the written put option at inception (i.e., a net purchased option), the instrument is within the scope of ASC 480 because the written put option component, if freestanding, would be a liability pursuant to ASC 480-10-25-14(c) as the monetary value of the issuer's obligation to deliver a variable number of shares under the written put option varies inversely in relation to changes in the fair value of the issuer's share price. The fair value would represent an asset if the fair value of the purchased option component exceeds the fair value of the written option component, and would represent a liability if the opposite were true.

## A.6.2 Recognition and measurement

ASC 480 provides guidance regarding the initial and subsequent measurement of instruments included within its scope.

Refer to Question 15 in section A.8 — How would share-settled obligations not within the scope of ASC 480 be measured?

### A.6.2.1 Share-settled debt

The general measurement guidance in ASC 480 requires obligations that can be settled in shares with a fixed monetary value at settlement (e.g., share-settled debt) to be carried at fair value unless other accounting guidance specifies another measurement attribute. We generally believe that ASC 835-30 is the appropriate accounting guidance for share-settled debt (i.e., accrue to the redemption amount using the interest method), unless the fair value option is elected pursuant to ASC 825-10-15.

Refer to section 5.23 for guidance on bridge loans, which are often share-settled debt.

### A.6.2.2 Other share-settled obligations

All other share-settled obligations in the scope of ASC 480-10-25-14 should be measured initially at fair value unless other accounting guidance specifies another measurement attribute.

Financial instruments within the scope of ASC 815 subsequently are measured as required by the provisions of that derivatives guidance. All other share-settled obligations are measured subsequently at fair value with changes in fair value recognized in earnings, unless other accounting guidance specifies another measurement attribute.

## A.7 Presentation, earnings per share and disclosure

### A.7.1 Presentation

**Excerpt from Accounting Standards Codification**

**Distinguishing Liabilities from Equity — Overall**

*Other Presentation Matters*

*480-10-45-1*

Items within the scope of this Subtopic shall be presented as liabilities (or assets in some circumstances). Those items shall not be presented between the liabilities section and the equity section of the statement of financial position.

*480-10-45-2*

Entities that have no equity instruments outstanding but have financial instruments issued in the form of shares, all of which are mandatorily redeemable financial instruments required to be classified as liabilities, shall describe those instruments as shares subject to mandatory redemption in statements of financial position to distinguish those instruments from other liabilities. Similarly, payments to holders of such instruments and related accruals shall be presented separately from payments to and interest due to other creditors in statements of cash flows and income.

*480-10-45-2A*

Some entities have outstanding shares, all of which are subject to mandatory redemption on the occurrence of events that are certain to occur. The redemption price may be a fixed amount or may vary based on specified conditions. If all of an entity's shares are subject to mandatory redemption and the entity is not subject to the deferral in paragraphs 480-10-15-7A through 15-7F, an excess of the redemption price of the shares over the entity's equity balance shall be reported as an excess of liabilities over assets (a deficit), even though the mandatorily redeemable shares are reported as a liability. If the redemption price of the mandatorily redeemable shares is less than the book value of those shares, the entity should report the excess of that book value over the liability reported for the mandatorily redeemable shares as an excess of assets over liabilities (equity).

*480-10-45-2B*

Depending on the settlement terms, this Subtopic requires that mandatorily redeemable shares that are not subject to the deferral in paragraphs 480-10-15-7A through 15-7F be measured at either the present value of the amount to be paid at settlement or the amount of cash that would be paid under the conditions specified in the contract if settlement occurred at the reporting date, recognizing the resulting change in that amount as interest cost (change in redemption amount).

*480-10-45-3*

Any amounts paid or to be paid to holders of the contracts discussed in paragraph 480-10-35-3 in excess of the initial measurement amount shall be reflected in interest cost.

For redeemable shares that are not accounted for as liabilities pursuant to ASC 480 (e.g., because they are contingently or optionally redeemable), public companies should consider the SEC staff's redeemable equity guidance (refer to Appendix C) and likely classify the redemption amount associated with those instruments outside of permanent equity (i.e., in temporary equity).

An issuer may have only one class of common stock, all of which is mandatorily redeemable and classified as a liability.[73] For example, an issuer may require its shareholders to sell their shares back to the issuer upon their death or upon other circumstances that are certain to occur. In that circumstance, the issuer essentially has no equity, although the mandatorily redeemable common shares represent a residual interest. To accommodate this circumstance, the Board requires that the mandatorily redeemable instruments be described in the statement of financial position as "shares subject to mandatory redemption" apart from other liabilities.

Payments to holders of such instruments and related accruals should also be presented separately from payments to and interest due to other creditors in the statements of cash flows and operations. The nature of the redemption feature and terms of those instruments should be disclosed in the notes to the financial statements. Additionally, the components of the mandatorily redeemable instruments should be disclosed (e.g., par value and paid-in capital of mandatorily redeemable instruments should be disclosed separately from the amount of retained earnings or accumulated deficit). An example of the disclosure is in ASC 480-10-55-64.

Refer to the following Questions in section A.8:

- Question 10 — How should an entity account for a stock required to be redeemed upon death of a holder?
- Question 11 — How should an entity measure and present mandatorily redeemable instruments when the entity has no equity-classified instruments?
- Question 12 — How should an entity measure and present mandatorily redeemable NCI classified as liabilities that were issued before 5 November 2003?

## A.7.2 Earnings per share (for mandatorily redeemable instruments and physically settled forward purchase contracts)

**Excerpt from Accounting Standards Codification**

**Distinguishing Liabilities from Equity — Overall**

*Other Presentation Matters*

*480-10-45-4*

Entities that have issued mandatorily redeemable shares of common stock or entered into forward contracts that require **physical settlement** by repurchase of a fixed number of the **issuer's equity shares** of common stock in exchange for cash shall exclude the common shares that are to be redeemed or repurchased in calculating basic and diluted earnings per share (EPS). Any amounts, including contractual (accumulated) dividends and participation rights in undistributed earnings, attributable to shares that are to be redeemed or repurchased that have not been recognized as interest costs in accordance with paragraph 480-10-35-3 shall be deducted in computing income available to common shareholders (the numerator of the EPS calculation), consistently with the two-class method set forth in paragraphs 260-10-45-60 through 45-70.

The FASB concluded that in most situations the guidance in ASC 260-10 adequately addresses the calculation of EPS with respect to the instruments subject to liability classification pursuant to ASC 480. However, entities that have issued mandatorily redeemable shares of common stock or have entered into forward contracts that require physical settlement by repurchase of a fixed number of the issuer's equity shares in exchange for cash, are required to exclude the common shares to be redeemed or repurchased in calculating basic and diluted EPS.

[73] ASC 480-10-15-7A through 15-7F provides a scope exception to the application of the guidance in ASC 480 to certain mandatorily redeemable shares. Refer to section A.3.5.

With respect to such instruments, the Board's view[74] is that because the issuer has reduced its equity (or NCI, if the shares to be purchased are shares of a consolidated subsidiary) while the shares remain legally outstanding, the shares should be accounted for as if effectively retired for the purposes of calculating basic and diluted EPS.

As the shares that will be repurchased typically participate in dividends during the period that the mandatorily redeemable instruments or forward purchase contracts are outstanding, the two-class method[75] of computing EPS should be applied (unless the forward contract passes dividends on the underlying shares back to the issuer).

Refer to section 4.10 of our FRD publication, ***Earnings per share***, for further discussion of EPS considerations for mandatorily redeemable shares of common stock and certain physically settled forward purchase contracts. Also refer to section 5 of our FRD publication, ***Earnings per share***, for further discussion on participating securities and the two-class method.

## A.7.3 Disclosures

**Excerpt from Accounting Standards Codification**

**Distinguishing Liabilities from Equity — Overall**

*Disclosure*

*480-10-50-1*

Entities that issue financial instruments recognized under the guidance in Section 480-10-25 shall disclose both of the following:

a. The nature and terms of the financial instruments

b. The rights and obligations embodied in those instruments, including both:

   1. Settlement alternatives, if any, in the contract

   2. The entity that controls the settlement alternatives.

*480-10-50-2*

Additionally, for all outstanding financial instruments recognized under the guidance in Section 480-10-25 and for each settlement alternative, issuers shall disclose all of the following:

a. The amount that would be paid, or the number of shares that would be issued and their fair value, determined under the conditions specified in the contract if the settlement were to occur at the reporting date

b. How changes in the fair value of the issuer's equity shares would affect those settlement amounts (for example, "the issuer is obligated to issue an additional X shares or pay an additional Y dollars in cash for each $1 decrease in the fair value of one share")

c. The maximum amount that the issuer could be required to pay to redeem the instrument by physical settlement, if applicable

d. The maximum number of shares that could be required to be issued, if applicable

e. 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

[74] Paragraph B68 of the Basis for Conclusions to Statement 150.

[75] Participating securities and the application of the two-class method are discussed in ASC 260-10.

f. For a forward contract or an option indexed to the issuer's equity shares, all of the following:

1. The forward price or option strike price
2. The number of issuer's shares to which the contract is indexed
3. The settlement date or dates of the contract, as applicable.

*480-10-50-3*

Paragraph 505-10-50-3 requires additional disclosures for actual issuances and settlements that occurred during the accounting period.

*480-10-50-4*

Some entities have no equity instruments outstanding but have financial instruments in the form of shares, all of which are mandatorily redeemable financial instruments required to be classified as liabilities. Those entities shall disclose the components of the liability that would otherwise be related to shareholders' interest and other comprehensive income (if any) subject to the redemption feature (for example, par value and other paid-in amounts of mandatorily redeemable instruments shall be disclosed separately from the amount of retained earnings or accumulated deficit).

ASC 480 generally does not require substantial additional disclosures in the notes to the financial statements beyond those required by existing accounting standards. If an issuer has issued financial instruments or entered into contracts that are within the scope of ASC 480, disclosure regarding the nature and terms of the financial instruments and the obligations embodied in those instruments is required, similar to that required by ASC 505-10-50.

The disclosure requirements in ASC 480-10-50-2 are required for outstanding financial instruments within the scope of ASC 480 (as applicable) and generally are consistent with the disclosures already required by ASC 815-40. These disclosures are also required for mandatorily redeemable NCI that are subject to the scope exception described in section A.3.5.2.

## A.8 Frequently asked questions

The following Questions are included in this section:

- Question 1 — How does the scope of the guidance in ASC 480 interact with other areas of the financial instrument guidance?
- Question 2 — What is an example of an option to redeem shares embedded in a minimal host?
- Question 3 — What are examples of various combinations of a share, a written put and a purchased call to illustrate the assessment of combinations of instruments?
- Question 4 — What are examples of various combinations of NCI with (1) a forward contract, (2) a combination of put and call options and (3) a total return swap?
- Question 5 — Does the increasing-rate nature of increasing-rate preferred stock cause it to be considered mandatorily redeemable pursuant to ASC 480?
- Question 6 — If the NCI of a consolidated limited-life subsidiary is mandatorily redeemable, how does that affect the consolidated financial statements? Are such interests affected by the scope exception in ASC 480?
- Question 7 — What are the accounting considerations for contingently redeemable instruments?
- Question 8 — What is an example of a contingently redeemable share that is reclassified when it becomes mandatorily redeemable?
- Question 9 — How does the scope exception in ASC 480 affect trust preferred securities?

- Question 10 — How should an entity account for a stock required to be redeemed upon death of a holder?
- Question 11 — How should an entity measure and present mandatorily redeemable instruments when the entity has no equity-classified instruments?
- Question 12 — How should an entity measure and present mandatorily redeemable NCI classified as liabilities that were issued before 5 November 2003?
- Question 13 — What is the classification and measurement guidance for a freestanding written put option or a forward purchased contract within the scope of ASC 480?
- Question 14 — What are examples of instruments composed of more than one option or forward contract?
- Question 15 — How would share-settled obligations not within the scope of ASC 480 be measured?
- Question 16 — What are examples of physically settled forward contracts to purchase shares?
- Question 17 — What is the monetary value of a contract?
- Question 18 — What are examples of monetary values that do not change and are settled in a variable number of shares that the issuer must or may settle by issuing a variable number of shares?
- Question 19 — What are examples of what it means to vary with something other than changes in the fair value of the issuer's equity shares?
- Question 20 — What are examples of what it means to have a monetary value move in the opposite direction as the value of the issuer's equity shares?

**Question 1** **How does the scope of the guidance in ASC 480 interact with other areas of the financial instrument guidance?**

The guidance in ASC 480 and ASC 815-40 addresses many of the same instruments. In practice, an instrument is usually evaluated first to determine whether it is in the scope of ASC 480 for recognition and measurement. If in the scope of ASC 480, the instrument should be further evaluated to determine whether it would also be a derivative pursuant to ASC 815. If so, that instrument would be subject to any incremental guidance in ASC 815-40, particularly the disclosures required for derivative instruments. If the instrument is not in the scope of ASC 480, the instrument's accounting should be determined pursuant to other relevant GAAP, including ASC 815-40.

**Question 2** **What is an example of an option to redeem shares embedded in a minimal host?**

**Excerpt from Accounting Standards Codification**

**Distinguishing Liabilities from Equity — Overall**

***Implementation Guidance***

***Option to Redeem Shares Embedded in a Minimal Host***

***480-10-55-41***

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 480-10-25-1 in applying the classification provisions of this Subtopic. Therefore, under either paragraphs 480-10-25-8 through 25-12 or 480-10-25-14(c) (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.

**Question 3** **What are examples of various combinations of a share, a written put and a purchased call to illustrate the assessment of combinations of instruments?**

The following examples from the FASB's implementation guidance in ASC 480 illustrate the differences in the accounting between (1) a single instrument that comprises two components and (2) two instruments that are issued at the same time but are separate, freestanding financial instruments.

## Excerpt from Accounting Standards Codification

**Distinguishing Liabilities from Equity — Overall**

*Implementation Guidance*

*Three Freestanding Instruments*

*480-10-55-34*

An issuer has the following three freestanding instruments with the same counterparty, entered into contemporaneously:

a. A written put option on its equity shares

b. A purchased call option on its equity shares

c. Outstanding shares of stock.

*480-10-55-35*

Under this Subtopic those three contracts would be separately evaluated. The written put option is reported as a liability under either paragraphs 480-10-25-8 through 25-12 or 480-10-25-14(c) (depending on the form of settlement) and is measured at fair value. The purchased call option does not embody an obligation and, therefore, is not within the scope of this Subtopic. The outstanding shares of stock also are not within the scope of this Subtopic, because the shares do not embody an obligation for the issuer. Under paragraph 480-10-25-15, neither the purchased call option nor the shares of stock are to be combined with the written put option in applying paragraphs 480-10-25-4 through 25-14 unless otherwise required by Topic 815. If that Topic required the freestanding written put option and purchased call option to be combined and viewed as a unit, the unit would be accounted for as a combination of options, following the guidance in paragraphs 480-10-55-18 through 55-20.

*Two Freestanding Instruments*

*480-10-55-36*

An issuer has the following two freestanding instruments with the same counterparty entered into contemporaneously:

a. A contract that combines a written put option at one strike price and a purchased call option at another strike price on its equity shares

b. Outstanding shares of stock.

*480-10-55-37*

As required by paragraph 480-10-25-1, paragraphs 480-10-25-4 through 25-14 are applied to the entire freestanding instrument that comprises both a put option and a call option. Because the put option element of the contract embodies an obligation to repurchase the issuer's equity shares, the freestanding instrument that comprises a put option and a call option is reported as a liability (or asset) under either paragraphs 480-10-25-8 through 25-12 or 480-10-25-14(c) (depending on the form of settlement) and is measured at fair value. Under paragraphs 480-10-15-3 through 15-4 and 480-10-25-1, that freestanding financial instrument is within the scope of this Subtopic regardless of whether at current prices it is a net written, net purchased, or zero-cost collar option and regardless of the form of settlement. The

outstanding shares of stock are not within the scope of this Subtopic and, under paragraph 480-10-25-15, are not combined with the freestanding written put and purchased call option. (Some outstanding shares of stock are within the scope of this Subtopic, for example, mandatorily redeemable shares or shares subject to a physically settled forward purchase contract in exchange for cash.)

***One Freestanding Instrument that Is an Outstanding Share of Stock Containing Multiple Embedded Features***

*480-10-55-38*

An entity issues a share of stock that is not mandatorily redeemable. However, under its terms the stock is both of the following:

a. Puttable by the holder any time after five years or upon a change in control

b. Callable by the issuer any time after five years.

*480-10-55-39*

That instrument is outside the scope of this Subtopic. The instrument as a whole is not mandatorily redeemable under paragraphs 480-10-25-4 and 480-10-25-6 because of both of the following conditions:

a. The redemption is optional (conditional).

b. A written put option and a purchased call option issued together with the same terms differ from a forward purchase contract under this Subtopic.

*480-10-55-40*

That combination of embedded features does not render the stock mandatorily redeemable because the options could expire at the money, unexercised, and, thus, the redemption is not unconditional. Because the instrument as a whole is an outstanding share, it is not subject to paragraphs 480-10-25-8 through 25-12, nor, because the embedded obligation is conditional, is it subject to paragraph 480-10-25-14. As a financial instrument that is not a derivative instrument in its entirety, it is subject to analysis under Subtopic 815-15 to determine whether the issuer must account for any embedded feature separately as a derivative instrument. Because of the guidance in paragraph 480-10-25-2, paragraphs 480-10-25-4 through 25-14 shall not be applied to any embedded feature for the purposes of that analysis. In applying paragraph 815-15-25-1, the embedded written put option is evaluated under the guidance in Subtopic 815-40 and would generally be classified in equity. If so, the embedded written put option meets the criterion for exclusion in paragraph 815-10-15-74(a) and, therefore, is not separated from its host contract. If the written put option was not embedded in the share, but was issued as a freestanding instrument, it would be a liability under this Subtopic.

Question 4

**What are examples of various combinations of NCI with (1) a forward contract, (2) a combination of put and call options and (3) a total return swap?**

## Excerpt from Accounting Standards Codification

**Distinguishing Liabilities from Equity — Overall**

*Implementation Guidance*

***Majority Owner's Accounting for a Transaction in the Shares of a Consolidated Subsidiary and a Derivative Instrument Indexed to the Noncontrolling Interest in that Subsidiary***

*480-10-55-53*

A controlling majority owner (parent) holds 80 percent of a subsidiary's equity shares. The remaining 20 percent (the noncontrolling interest) is owned by an unrelated entity (the noncontrolling interest holder). Simultaneous with the acquisition of the noncontrolling interest, the noncontrolling interest

holder and the parent enter into a derivative instrument that is indexed to the subsidiary's equity shares. The terms of the derivative instrument may be any of the following:

a. The parent has a fixed-price forward contract to buy the other 20 percent at a stated future date. (Derivative 1)

b. The parent has a call option to buy the other 20 percent at a fixed price at a stated future date, and the noncontrolling interest holder has a put option to sell the other 20 percent to the parent under those same terms, that is, the fixed price of the call is equal to the fixed price of the put option. (Derivative 2)

c. The parent and the noncontrolling interest holder enter into a total return swap. The parent will pay to the counterparty (initially the noncontrolling interest holder) an amount computed based on the London Interbank Offered Rate (LIBOR), plus an agreed spread, plus, at the termination date, any net depreciation of the fair value of the 20 percent interest since inception of the swap. The counterparty will pay to the parent an amount equal to dividends paid on the 20 percent interest and, at the termination date, any net appreciation of the fair value of the 20 percent interest since inception of the swap. At the termination date, the net change in the fair value of the 20 percent interest may be determined through an appraisal or the sale of the stock. (Derivative 3)

*480-10-55-54*

If the terms correspond with Derivative 1, the forward purchase contract that requires physical settlement by repurchase of a fixed number of shares (the noncontrolling interest) in exchange for cash is recognized as a liability, initially measured at the present value of the contract amount; the noncontrolling interest is correspondingly reduced. Subsequently, accrual to the contract amount and any amounts paid or to be paid to holders of those contracts are reflected as interest cost. In effect, the parent accounts for the transaction as a financing of the noncontrolling interest and, consequently, consolidates 100 percent of the subsidiary.

*480-10-55-55*

Depending on how Derivative 2 was issued, one of three different accounting methods applies. If Derivative 2 was issued as a single freestanding instrument, under this Subtopic it would be accounted for in its entirety as a liability (or an asset in some circumstances), initially and subsequently measured at fair value. If the written put option and the purchased call option in Derivative 2 were issued as freestanding instruments, the written put option would be accounted for under this Subtopic as a liability measured at fair value, and the purchased call option would be accounted for under Subtopic 815-40. Under both of those situations, the noncontrolling interest is accounted for separately from the derivative instrument under applicable guidance. However, if the written put option and purchased call option are embedded in the shares (noncontrolling interest) and the shares are not otherwise classified as liabilities under the guidance in this Subtopic, the instrument shall be accounted for as discussed in paragraph 480-10-55-59 with the parent consolidating 100 percent of the subsidiary.

*480-10-55-56*

If the terms correspond with Derivative 3, the total return swap is indexed to an obligation to repurchase the issuer's shares and may require the issuer to settle the obligation by transferring assets. Therefore it is in the scope of this Subtopic and is required to be accounted for as a liability (or asset in some circumstances), initially, and subsequently measured at fair value. The noncontrolling interest is accounted for separately from the total return swap.

*480-10-55-57*

In applying paragraphs 480-10-25-4 through 25-14 to determine classification, a freestanding financial instrument within this Subtopic's scope is precluded from being combined with another freestanding financial instrument, unless combination is required under the provisions of Topic 815; therefore, unless under the particular facts and circumstances that Topic provides otherwise, freestanding derivative instruments in the scope of this Subtopic would not be combined with the noncontrolling interest.

*480-10-55-58*

This guidance is limited to circumstances in which the parent owns a majority of the subsidiary's outstanding common stock and consolidates that subsidiary at inception of the derivative instrument. This guidance is limited to the specific derivative instruments described.

***Written Put Option and Purchased Call Option Embedded in Noncontrolling Interest***

*480-10-55-59*

If the derivative instrument in Derivative 2 is embedded in the shares (noncontrolling interest) and the shares are not otherwise classified as liabilities under the guidance in this Subtopic, the combination of options should be viewed on a combined basis with the noncontrolling interest and accounted for as a financing of the parent's purchase of the noncontrolling interest.

*480-10-55-60*

Under that approach, the parent would consolidate 100 percent of the subsidiary and would attribute the stated yield earned under the combined derivative instrument and noncontrolling interest position to interest expense (that is, the financing would be accreted to the strike price of the forward or option over the period until settlement). No gain or loss would be recognized on the sale of the noncontrolling interest by the parent to the noncontrolling interest holder at the inception of the derivative instrument.

*480-10-55-61*

The risks and rewards of owning the noncontrolling interest have been retained by the parent during the period of the derivative instrument, notwithstanding the legal ownership of the noncontrolling interest by the counterparty. Combining the two transactions in this circumstance reflects the substance of the transactions; that the counterparty is financing the noncontrolling interest. Upon such combination, the resulting instrument is not a derivative instrument subject to Subtopic 815-10.

*480-10-55-62*

This accounting applies even if the exercise prices of the put and call options are not equal, as long as those exercise prices are not significantly different.

ASC 480-10-55-53 through 55-56 describe three different derivative instruments indexed to the stock of a consolidated subsidiary. One instrument includes a written put and purchased call. ASC 480-10-55-55 provides for three different ways to account for the written put and purchased call, based on how the instruments were issued relative to the NCI (i.e., freestanding from or embedded in the NCI).

ASC 480-10-55-59 clarifies that when a written put option and a purchased call option are embedded in the NCI (provided that the NCI is not classified as a liability for other reasons), they should be viewed on a combined basis with the NCI and accounted for as a financing of the parent's purchase of the NCI.

Refer to section 5.10 for further discussion of equity contracts on NCI.

**Question 5** **Does the increasing-rate nature of increasing-rate preferred stock cause it to be considered mandatorily redeemable pursuant to ASC 480?**

Some types of preferred stock initially pay little or no dividends and then pay dividends at an increasing rate (often characterized as increasing-rate preferred stock). The dividend rate can rise to a level that may be considered onerous, essentially economically compelling the issuer to redeem the instrument. The FASB explicitly considered economic compulsion and concluded that only if an increasing-rate preferred stock is mandatorily redeemable on (or not later than) a specified date, does it embody an obligation to transfer assets. Economic compulsion is not a concept within the ASC 480 model.

**Question 6** **If the NCI of a consolidated limited-life subsidiary is mandatorily redeemable, how does that affect the consolidated financial statements? Are such interests affected by the scope exception in ASC 480?**

As discussed in section A.3.5.2, while ASC 480 considers an instrument issued by a consolidated subsidiary with a limited life that is redeemable upon liquidation or termination of the subsidiary to be mandatorily redeemable in the consolidated financial statements, a scope exception is provided for the application of the classification and measurement guidance of ASC 480 in this circumstance.

Many partnerships and limited liability corporations (LLCs) have finite lives, as their governing documents establish a date on which the assets and liabilities of the entity will be liquidated and settled. Those limitations may be based on state or federal laws, laws in other countries or tax requirements. A finite-lived entity may need to be consolidated.

If a subsidiary is required by its articles of incorporation or other legal requirements to be liquidated on a specified date, the subsidiary will be required to transfer assets to its shareholders (or other residual interest holders) on that date (regardless of whether it must transfer either its assets and liabilities or the remaining net proceeds from its liquidation).

The equity instruments of the subsidiary are not considered liabilities in the standalone financial statements of that subsidiary because ASC 480-10-25-4 provides an exception to liability classification when redemption is required only upon liquidation of the reporting entity (i.e., the subsidiary). However, this exception would not apply in the consolidated financial statements of the parent because the reporting entity is the parent thus liability classification is required.

However, ASC 480-10-15-7E provides a scope exception to the classification and measurement guidance in ASC 480 for NCI that are classified as equity in the financial statements of the subsidiary but would be classified as a liability in the parent's financial statements pursuant to ASC 480 (e.g., NCI in limited-life subsidiaries).

As a result of this scope exception, issuers are not required to recognize NCI in a limited-life subsidiary as a liability in the consolidated financial statements provided that the reason for liability classification pursuant to ASC 480 is limited to the fact that the subsidiary has a limited life. Importantly, if the ownership interests in the limited-life subsidiary must instead be redeemed upon a specified date or upon an event certain to occur, regardless of whether or when the entity is liquidated, the scope exception does not apply to those ownership interests, and they should be classified as liabilities in the financial statements of both the subsidiary and the parent.

However, all of the relevant disclosure requirements of ASC 480 continue to apply, including the requirement in ASC 480-10-50-2(a) to disclose the "amount that would be paid, or the number of shares that would be issued and their value, determined under the conditions specified in the contract if the settlement were to occur at the reporting date."

The scope exception does not apply to the requirements to classify obligations to purchase a subsidiary's outstanding shares or certain obligations to issue a variable number of shares of a subsidiary. For example, if an entity enters into a freestanding forward contract to purchase the shares of a consolidated subsidiary or writes a freestanding put contract on the shares of the subsidiary, the forward or put would not be subject to the scope exception and should be classified as a liability.

**Question 7** **What are the accounting considerations for contingently redeemable instruments?**

Although not a liability within the scope of ASC 480, a contingently or optionally redeemable instrument in the form of a share may contain an embedded derivative. Any embedded redemption features (e.g., the embedded written put option in puttable common stock or any put features in contingently redeemable preferred stock) should be analyzed pursuant to ASC 815 to determine whether they should be bifurcated. The guidance in ASC 815-15-25-1 is the starting point in determining whether bifurcation is required. Applying this guidance also requires consideration of the nature of the host instrument for redeemable preferred stock pursuant to ASC 815-15-25-17A through 25-17D.

If the redemption feature (put or call) is not considered clearly and closely related to the host instrument, and it meets the definition of a derivative if freestanding, the feature should be analyzed to determine if it qualifies for the exemption in ASC 815-10-15-74(a) by determining whether it is indexed to the issuer's equity and would be classified as equity if it were freestanding. Because ASC 480 does not affect the accounting for embedded features, the analysis of whether the embedded derivative would be classified as equity if it were freestanding should be made pursuant to the indexation and equity classification guidance in ASC 815-40.

If preferred stock with a mandatory redemption date was not classified as a liability pursuant to ASC 480 due to the existence of an embedded conversion option, that embedded feature should also be evaluated as a potential derivative requiring bifurcation.

Refer section 3.2.9 for further discussion of evaluating redemption features in shares.

**Question 8** **What is an example of a contingently redeemable share that is reclassified when it becomes mandatorily redeemable?**

The following examples are from the FASB's implementation guidance in ASC 480.

**Excerpt from Accounting Standards Codification**

**Distinguishing Liabilities from Equity — Overall**

*Implementation Guidance*

*Mandatorily Redeemable Financial Instruments*

*Reclassification of Stock that Becomes Mandatorily Redeemable*

*480-10-55-10*

The guidance that follows discusses the requirement in paragraph 480-10-25-7 for reclassification of stock that becomes mandatorily redeemable. For example, an entity may issue equity shares on January 2, 2004, that must be redeemed (not at the option of the holder) six months after a change in control. When issued, the shares are conditionally redeemable and, therefore, do not meet the definition of mandatorily redeemable. On December 30, 2008, there is a change in control, requiring the shares to be redeemed on June 30, 2009. On December 31, 2008, the issuer would treat the shares as mandatorily redeemable and reclassify the shares as liabilities, measured initially at fair value. Additionally, the issuer would reduce equity by the amount of that initial measure, recognizing no gain or loss.

*480-10-55-11*

For another example of a conditionally redeemable instrument, an entity may issue preferred shares with a stated redemption date 30 years hence that also are convertible at the option of the holders into a fixed number of common shares during the first 10 years. Those instruments are not mandatorily redeemable for the first 10 years because the redemption is conditional, contingent upon the holder's not exercising its option to convert into common shares. However, when the conversion option (the condition) expires, the shares would become mandatorily redeemable and would be reclassified as liabilities, measured initially at fair value.

*480-10-55-12*

If the conversion option were nonsubstantive, for example, because the conversion price is extremely high in relation to the current share price, it would be disregarded as provided in paragraph 480-10-25-1. If that were the case at inception, those preferred shares would be considered mandatorily redeemable and classified as liabilities with no subsequent reassessment of the nonsubstantive feature.

**Question 9** **How does the scope exception in ASC 480 affect trust preferred securities?**

Trust preferred securities are sometimes referred to as MIPS (Monthly Income Preferred Stock), QUIPS (Quarterly Income Preferred Stock), QUICS (Quarterly Income Capital Securities), or TOPRS (Trust Originated Preferred Redeemable Stock). In order to issue trust preferred securities, a sponsor typically organizes a new subsidiary that issues preferred securities to investors. The sponsor purchases all of the trust's common securities and may guarantee the obligations of the trust. The proceeds received for issuing common and preferred securities are used to purchase subordinated debentures issued by the sponsor. The terms of the debentures are identical to those of the trust preferred securities, except that the debt has an explicit maturity date. The trust documents require either that the trust be liquidated upon repayment of the debt or that the proceeds be used to redeem the preferred securities.

If trust preferred securities must be repaid only upon liquidation of the trust, they normally would qualify as equity in the trust's financial statements pursuant to ASC 480-10-25-4. For the consolidated financial statements (if the trust is consolidated pursuant to the relevant guidance), while the trust preferred securities must be redeemed before the liquidation of the reporting entity (i.e., the parent), ASC 480-10-15-7E provides a scope exception to the classification and measurement provisions of ASC 480 and allows the parent to classify such mandatorily redeemable NCI as equity in the consolidated financial statements. Refer to section A.3.5.2 for further discussion of the scope exception.

**Question 10** **How should an entity account for shares required to be redeemed upon death of a holder?**

An entity may issue shares that are required to be redeemed upon the death of the holder. Pursuant to ASC 480-10-55-3 through 55-5, a share that is required to be redeemed upon the death of the holder embodies an unconditional obligation of the issuer to redeem the shares at death, which is an event that is certain to occur and would thus require liability classification. A life insurance contract purchased by the entity that would cover the cost of the redemption does not affect the classification of the shares as a liability.

However, if the entity has a limited life, further analysis should be performed because redemption that is required only upon the liquidation or termination of an entity does not cause the shares to be mandatorily redeemable under ASC 480-10-25-4. For example, assume a partnership with three partners has a limited life of 10 years, and the partnership agreement specifies that the partnership interests will be redeemed upon the death of any partner. Further, assume all three partners are 60 years old at the formation of the partnership. In this fact pattern, the liquidation exception under ASC 480-10-25-4 should be applied because the death of any partner is not certain to occur before the entity liquidates in 10 years. Facts and circumstances, including the age of investors and the life of the entity, should be considered.

Pursuant to ASC 480-10-55-64, if the stock represents the only shares of the entity, the entity should report those instruments in the liabilities section of its statement of financial position and describe them as shares subject to mandatory redemption so as to distinguish the instruments from other financial statement liabilities. The issuer should also present interest cost and payments to holders of such instruments separately, apart from interest and payments to other creditors in statements of income and cash flows. The fact that the instruments are mandatorily redeemable upon the death of the holder should be disclosed.

**Question 11** **How should an entity measure and present mandatorily redeemable instruments when the entity has no equity-classified instruments?**

When all of an entity's shares are mandatorily redeemable (which may be the case for certain nonpublic companies) at other than book value, retained earnings and other comprehensive income are included in the carrying amount of the mandatorily redeemable shares.

Any difference between the book value and the settlement value is accumulated in a separate gain or loss account on the balance sheet pursuant to ASC 480-10-45-2A and 45-2B. That is, the redeemable shares are remeasured at settlement value, and any resulting adjustment is recognized as interest income or expense. If the settlement value of the mandatorily redeemable shares is greater than the book value of those shares, the issuer reports the excess of that liability over the book value as an "excess of liabilities over assets (a deficit)." If the settlement value of the mandatorily redeemable shares is less than the book value of those shares, the issuer reports the excess of that book value over the liability reported for the mandatorily redeemable shares as an "excess of assets over liabilities (equity)."

The following illustrations were provided in the original FASB interpretive guidance issued pre-Codification, but not included in the Codification. The illustrations assumed that all shares of the entity were mandatorily redeemable and are, therefore, consistent with required presentation and disclosures in ASC 480-10-45-2 and ASC 480-10-50-4. However, if the entity had other classes of shares outstanding and classified in equity, there were no special presentation and disclosure requirements. Although those illustrations are in the context of the adoption of Statement 150, we generally believe that they may be relevant when all of an entity's shares are mandatorily redeemable at other than book value.

*Illustrations of Accounting for Mandatorily Redeemable Shares with a Redemption Value That Differs from the Issuer's Book Value*

**Illustration A-1: Mandatorily redeemable shares with a redemption value above book value**

Assume a company adopts Statement 150 on 1 January 20XX, and that the fair value (which equals the redemption value) of the mandatorily redeemable shares is $20 million and the book value of those shares is $15 million, of which $10 million is paid-in capital. On the date of adoption, the issuer would recognize a liability of $20 million by transferring $15 million out of equity and recognizing a cumulative transition adjustment loss of $5 million. Subsequently, net income attributable to the mandatorily redeemable shares is $1 million for the year 20XX and the fair value of those shares at the reporting date of 31 December 20XX, is $21.2 million. Also assume that the company did not pay any cash dividends.

The following illustrates the statement of position at 1 January 20XX, and 31 December 20XX, and the statement of income for the year ended 31 December 20XX (income tax considerations have been disregarded):

Statement of Financial Position:

| | 1 January 20XX | 31 December 20XX |
|---|---|---|
| Total assets | $ 25,000,000 | $ 26,000,000 |
| Liabilities other than shares | $ 10,000,000 | $ 10,000,000 |
| Shares subject to mandatory redemption* | 20,000,000 | 21,200,000 |
| Total liabilities | 30,000,000 | 31,200,000 |
| Excess of liabilities over assets (deficit) | (5,000,000) | (5,200,000) |
| Total | $ 25,000,000 | $ 26,000,000 |

Notes to Financial Statements:

*Shares, all subject to mandatory redemption upon death of the holders, consist of:

| | 1 January 20XX | 31 December 20XX |
|---|---|---|
| Common stock — $100 par value, 200,000 shares authorized, 100,000 shares issued and outstanding | $ 10,000,000 | $ 10,000,000 |
| Retained earnings attributable to those shares | 5,000,000 | 6,000,000 |
| Excess of redemption amount over common stock and retained earnings attributable to those shares | 5,000,000 | 5,200,000 |
| | $ 20,000,000 | $ 21,200,000 |

Partial Statement of Income (for the Year Ended 31 December 20XX):

| | |
|---|---|
| Income before interest on mandatory redeemable shares | $ 1,000,000 |
| Less: Interest on mandatorily redeemable shares (change in redemption amount) | 1,200,000 |
| Income (loss) before cumulative effect of a change in accounting principle | $ (200,000) |
| Cumulative effect of change in accounting principle | (5,000,000) |
| Net loss | $ (5,200,000) |

**Illustration A-2: Mandatorily redeemable shares with a redemption value below book value**

Assume the same facts as in Example 1 except that the shares are to be redeemed at an amount ($11 million) that is less than their book value. On the date of adoption, 1 January 20XX, the issuer would recognize a liability of $11 million by transferring $11 million out of equity.

The following illustrates the statement of position at 1 January 20XX:

Statement of Financial Position (as of 1 January 20XX):

| | |
|---|---|
| Total assets | $ 25,000,000 |
| Liabilities other than shares | $ 10,000,000 |
| Shares subject to mandatory redemption* | 11,000,000 |
| Total liabilities | 21,000,000 |
| Excess of assets over liabilities (equity) | 4,000,000 |
| Total | $ 25,000,000 |

Notes to Financial Statements:

*Shares, all subject to mandatory redemption upon death of the holders, consist of:

| | |
|---|---|
| Common stock — $100 par value, 200,000 shares authorized, 100,000 shares issued and outstanding | $ 10,000,000 |
| Retained earnings attributable to those shares | 5,000,000 |
| Excess of common stock and retained earnings attributable to those shares over redemption amount | (4,000,000) |
| Total | $ 11,000,000 |

**Question 12** **How should an entity measure and present mandatorily redeemable noncontrolling interests classified as liabilities that were issued before 5 November 2003?**

For mandatorily redeemable NCI that are classified as liabilities in the financial statements of the subsidiary (e.g., NCI that must be redeemed prior to the liquidation of the subsidiary) that were issued before 5 November 2003, the measurement provisions of ASC 480 do not apply, both for the parent in consolidated financial statements and for the subsidiary that issued the instruments that result in the mandatorily redeemable noncontrolling interest.

However, the classification and the disclosure provisions of ASC 480 continue to apply. That is, those mandatorily redeemable NCI are classified as liabilities and the disclosures required by ASC 480, including the disclosure of settlement value required by ASC 480-10-50-2(a), must be provided. However, any changes to the carrying amount continue to be based on the accounting guidance applied before ASC 480 was adopted (e.g., the SEC staff's redeemable equity guidance). If the mandatorily redeemable noncontrolling interests were issued on or after 5 November 2003, the measurement guidance in ASC 480 applies. Refer to section A.3.5.2 for further discussion of the scope exception.

**Question 13** **What is the classification and measurement guidance for a freestanding written put option or a forward purchased contract within the scope of ASC 480?**

A freestanding written put option or forward purchase contract is classified as a liability pursuant to ASC 480. While the settlement method (in cash or other assets or in a variable number of shares) does not impact the classification, it may impact the subsequent measurement of the instrument. The following table is from the FASB's implementation guidance in ASC 480. It has been slightly reformatted for presentation here.

**Excerpt from Accounting Standards Codification**

**Distinguishing Liabilities from Equity — Overall**

*Implementation Guidance*

*480-10-55-63*

The following table addresses classification of freestanding written put options and forward purchase contracts within the scope of this Subtopic.

| | | Initial and subsequent classification and measurement | |
|---|---|---|---|
| | | Equity | Asset/Liability |
| One settlement method | Physical [a] | | X [b] |
| | Net share | | X [c] |
| | Net cash | | X [c] |
| Entity choice | Net share or physical [a] | | X [c] |
| | Net share or net cash | | X [c] |
| | Net cash or physical [a] | | X [c] |
| Counterparty choice | Net share or physical [a] | | X [c] |
| | Net share or net cash | | X [c] |
| | Net cash or physical [a] | | X [c] |

[a] Physical settlement of the contract requires that the entity deliver cash to the holder in exchange for the shares.

[b] Initial measurement of certain forward purchase contracts is at the present value of the redemption amount, adjusted for any consideration or unstated rights or privileges, with equity reduced by the fair value of the shares. Subsequent measurement of those forward purchase contracts is at the present value of the share redemption amount with the accretion and any amounts paid or to be paid to holders (including dividends) reflected as interest cost. Measurement of a written put option, or of a forward purchase contract that is not for a fixed number of shares in exchange for cash, is at fair value with subsequent changes in fair value recorded in earnings.

[c] Initial and subsequent measurement is at fair value with subsequent changes in fair value recorded in earnings.

**Note**: In all cases above, the contracts must be reassessed at each reporting period in order to determine whether or not the contract must be reclassified.

This table is an updated version of a table initially provided in EITF 00-19, *Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock*. We believe the footnotes were carried over from that initial guidance without reconsideration. While instruments pursuant to ASC 815-40 are reassessed at each reporting date, such reassessment will have no effect on the classification of instruments pursuant to the scope of ASC 480.

**Question 14** **What are examples of instruments composed of more than one option or forward contract?**

**Excerpt from Accounting Standards Codification**

**Distinguishing Liabilities from Equity — Overall**

*Implementation Guidance*

*Obligations to Repurchase an Issuer's Equity Shares that Require a Transfer of Assets*

*Combination of Written Put Option and Purchased Call Option Issued as a Freestanding Instrument*

*480-10-55-18*

If a freestanding financial instrument consists solely of a written put option to repurchase the issuer's equity shares and another option, that freestanding financial instrument in its entirety is subjected to paragraphs 480-10-25-4 through 25-14 to determine if it meets the requirements to be classified as a liability.

*480-10-55-19*

For example, an entity may enter into a contract that requires it to purchase 100 shares of its own stock on a specified date for $20 if the stock price falls below $20 and entitles the entity to purchase 100 shares on that date for $21 if the stock price is greater than $21. That contract shall be analyzed as the combination of a written put option and a purchased call option and not as a forward contract. The written put option on 100 shares has a strike price of $20, and the purchased call option on 100 shares has a strike price of $21. If at issuance the fair value of the written put option exceeds the fair value of the purchased call option, the issuer receives cash and the contract is a net written option—a liability. If required to be physically settled, that contract is a liability under the provisions in paragraphs 480-10-25-8 through 25-12 because it embodies an obligation that may require repurchase of the issuer's equity shares and settlement by a transfer of assets. If the issuer must or can net cash settle the contract, the contract is a liability under the provisions of those paragraphs because it embodies an obligation that is indexed to an obligation to repurchase the issuer's equity shares and may require settlement by a transfer of assets. If the issuer must or can net share settle the contract, that contract is a liability under the provisions in paragraph 480-10-25-14(c), because the monetary value of the obligation varies inversely in relation to changes in the fair value of the issuer's equity shares.

*480-10-55-20*

If, in this example, the fair value of the purchased call option at issuance exceeds the fair value of the written put option, the issuer pays out cash and the contract is a net purchased option, to be initially classified as an asset under either paragraphs 480-10-25-8 through 25-12 or 480-10-25-14(c). If the fair values of the two options are equal and opposite at issuance, the financial instrument has an initial fair value of zero, and is commonly called a zero-cost collar. Thereafter, if the fair value of the instrument changes, the instrument is classified as an asset or a liability and measured subsequently at fair value.

*Financial Instruments Involving Multiple Components*

*480-10-55-29*

The implementation guidance that follows addresses financial instruments involving multiple components that embody (or are indexed to) an obligation to repurchase the issuer's shares and that may require settlement by transferring assets. Some freestanding financial instruments composed of

more than one option or forward contract embodying obligations require or may require settlement by transfer of assets. Paragraphs 480-10-15-3 through 15-4 state that the provisions of this Subtopic apply to freestanding financial instruments, including those that comprise more than one option or forward contract, and paragraphs 480-10-25-4 through 25-14 shall be applied to a freestanding financial instrument in its entirety. Under paragraphs 480-10-25-8 through 25-12, if a freestanding instrument is composed of a written call option and a written put option, the existence of the written call option does not affect the classification. Unlike the application of paragraph 480-10-25-14, applying paragraphs 480-10-25-8 through 25-12 does not involve making any judgments about predominance among obligations or contingencies.

*480-10-55-30*

Consider, for example, a puttable warrant that allows the holder to purchase a fixed number of the issuer's shares at a fixed price that also is puttable by the holder at a specified date for a fixed monetary amount that the holder could require the issuer to pay in cash. The warrant is not an outstanding share and therefore does not meet the exception for outstanding shares in paragraphs 480-10-25-8 through 25-12. As a result, the example puttable warrant is a liability under those paragraphs, because it embodies an obligation indexed to an obligation to repurchase the issuer's shares and may require a transfer of assets. It is a liability even if the repurchase feature is conditional on a defined contingency in addition to the level of the issuer's share price.

*Puttable Warrant that May Require Cash Settlement*

*480-10-55-31*

Entity A issues a puttable warrant to Holder. The warrant feature allows Holder to purchase 1 equity share at a strike price of $10 on a specified date. The put feature allows Holder instead to put the warrant back to Entity A on that date for $2, and to require settlement in cash. If the share price on the settlement date is greater than $12, Holder would be expected to exercise the warrant, obligating Entity A to issue a fixed number of shares in exchange for a fixed amount of cash. That feature does not result in a liability under paragraphs 480-10-25-8 through 25-12. However, if the share price is equal to or less than $12, Holder would be expected to put the warrant back to Entity A and could choose to obligate Entity A to pay $2 in cash. That feature does result in a liability, because the financial instrument embodies an obligation that is indexed to an obligation to repurchase the issuer's shares (as the share price decreases toward $12, the fair value of the issuer's obligation to stand ready to pay $2 begins to increase) and may require a transfer of assets. Therefore, paragraphs 480-10-25-8 through 25-12 require Entity A to classify the instrument as a liability.

*Warrant for Shares that Are Puttable that May Require Cash Settlement*

*480-10-55-32*

Entity B issues a warrant for shares that can be put back by Holder immediately after exercise of the warrant. The warrant feature allows Holder to purchase 1 equity share at a strike price of $10 on a specified date. The put feature allows Holder to put the shares obtained by exercising the warrant back to Entity B on that date for $12, and to require physical settlement in cash. If the share price on the settlement date is greater than $12, Holder would be expected to exercise the warrant obligating Entity B to issue a fixed number of shares in exchange for a fixed amount of cash, and retain the shares. That feature alone does not result in a liability under paragraphs 480-10-25-8 through 25-12. However, if the share price is equal to or less than $12, Holder would be expected to put the shares back to Entity B and could choose to obligate Entity B to pay $12 in cash. That feature does result in a liability, because the financial instrument embodies an obligation to repurchase the issuer's shares and may require a transfer of assets. Therefore, those paragraphs require Entity B to classify the warrant as a liability. A warrant to issue shares that will be mandatorily redeemable is also classified as a liability, and should be analyzed under Topic 815.

*Certain Financial Instruments Involving Multiple Components that May Be Settled in a Variable Number of Shares*

*480-10-55-42*

A financial instrument composed of more than one option or forward contract embodying obligations to issue shares must be analyzed to determine whether the obligations under any of its components have one of the characteristics in paragraph 480-10-25-14, and if so, whether those obligations are predominant relative to other obligations. For example, a puttable warrant that allows the holder to purchase a fixed number of the issuer's shares at a fixed price that also is puttable by the holder at a specified date for a fixed monetary amount to be paid, at the issuer's discretion, in cash or in a variable number of shares.

*480-10-55-43*

The analysis can be summarized in two steps:

a. Identify any component obligations that, if freestanding, would be liabilities under paragraph 480-10-25-14. Also identify the other component obligation(s) of the financial instrument.

b. Assess whether the monetary value of any obligations embodied in components that, if freestanding, would be liabilities under paragraph 480-10-25-14 is (collectively) predominant over the (collective) monetary value of other component obligation(s). If so, account for the entire instrument under that paragraph. If not, the financial instrument is not in the scope of this Subtopic and other guidance applies.

*480-10-55-44*

In an instrument that allows the holder either to purchase a fixed number of the issuer's shares at a fixed price or to compel the issuer to reacquire the instrument at a fixed date for shares equal to a fixed monetary amount known at inception, the holder's choice will depend on the issuer's share price at the settlement date. The issuer must analyze the instrument at inception and consider all possible outcomes to judge which obligation is predominant. To do so, the issuer considers all pertinent information as applicable, which may include its current stock price and volatility, the strike price of the instrument, and any other factors. If the issuer judges the obligation to issue a variable number of shares based on a fixed monetary amount known at inception to be predominant, the instrument is a liability under paragraph 480-10-25-14. Otherwise, the instrument is not a liability under this Subtopic but is subject to other applicable guidance such as Subtopic 815-40.

*Warrant with Share-Settleable Puts*

*480-10-55-45*

Entity C issues a puttable warrant to Holder. The warrant feature allows Holder to purchase 1 equity share at a strike price of $10 on a specified date. The put feature allows Holder instead to put the warrant back to Entity C on that date for $2, settleable in fractional shares. If the share price on the settlement date is greater than $12, Holder would be expected to exercise the warrant, obligating Entity C to issue a fixed number of shares in exchange for a fixed amount of cash; the monetary value of the shares varies directly with changes in the share price above $12. If the share price is equal to or less than $12, Holder would be expected to put the warrant back to Entity C obligating the entity to issue a variable number of shares with a fixed monetary value, known at inception, of $2. Thus, at inception, the number of shares that the puttable warrant obligates Entity C to issue can vary, and the financial instrument must be examined under paragraph 480-10-25-14.

*480-10-55-46*

The facts and circumstances should be considered in judging whether the monetary value of the obligation to issue a number of shares that varies is predominantly based on a fixed monetary amount known at inception; if so, it is a liability under paragraph 480-10-25-14(a). For example, if the following circumstances existed, they would suggest that the monetary value of the obligation to issue shares would be judged to be based predominantly on a fixed monetary amount known at inception ($2 worth of shares), and the instrument would be classified as a liability:

a. Entity C's share price is well below the $10 exercise price of the warrant at inception of the instrument.

b. The warrant has a short life.

c. Entity C's stock is determined to have very low volatility.

*480-10-55-47*

Entity E issues a warrant to Holder allowing Holder to purchase 1 equity share at a strike price of $10. The warrant has an embedded liquidity make-whole put that entitles Holder to receive from Entity E the net amount of any difference between the share price on the date the warrants are exercised and the sales price the holder receives when the shares are later sold. The make-whole provision is not legally detachable. Entity E can settle by issuing a variable number of shares. For example, if on the date Holder exercises the warrant, the share price is $15 and the share price subsequently decreases to $12 at the date Holder sells the shares, Holder would receive $3 worth of equity shares from Entity E.

*480-10-55-48*

The financial instrument embodies an obligation to deliver a number of shares that varies-either a fixed number of shares under exercise of the warrant or additional shares if the share price declines after the warrant is exercised. However, unless it is judged that the possibility of having to issue a variable number of shares with a monetary value that is inversely related to the share price is predominant, the financial instrument is not in the scope of paragraph 480-10-25-14(c) and would be evaluated under Subtopic 815-40.

*480-10-55-49*

If exercisability of a feature into a fixed or variable number of shares is contingent on both the occurrence or nonoccurrence of a specified event and the issuer's share price, a financial instrument settleable in a number of shares that can vary should be analyzed following the same method as for the examples in paragraphs 480–10–55–45 and 480-10-55-50 to consider all possibilities. In some cases, it may be determined that the instrument may not be within the scope of paragraph 480-10-25-14 and thus not a liability under this Subtopic. That determination depends on whether the obligation to deliver a variable number of shares, with a monetary value based on either a fixed monetary amount known at inception or an inverse relationship with the share price, is predominant at inception.

*Variable Share Forward Sales Contract*

*480-10-55-50*

Entity D enters into a contract to issue shares of Entity D's stock to Counterparty in exchange for $50 on a specified date. If Entity D's share price is equal to or less than $50 on the settlement date, Entity D will issue 1 share to Counterparty. If the share price is greater than $50 but equal to or less than $60, Entity D will issue $50 worth of fractional shares to Counterparty. Finally, if the share price is greater than $60, Entity D will issue .833 shares. At inception, the share price is $49. Entity D has an obligation to issue a number of shares that can vary; therefore, paragraph 480-10-25-14 may apply. However, unless it is determined that the monetary value of the obligation to issue a variable number of shares is predominantly based on a fixed monetary amount known at inception (as it is in the $50 to $60 share price range), the financial instrument is not in the scope of this Subtopic.

*480-10-55-51*

Some financial instruments that are composed of more than one option or forward contract embody an obligation to issue a fixed number of shares and, once those shares are issued, potentially to issue a variable number of additional shares. The issuer must analyze that kind of financial instrument, at inception, to assess whether the possibility of issuing a variable number of shares in which the monetary value of that obligation meets one of the conditions in paragraph 480-10-25-14 is predominant.

*Contingently Puttable Warrant*

*480-10-55-52*

Entity F has a share-settleable puttable warrant that provides that the put feature is exercisable only if Entity F fails to accomplish an operational plan (for example, failure to complete a building within two years). If at inception the possibility that both the building will not be completed in two years and the put will be exercised is judged to be predominant, the put warrant would be recognized as a liability under paragraph 480-10-25-14(a).

*Glossary*

*480-10-20*

*Variable-Rate Forward Contracts*

Variable-rate forward contracts are commonly used to effect equity forward transactions. The contract price on those forward contracts is not fixed at inception but varies based on changes in a specified index (for example, three-month U.S. London Interbank Offered Rate [LIBOR]) during the life of the contract.

**Question 15** **How would share-settled obligations not within the scope of ASC 480 be measured?**

ASC 480 does not apply to instruments (1) that do not represent obligations or (2) for which the monetary value of the obligation changes in the same direction as the issuer's shares. For example, because purchased options indexed to, and potentially settled in, the issuer's own shares are not obligations (i.e., purchased options give the issuer the right, not the obligation, to sell or purchase shares), they are not within the scope of ASC 480. This conclusion applies even for purchased call options (i.e., the issuer has the right to purchase its own shares for a specified price), despite the fact that the monetary value to the counterparty changes in the opposite direction of the issuer's stock.

Further, even though written call options and forward sale contracts indexed to the issuer's non-redeemable shares represent obligations to issue shares (under physical or net share settlement), or a potential obligation to transfer cash (under net cash settlement), because the monetary value to the counterparty changes in the same direction as the issuer's shares, they are generally not subject to ASC 480 (provided that the monetary value of the obligation also is not predominantly fixed at inception). However, the same instruments indexed to the issuer's redeemable shares would be liabilities under ASC 480.

Financial instruments indexed to, and potentially settled in, the issuer's equity shares that are not within the scope of ASC 480, are subject to the guidance in ASC 815-40 for contracts in an entity's own equity. As previously discussed, if under all circumstances (except for the limited exceptions for net cash settlement provided in ASC 815-40-25-8) the issuer can settle the financial instruments by issuing its shares, ASC 815-40 generally permits those financial instruments to be classified as equity. However, the requirements of ASC 815-40 are complex and should be consulted to determine whether equity classification is appropriate for a particular instrument and issuer. Refer to Appendix B for further discussion of the application of the ASC 815-40.

**Question 16** What are examples of physically settled forward contracts to purchase shares?

## Excerpt from Accounting Standards Codification

**Distinguishing Liabilities from Equity — Overall**

*Implementation Guidance*

*Physically Settled Forward Purchase Contract*

*480-10-55-14*

For example, an entity may enter into a forward contract to repurchase 1 million shares of its common stock from another party 2 years later. At inception, the forward contract price per share is $30, and the current price of the underlying shares is $25. The contract's terms require that the entity pay cash to repurchase the shares (the entity is obligated to transfer $30 million in 2 years). Because the instrument embodies an unconditional obligation to transfer assets, it is a liability under paragraphs 480-10-25-8 through 25-12. The entity would recognize a liability and reduce equity by $25 million (which is the present value, at the 9.54 percent rate implicit in the contract, of the $30 million contract amount, and also, in this example, the fair value of the underlying shares at inception). Interest would be accrued over the 2-year period to the forward contract amount of $30 million, using the 9.54 percent rate implicit in the contract. If the underlying shares are expected to pay dividends before the repurchase date and that fact is reflected in the rate implicit in the contract, the present value of the liability and subsequent accrual to the contract amount would reflect that implicit rate. Amounts accrued are recognized as interest cost.

*480-10-55-15*

In this example, no consideration or other rights or privileges changed hands at inception. If the same contract price of $30 per share had been agreed to even though the current price of the issuer's shares was $30, because the issuer had simultaneously sold the counterparty a product at a $5 million discount, that right or privilege unstated in the forward purchase contract would be taken into consideration in arriving at the appropriate implied discount rate—9.54 percent rather than 0 percent—for that contract. That entity would recognize a liability for $25 million, reduce equity by $30 million, and increase its revenue for the sale of the product by $5 million. Alternatively, if the same contract price of $30 per share had been agreed to even though the current price of the issuer's shares was only $20, because the issuer received a $5 million payment at inception of the contract, the issuer would recognize a liability for $25 million and reduce equity by $20 million. In both examples, interest would be accrued over the 2-year period using the 9.54 percent implicit rate, increasing the liability to the $30 million contract price.

*480-10-55-16*

If a variable-rate forward contract requires physical settlement, a different measurement method is required subsequently, as set forth in paragraph 480-10-35-3.

*480-10-55-17*

In contrast to forward purchase contracts that require physical settlement in exchange for cash, forward purchase contracts that require or permit net cash settlement, require or permit net share settlement, or require physical settlement in exchange for specified quantities of assets other than cash are measured initially and subsequently at fair value, as provided in paragraphs 480-10-30-2, 480-10-30-7, 480-10-35-1, and 480-10-35-5 (as applicable), and classified as assets or liabilities depending on the fair value of the contracts on the reporting date.

**Question 17** What is the monetary value of a contract?

## Excerpt from Accounting Standards Codification

**Distinguishing Liabilities from Equity — Overall**

*Implementation Guidance*

*Monetary Value*

*480-10-55-2*

Paragraph 480-10-05-5 explains that how the monetary value of a financial instrument varies in response to changes in market conditions depends on the nature of the arrangement, including, in part, the form of settlement. For example, for a financial instrument that embodies an obligation that requires:

a. Settlement either by transfer of $100,000 in cash or by issuance of $100,000 worth of equity shares, the monetary value is fixed at $100,000, even if the share price changes.

b. Physical settlement by transfer of $100,000 in cash in exchange for the issuer's equity shares, the monetary value is fixed at $100,000, even if the fair value of the equity shares changes.

c. Net share settlement by issuance of a variable number of shares based on the change in the fair value of a fixed number of the issuer's equity shares, the monetary value varies based on the number of shares required to be issued to satisfy the obligation. For example, if the exercise price of a net-share-settled written put option entitling the holder to put back 10,000 of the issuer's equity shares is $11, and the fair value of the issuing entity's equity shares on the exercise date decreases from $13 to $10, that change in fair value of the issuer's shares increases the monetary value of that obligation at settlement from $0 to $10,000 ($110,000 minus $100,000), and the option would be settled by issuance of 1,000 shares ($10,000 divided by $10).

d. Net cash settlement based on the change in the fair value of a fixed number of the issuer's equity shares, the monetary value varies in the same manner as in (c) for net share settlement, but the obligation is settled with cash. In a net-cash-settled variation of the previous example, the option would be settled by delivery of $10,000.

e. Settlement by issuance of a variable number of shares that is based on variations in something other than the issuer's equity shares, the monetary value varies based on changes in the price of another variable. For example, a net-share-settled obligation to deliver the number of shares equal in value at settlement to the change in fair value of 100 ounces of gold has a monetary value that varies based on the price of gold and not on the price of the issuer's equity shares.

Question 18 **What are examples of monetary values that do not change and are settled in a variable number of shares that the issuer must or may settle by issuing a variable number of shares?**

## Excerpt from Accounting Standards Codification

**Distinguishing Liabilities from Equity — Overall**

*Implementation Guidance*

*Certain Obligations to Issue a Variable Number of Shares*

*Obligation to Issue Shares with Monetary Value Based on a Fixed Monetary Amount Known at Inception*

*480-10-55-22*

Certain financial instruments embody obligations that require (or permit at the issuer's discretion) settlement by issuance of a variable number of the issuer's equity shares that have a value equal to a fixed monetary amount. For example, an entity may receive $100,000 in exchange for a promise to issue a sufficient number of its own shares to be worth $110,000 at a future date. The number of shares required to be issued to settle that unconditional obligation is variable, because that number will be determined by the fair value of the issuer's equity shares on the date of settlement. Regardless of the fair value of the shares on the date of settlement, the holder will receive a fixed monetary value of $110,000. Therefore, the instrument is classified as a liability under paragraph 480-10-25-14(a). Some share-settled obligations of this kind require that the variable number of shares to be issued be based on an average market price for the shares over a stated period of time, such as the average over the last 30 days before settlement, instead of the fair value of the issuer's equity shares on the date of settlement. Thus, if the average market price differs from the share price on the date of settlement, the monetary value of the obligation is not entirely fixed at inception and is based, in small part, on variations in the fair value of the issuer's equity shares. Although the monetary amount of the obligation at settlement may differ from the initial monetary value because it is tied to the change in fair value of the issuer's equity shares over the last 30 days before settlement, the monetary value of the obligation is predominantly based on a fixed monetary amount known at inception. The obligation is classified as a liability under paragraph 480-10-25-14(a). Upon issuance of the shares to settle the obligation, equity is increased by the amount of the liability and no gain or loss is recognized for the difference between the average and the ending market price.

*Unconditional Obligation that Must Be Either Redeemed for Cash or Settled by Issuing Shares*

*480-10-55-27*

Some instruments do not require the issuer to transfer assets to settle the obligation but, instead, unconditionally require the issuer to settle the obligation either by transferring assets or by issuing a variable number of its equity shares. Because those instruments do not require the issuer to settle by transfer of assets, those instruments are not within the scope of paragraphs 480-10-25-4 through 25-6. However, those instruments may be classified as liabilities under paragraph 480-10-25-14.

*480-10-55-28*

For example, an entity may issue 1 million shares of cumulative preferred stock for cash equal to the stock's liquidation preference of $25 per share. The entity is required either to redeem the shares on the fifth anniversary of issuance for the issuance price plus any accrued but unpaid dividends in cash or to settle by issuing sufficient shares of its common stock to be worth $25 per share. Preferred stockholders are entitled to a mandatory dividend, payable quarterly at a rate of 6 percent per annum based on the $25 per share liquidation preference ($1.50 per share annually). The dividend is cumulative and is payable in cash or in a sufficient number of additional shares of the preferred stock based on the liquidation preference of $25 per share. That obligation does not represent an unconditional obligation to transfer assets and, therefore, is not a mandatorily redeemable financial instrument subject to paragraph 480-10-25-4. But it is still a liability, under paragraph 480-10-25-14(a), because the preferred shares embody an unconditional obligation that the issuer may settle by issuing a variable number of its equity shares with a monetary value that is fixed and known at inception. Because the preferred shares are liabilities, payments to holders are reported as interest cost, and accrued but not-yet-paid payments are part of the liability for the shares.

Question 19 **What are examples of what it means to vary with something other than changes in the fair value of the issuer's equity shares?**

## Excerpt from Accounting Standards Codification

**Distinguishing Liabilities from Equity — Overall**

*Implementation Guidance*

*Certain Obligations to Issue a Variable Number of Shares*

*Obligation to Issue Shares with Monetary Value Based on Something Other than Changes in the Fair Value of the Issuer's Equity*

*480-10-55-23*

An entity's guarantee of the value of an asset, liability, or equity security of another entity may require or permit settlement in the entity's equity shares. For example, an entity may guarantee that the value of a counterparty's equity investment in another entity will not fall below a specified level. The guarantee contract requires that the guarantor stand ready to issue a variable number of its shares whose fair value equals the deficiency, if any, on a specified date between the guaranteed value of the investment and its current fair value. Upon issuance, unless the guarantee is accounted for as a derivative instrument, the obligation to stand ready to perform is a liability addressed by Topic 460. If, during the period the contract is outstanding, the fair value of the guaranteed investment falls below the specified level, absent an increase in value, the guarantor will be required to issue its equity shares. At that point in time, the liability recognized in accordance with that Topic would be subject to the requirements of Topic 450. This Subtopic establishes that, even though the loss contingency is settleable in equity shares, the obligation under that Topic is a liability under paragraph 480-10-25-14(b) until the guarantor settles the obligation by issuing its shares. That is because the guarantor's conditional obligation to issue shares is based on the value of the counterparty's equity investment in another entity and not on changes in the fair value of the guarantor's equity instruments.

*480-10-55-24*

If this example were altered so that the monetary value of the obligation is based on the deficiency on a specified date between the guaranteed value of the investment in another entity and its current fair value plus .005 times the change in value of 100 of the guarantor's equity shares, the monetary value of the obligation would not be solely based on variations in something other than the fair value of the issuer's (guarantor's) equity shares.

*480-10-55-25*

However, the monetary value of the obligation would be predominantly based on variations in something other than the fair value of the issuer's (guarantor's) equity shares and, therefore, the obligation would be classified as a liability under paragraph 480-10-25-14(b). That obligation differs in degree from the obligation under a contract that is indexed in part to the issuer's shares and in part (but not predominantly) to something other than the issuer's shares (commonly called a dual-indexed obligation). The latter contract is not within the scope of this Subtopic. That paragraph applies only if the monetary value of an obligation to issue equity shares is based solely or predominantly on variations in something other than the fair value of the issuer's equity shares. For example, an instrument meeting the definition of a derivative instrument that requires delivery of a variable number of the issuer's equity shares with a monetary value equaling changes in the price of a fixed number of the issuer's shares multiplied by the Euro/U.S. dollar exchange rate embodies an obligation with a monetary value that is based on variations in both the issuer's share price and the foreign exchange rate and, therefore, is not within the scope of this Subtopic. (However, that instrument would be a derivative instrument under Topic 815. Paragraphs 815-10-15-74(a) and 815-10-15-75(b) address derivative instruments that are dual indexed and require an issuer to report those instruments as derivative instrument liabilities or assets.)

Question 20 **What are examples of what it means to have a monetary value move in the opposite direction as the value of the issuer's equity shares?**

**Excerpt from Accounting Standards Codification**

**Distinguishing Liabilities from Equity — Overall**

***Implementation Guidance***

***Certain Obligations to Issue a Variable Number of Shares***

***Obligation to Issue Shares with Monetary Value Based on Variations Inversely Related to Changes in the Fair Value of the Issuer's Equity Shares***

*480-10-55-26*

A freestanding forward purchase contract, a freestanding written put option, or a net written option (otherwise similar to the example in paragraphs 480-10-55-18 through 55-19) that must or may be net share settled is a liability under paragraph 480-10-25-14(c), because the monetary value of the obligation to deliver a variable number of shares embodied in the contract varies inversely in relation to changes in the fair value of the issuer's equity shares; when the issuer's share price decreases, the issuer's obligation under those contracts increases. Such a contract is measured initially and subsequently at fair value (with changes in fair value recognized in earnings) and classified as a liability or an asset, depending on the fair value of the contract on the reporting date. A net written or net purchased option or a zero-cost collar similar to the examples in paragraphs 480-10-55-18 through 55-20 that must or may be net share settled is classified as a liability (or asset) under paragraph 480-10-25-14(c), because the monetary value of the issuer's obligation to deliver a variable number of shares under the written put option varies inversely in relation to changes in the fair value of the issuer's share price. The purchased call option element of that freestanding instrument does not embody an obligation to deliver a variable number of shares and does not affect the classification of the entire instrument when applying that paragraph. In addition, a freestanding purchased call option is not within the scope of this Subtopic because it does not embody an obligation.

## A.9 Summary of application of ASC 480 to specific instruments

The following table summarizes the accounting requirements for instruments indexed to, and potentially settled in, common shares (that are not redeemable). While a useful reminder, it should not be relied upon exclusively in determining the appropriate accounting for an instrument. Unless otherwise indicated, the example instruments are assumed to (1) have a fixed strike price, (2) are not considered to be dual-indexed and (3) the underlying share is not itself redeemable.

| Instrument | Guidance | Classification | Measurement and recognition |
|---|---|---|---|
| **Mandatorily redeemable shares** | | | |
| Fixed redemption dates and amounts | ASC 480 | Liability | Initial recognition at fair value; accrete to redemption amount |
| Settlement date or amount not fixed | ASC 480 | Liability | Initial recognition at fair value; subsequently carried at current settlement amount |
| Contingently or optionally redeemable shares | SEC staff's redeemable equity guidance | Equity (temporary equity for public companies) | Refer to ASC 480-10-S99-3A |

| Instrument | Guidance | Classification | Measurement and recognition |
|---|---|---|---|
| **Physically settled forward purchase contract** | | | |
| Fixed settlement date and amount | ASC 480 | Liability | Initial recognition at the fair value of the underlying shares; accrete to redemption amount |
| Settlement date or amount not fixed | ASC 480 | Liability | Initial recognition at the fair value of the underlying shares; subsequently carried at current settlement amount |
| **Other contracts** | | | |
| Other forward purchase contracts (that provide for net cash or net share settlement) | ASC 480 | Asset/liability | Initially recognized and subsequently carried at fair value |
| Forward sale contract | ASC 815 and ASC 815-40 | Equity or asset/liability | Initially recognized at fair value; assets/liabilities are subsequently carried at fair value |
| Purchased collar (purchased put and written call) | ASC 815 and ASC 815-40 | Equity or asset/liability | Initially recognized at fair value; assets and liabilities subsequently carried at fair value |
| Written collar (purchased call and written put) | ASC 480 | Asset/liability | Initially recognized at fair value; assets and liabilities subsequently carried at fair value |
| Share-settled debt | ASC 480 | Liability | Initially recognized and subsequently carried at fair value unless other accounting guidance specifies another measurement attribute (e.g. ASC 835-30) |
| Purchased call option | ASC 815 and ASC 815-40 | Equity or asset | Initially recognized at fair value; assets are subsequently carried at fair value |
| Purchased put option | ASC 815 and ASC 815-40 | Equity or asset | Initially recognized at fair value; assets are subsequently carried at fair value |
| Written call option (e.g., warrant) | ASC 815 and ASC 815-40 | Equity or liability | Initially recognized at fair value; liabilities are subsequently carried at fair value |
| Written put option | ASC 480 | Liability | Initially recognized and subsequently carried at fair value |

# B Contracts in an entity's own equity

## B.1 Summary and overview

This appendix broadly discusses the application of ASC 815-40, *Derivatives and Hedging — Contracts in Entity's Own Equity*. This guidance was primarily codified from former EITF 07-5 and EITF 00-19.

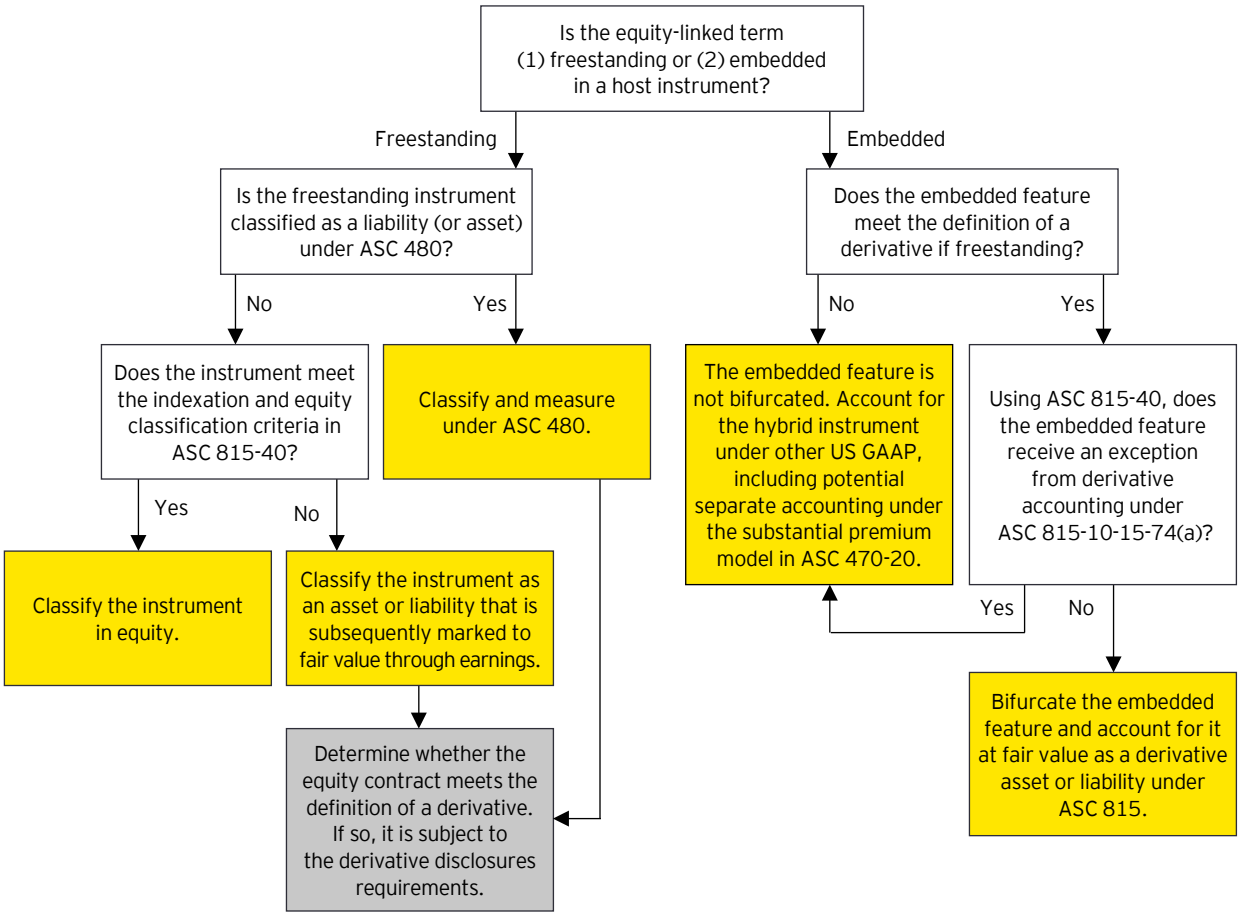
Companies issue freestanding contracts or embedded features that are indexed to, and can be fully or partially settled in, their own stock. Examples of such freestanding instruments include written call options (warrants), purchased call options, purchased put options and forward sale contracts. Examples of such embedded instruments are conversion features (embedded written call options) and mandatory share settlement features (embedded forward sale contracts).

Those instruments are referred to as "equity contracts" or "equity-linked" instruments or features in this publication. An equity contract is a freestanding financial instrument (other than an outstanding equity share) whose underlying is based on an issuer's own equity securities (e.g., common stock, preferred shares) such that its value fluctuates with changes in the underlying equity price and related factors (e.g., volatility of the share). Certain equity contracts meet the definition of a derivative pursuant to ASC 815 and are referred to as equity derivatives in this publication.

ASC 815-40 provides guidance to determine whether (1) a freestanding instrument should be accounted for as equity or as an asset/liability contract and (2) an embedded equity-linked feature that meets the definition of a derivative requires an exception from derivative accounting (bifurcation) under ASC 815. Equity contracts and bifurcated embedded features classified as assets or liabilities pursuant to ASC 815 are generally recorded at fair value with changes in fair value included in earnings. The accounting for the host instrument in a hybrid instrument should follow other classification and measurement guidance in this publication.

## B.1.1 Overall process for considering ASC 815-40

ASC 815-40 is applied when accounting for freestanding equity contracts and embedded equity-linked features. The following flowchart summarizes the relevant accounting evaluation:




## B.1.2 Overview of ASC 815-40

To qualify for equity classification (or non-bifurcation, if embedded), the instrument (or embedded feature) must be both (1) indexed to the issuer's stock and (2) meet the requirements of the equity classification guidance.

Determining whether the instrument (or embedded feature) is indexed to the entity's own equity requires two steps:

- Step 1 — Evaluate any exercise contingencies — Exercise contingencies based on an observable market or index that is not based on the issuer's stock or operations preclude an instrument from being considered indexed to an entity's own stock.
- Step 2 — Evaluating whether each settlement provision is consistent with a fixed-for-fixed equity instrument — Any settlement amount not equal to the difference between the fair value of a fixed number of the entity's equity shares and a fixed monetary amount precludes an instrument from being considered indexed to an entity's own stock (with a certain exception for variables that would be inputs to the valuation model for a fixed-for-fixed forward or option contract).

Those two steps, which are outlined in ASC 815-40-15-5 through 15-8 with implementation guidance in ASC 815-40-55-26 through 55-48, are generally referred to in this publication as the "indexation guidance."

An instrument (or embedded feature) that is indexed to the entity's own equity should also be evaluated to determine whether the form of contractual settlement supports a conclusion of equity classification. If an issuer is able, in all circumstances, to settle the contract in net shares or by physical settlement (i.e., the gross exchange of the contractual shares for the contractual consideration), the contract qualifies for equity classification. If a contract must be net cash settled, or such settlement is (1) a contractual alternative that is not within the control of the issuer or (2) presumed under the guidance, the contract is precluded from being classified in equity. In determining whether an entity controls settlement in shares, the contractual provisions as well as the entity's current capital structure and any legal barriers to share settlement should be considered.

The evaluation of settlement methods is outlined in ASC 815-40-25-1 through 25-43, and related implementation guidance in ASC 815-40-55-2 through 55-18, and is referred to in this publication as the "equity classification guidance."

## B.2 Scope of ASC 815-40

**Excerpt from Accounting Standards Codification**

**Derivatives and Hedging — Contracts in Entity's Own Equity**

***Overview and Background***

***815-40-05-1***

For a number of business reasons, an entity may enter into contracts that are indexed to, and sometimes settled in, its own stock. This Subtopic provides guidance on accounting for such contracts. Examples of these contracts include put and call options (both written and purchased) and forward contracts (for both sales and purchases). These contracts may be settled using a variety of settlement methods, or the issuing entity or counterparty may have a choice of settlement methods. The contracts may be either freestanding or embedded in another financial instrument.

**Derivatives and Hedging — Contracts in Entity's Own Equity**

***Scope and Scope Exceptions***

***815-40-15-1***

The guidance in this Subtopic applies to all entities.

***815-40-15-2***

The guidance in this Subtopic applies to freestanding contracts that are potentially indexed to, and potentially settled in, an entity's own stock.

***815-40-15-2A***

The scope of this Subtopic includes security price guarantees or other financial instruments indexed to, or otherwise based on, the price of the entity's stock that are issued in connection with a business combination and that are accounted for as contingent consideration.

***815-40-15-3***

The guidance in this Subtopic does not apply to any of the following:

a. Subparagraph superseded by Accounting Standards Update No. 2020-06.

b. Contracts that are issued to compensate grantees in a share-based payment arrangement within the scope of Topic 718

c. Subparagraph superseded by Accounting Standards Update No. 2018-07.

d. A written put option and a purchased call option embedded in the shares of a noncontrolling interest of a consolidated subsidiary if the arrangement is accounted for as a financing under the guidance beginning in paragraph 480-10-55-53

e. Financial instruments that are within the scope of Topic 480 (see paragraph 815-40-15-12).

*815-40-15-4*

The guidance in this Subtopic applies to derivatives embedded in contracts in analyzing the embedded feature under paragraphs 815-15-25-1(c) and 815-15-25-14 as though it were a freestanding instrument (as further discussed in paragraphs 815-40-25-39 through 25-40).

*815-40-15-5*

The guidance in this paragraph through paragraph 815-40-15-8 applies to any freestanding financial instrument or embedded feature that has all the characteristics of a derivative instrument (see the guidance beginning in paragraph 815-10-15-83). That guidance applies for the purpose of determining whether that instrument or embedded feature qualifies for the first part of the scope exception in paragraph 815-10-15-74(a). That guidance does not address the second part of the scope exception in paragraph 815-10-15-74(a), which is addressed in Section 815-40-25. The guidance also applies to any freestanding financial instrument that is potentially settled in an entity's own stock, regardless of whether the instrument has all the characteristics of a derivative instrument for purposes of determining whether the instrument is within the scope of this Subtopic.

*815-40-15-5A*

The guidance in this paragraph through paragraph 815-40-15-8 does not apply to share-based payment awards within the scope of Topic 718 for purposes of determining whether instruments are classified as liability awards or equity awards under that Topic. Equity-linked financial instruments issued to investors for purposes of establishing a market-based measure of the grant-date fair value of employee stock options are not within the scope of Topic 718 themselves. Consequently, the guidance in this paragraph through paragraph 815-40-15-8 applies to such market-based share-based payment stock option valuation instruments for purposes of making the determinations described in paragraph 815-40-15-5.

*815-40-15-5B*

The guidance in paragraphs 815-40-15-5 through 15-8 shall be applied to the appropriate unit of accounting, as determined under other applicable U.S. generally accepted accounting principles. For example, if an entity issues two freestanding financial instruments and concludes that those two instruments are required to be accounted for separately, then the guidance in paragraphs 815-40-15-5 through 15-8 shall be applied separately to each instrument. In contrast, if an entity issues two freestanding financial instruments and concludes that those two instruments are required to be linked and accounted for on a combined basis as a single financial instrument (for example, pursuant to the guidance in paragraph 815-10-15-8), then the guidance in paragraphs 815-40-15-5 through 15-8 shall be applied to the combined financial instrument.

*815-40-15-6*

The guidance in this paragraph applies to both the issuer and the holder of the instrument. Outstanding instruments within the scope of the guidance in paragraphs 815-40-15-5 through 15-8 shall always be considered issued for accounting purposes, except as discussed in the next sentence. Lock-up options shall not be considered issued for accounting purposes unless and until the options become exercisable.

**Derivatives and Hedging — Contracts in Entity's Own Equity**

*Recognition*

*815-40-25-39*

For purposes of evaluating under paragraph 815-15-25-1 whether an embedded derivative indexed to an entity's own stock would be classified in stockholders' equity if freestanding, the requirements of paragraphs 815-40-25-7 through 25-30 and 815-40-55-2 through 55-6 do not apply if the hybrid contract is a convertible debt instrument in which the holder may only realize the value of the conversion option by exercising the option and receiving the entire proceeds in a fixed number of shares or the equivalent amount of cash (at the discretion of the issuer).

*815-40-25-40*

However, the requirements of paragraphs 815-40-25-7 through 25-30 and 815-40-55-2 through 55-6 do apply if an issuer is evaluating whether any other embedded derivative is an equity instrument and thereby excluded from the scope of Subtopic 815-10.

*815-40-25-41*

Instruments that provide the holder with an option to convert into a fixed number of shares (or equivalent amount of cash at the discretion of the issuer) for which the ability to exercise the option is based on the passage of time or a contingent event shall qualify for the exceptions included in paragraph 815-40-25-39. Standard antidilution provisions contained in an instrument do not preclude a conclusion that the instrument is convertible into a fixed number of shares.

*815-40-25-42*

Convertible preferred stock with a mandatory redemption date may qualify for the exception included in paragraph 815-40-25-39 if the economic characteristics indicate that the instrument is more akin to debt than equity. An entity shall consider the guidance in paragraph 815-15-25-17 in assessing whether the instrument is more akin to debt or equity. That paragraph explains that, if the preferred stock is more akin to equity than debt, an equity conversion feature would be clearly and closely related to that host instrument.

Instruments in the scope of ASC 480 are outside the scope of ASC 815-40. Therefore, written put options and forward agreements to repurchase the issuer's shares will generally be outside the scope of ASC 815-40 as they are classified as liabilities (or assets in certain circumstances) pursuant to ASC 480. Other equity contracts (e.g., written call options) may also be within the scope of ASC 480 if the underlying share is redeemable. Refer to Appendix A for guidance on instruments in the scope of ASC 480.

ASC 815-10-15-74(a) provides an exception to derivative accounting for "contracts issued or held by that reporting entity that are both (1) indexed to its own stock and (2) classified in stockholders' equity in its statement of financial position." For purposes of determining whether the scope exception in ASC 815-10-15-74(a) is met, the guidance in ASC 815-40 should be applied. Further, pursuant to ASC 815-10-15-76, temporary equity is considered stockholders' equity for purposes of applying ASC 815-10-15-74(a) even though the instrument may be required by the SEC to be displayed outside of permanent equity pursuant to ASC 480-10-S99.

Instruments that meet the definition of a derivative but do not qualify for a scope exception must be classified as assets or liabilities and measured at fair value in accordance with ASC 815. The provisions of ASC 815-40 should be applied to determine the classification (i.e., as equity or as an asset or liability) for freestanding financial instruments that are not classified as an asset or liability pursuant to ASC 480 or ASC 815.

In addition, the following are specifically included within the scope of ASC 815-40:

- Security price guarantees or other financial instruments indexed to, or otherwise based on, the price of the issuer's own stock that are issued in connection with a business combination and that are accounted for as contingent consideration (pursuant to ASC 805-30-25-6)
- Certain contracts issued to acquire goods or services from nonemployees where performance has occurred, as discussed below

ASC 815-40 explicitly excludes any of the following:

- A written put option and a purchased call option embedded in the shares of a noncontrolling interest of a consolidated subsidiary if the arrangement is accounted for as a financing pursuant to ASC 480-10-55-53
- Share-based payments within the scope of ASC 718
- Certain contracts issued to acquire goods or services from nonemployees where performance has not occurred (discussed further below)
- Financial instruments within the scope of ASC 480

ASC 718-10-35-10 states that a freestanding financial instrument that is subject to ASC 718 continues to be subject to that guidance for its life, unless its terms are modified after a grantee:

- Is no longer an employee
- Vests in the award and is no longer providing goods or services
- Vests in the award and is no longer a customer

Refer to section 5.5 of our FRD publication, ***Share-based payment***, for further guidance.

Pursuant to ASC 815-40-15-6, outstanding instruments within the scope of ASC 815-40 are always considered issued for accounting purposes, except for certain lock-up options[76] sometimes exchanged in anticipation of a planned business combination. As a result, we generally believe that if an entity has a contractual obligation to issue instruments that are indexed to the entity's shares as a result of a contingent event, those instruments should be considered outstanding for accounting purposes prior to the occurrence of the contingent event (i.e., a contingently issuable equity contract is effectively the same as a contingently exercisable equity contract).

Refer to Question 1 in section B.9 — How should a contingently issuable contract be considered pursuant to ASC 815-40?

[76] Such lock-up options are contingently exercisable options to purchase equity securities of another party to a business combination, at favorable prices, to encourage successful completion of that combination. If the merger is consummated as proposed, the options expire unexercised. If, however, a specified event occurs that interferes with the planned business combination, the options become exercisable.

## B.3 The indexation guidance (ASC 815-40-15)

### B.3.1 Introduction

**Excerpt from Accounting Standards Codification**

**Derivatives and Hedging — Contracts in Entity's Own Equity**

*Scope and Scope Exceptions*

*815-40-15-7*

An entity shall evaluate whether an equity-linked financial instrument (or embedded feature), as discussed in paragraphs 815-40-15-5 through 15-8 is considered indexed to its own stock within the meaning of this Subtopic and paragraph 815-10-15-74(a) using the following two-step approach:

a. Evaluate the instrument's contingent exercise provisions, if any.

b. Evaluate the instrument's settlement provisions.

ASC 815-40-15-7 includes two steps for evaluating whether an instrument or feature is deemed indexed to the entity's own equity. In the first step, the issuer evaluates any exercise contingencies. In the second step, the issuer evaluates the instrument's settlement provisions.

### B.3.2 Step 1 — Evaluating exercise contingencies

In applying the first step of the indexation guidance, if there are no exercise contingencies (i.e., the instrument or feature is immediately exercisable or exercisable only with the passage of time), Step 1 is not applicable and Step 2 would be considered.

In a freestanding instrument, if there are multiple exercise contingencies, the failure of a single contingency to meet the requirements of Step 1 results in the instrument not being considered indexed to the entity's stock. However, in an embedded equity contract with multiple exercise contingencies, there may be more latitude in determining the unit of analysis for the bifurcation evaluation. One approach would consider the embedded equity-linked feature to be a single term with multiple exercise contingencies, in which case the entire equity-linked feature would fail Step 1 if a single contingency fails. A second approach would view the hybrid instrument as containing multiple embedded equity-linked features, each with a single exercise contingency. Pursuant to this approach, if an exercise contingency fails the indexation guidance, only the defined equity-linked feature associated with that contingency would be affected. Refer to section 2.2.3.1 for further discussion of these concepts.

**Excerpt from Accounting Standards Codification**

**Derivatives and Hedging — Contracts in Entity's Own Equity**

*Glossary*

*815-40-20*

*Exercise Contingency*

A provision that entitles the entity (or the counterparty) to exercise an equity-linked financial instrument (or embedded feature) based on changes in an underlying, including the occurrence (or nonoccurrence) of a specified event. Provisions that accelerate the timing of the entity's (or the counterparty's) ability to exercise an instrument and provisions that extend the length of time that an instrument is exercisable are examples of exercise contingencies.

**Derivatives and Hedging — Contracts in Entity's Own Equity**

***Scope and Scope Exceptions***

***815-40-15-7A***

An exercise contingency shall not preclude an instrument (or embedded feature) from being considered indexed to an entity's own stock provided that it is not based on either of the following:

a. An observable market, other than the market for the issuer's stock (if applicable)

b. An observable index, other than an index calculated or measured solely by reference to the issuer's own operations (for example, sales revenue of the issuer; earnings before interest, taxes, depreciation, and amortization of the issuer; net income of the issuer; or total equity of the issuer).

If the evaluation of Step 1 (this paragraph) does not preclude an instrument from being considered indexed to the entity's own stock, the analysis shall proceed to Step 2 (see paragraph 815-40-15-7C).

***815-40-15-7B***

If an instrument's strike price or the number of shares used to calculate the settlement amount would be adjusted upon the occurrence of an exercise contingency, the exercise contingency shall be evaluated under Step 1 (see the preceding paragraph) and the potential adjustment to the instrument's settlement amount shall be evaluated under Step 2 (see the guidance beginning in the following paragraph).

In applying the indexation guidance, it is important to determine whether a feature is an exercise contingency (subject to Step 1 of the indexation guidance) or an adjustment to the settlement amount (subject to Step 2 of the indexation guidance). In many cases, a term may act as an on/off switch for the exercise of an instrument, which would generally be an exercise contingency.

The following table includes examples of provisions within an equity contract that are subject to the evaluation under ASC 815-40.

| Warrants | Provisions | Evaluation |
|---|---|---|
| 1. | The holder may purchase 100 shares, but the warrant is exercisable only if the issuer's revenues exceed $100 million. | This provision operates as an exercise contingency and passes Step 1 because the exercise contingency is based on an index calculated or measured solely by reference to the issuer's own operations. |
| 2. | The holder may purchase (1) 50 shares regardless of the issuer's revenues, (2) 100 shares if the issuer's revenues exceed $100 million or (3) 150 shares if the issuer's revenues exceed $150 million. | The issuer's revenues do not affect the instrument's exercisability (i.e., the instrument can always be exercised for 50 shares regardless of the amount of revenue). Instead, it affects the settlement amount, by increasing the number of shares that may be purchased upon exercise of the warrant if revenues exceed $100 million. The contingency affects the value of the contract (on more of a sliding scale) and does not simply act as an on/off switch (triggering a settlement or no settlement). The effect of the contingency on the settlement amount should be evaluated pursuant to Step 2. |
| 3. | The holder may purchase (1) 100 shares if the issuer's revenues exceed $100 million or (2) 150 shares if revenues exceed $150 million. | The contingency is both an on/off switch and a sliding scale affecting the value of the contract. The on/off switch (revenues in excess of $100 million) should be evaluated pursuant to Step 1. The exercise contingency does not preclude the instrument from being considered indexed to the issuer's stock because the contingency is based on an index measured solely by reference to the entity's operations. However, the potential adjustment in the number of shares issuable under the instrument (for revenues in excess of $150 million) should be evaluated pursuant to Step 2. |

The need to distinguish exercise contingencies from adjustments to the settlement amount can create complexity in determining the unit of accounting. For example, assume an entity issues one warrant exercisable for 100 shares if the issuer's revenues are above $100 million and a second warrant that becomes exercisable for 50 shares if revenues are above $150 million. The combination of warrants results in the same economics as example 3 described in the preceding table.[77] If the warrants were evaluated separately, each warrant would be considered to have a permitted exercise contingency and settlement amount and thus indexed to the issuer's own stock pursuant to the indexation guidance. However, if the warrants were combined for accounting purposes, such as example 3 in the previous table, the combined instrument would be considered to include a potential adjustment to the settlement amount that should be evaluated pursuant to Step 2 before a conclusion could be reached pursuant to the indexation guidance.

To determine whether the instruments should be combined into a single unit of accounting, ASC 815-10-15-8 should generally be considered. If it is determined that two freestanding financial instruments are required to be linked and accounted for on a combined basis as a single financial instrument, the indexation guidance should be applied to the combined financial instrument, as discussed directly in ASC 815-40-15-5B.

The indexation guidance does not provide comprehensive guidance on how broadly to interpret an "index calculated or measured solely by reference to the issuer's own operations," when evaluating an exercise contingency. Therefore, we generally believe that determination should be based on the individual facts and circumstances.

For example, we generally believe that it is reasonable to conclude that an exercise contingency based on a change in credit rating of the issuer is "measured solely by reference to the issuer's own operations," because an issuer's creditworthiness is based on its ability to meet its financial commitments. While external factors also would affect a specific entity's credit rating (e.g., the general economic environment and conditions in the industry in which the entity operates), those factors should be considered in the context of their effect on the issuer (which chooses the industry in which to compete) and the likelihood that the specific issuer would default on its debt.

Another example of an exercise contingency that would be considered "measured solely by reference to an issuer's own operations" is one based on an entity-specific activity or transaction, such as a financing transaction or change in control. This concept is illustrated in Example 2 in ASC 815-40-55-26 in the context of an entity's IPO.

### B.3.3 Step 2 — Evaluating the settlement amount

The second step of the indexation guidance requires an analysis of features that affect the value distributed upon settlement. It is premised on a basic principle that the settlement amount should be based on an exchange of a fixed number of shares for a fixed amount of consideration. However, there are exceptions to this general rule.

This part of the guidance also addresses certain provisions in many equity contracts that are documented in standardized contracts and forms published by the ISDA (refer to section 1.3.1). Those documents may stipulate that on the occurrence of certain extraordinary events (e.g., merger, tender offer, nationalization, insolvency, delisting), the contract (and thus the settlement amount) may be modified or terminated for a calculated settlement amount that may vary. These adjustments (as with any adjustments in an equity contract) are evaluated in light of the fixed-for-fixed criteria and its exceptions.

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[77] An issuer could achieve the same economics in several different combinations of instruments. As another example, an issuer could issue one warrant that was exercisable for 100 shares but only if revenues were between $100 million and $150 million and a second warrant exercisable for 150 shares only if revenues exceeded $150 million. The two instruments should be evaluated for potential combination for accounting purposes.

### B.3.3.1 Fixed strike price, number of shares and fixed monetary amount

**Excerpt from Accounting Standards Codification**

**Derivatives and Hedging — Contracts in Entity's Own Equity**

*Scope and Scope Exceptions*

*815-40-15-7C*

Unless paragraph 815-40-15-7A precludes it, 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.

For example, an issued share option that gives the counterparty a right to buy a fixed number of the entity's shares for a fixed price or for a fixed stated principal amount of a bond issued by the entity shall be considered indexed to the entity's own stock.

*815-40-15-7D (first part of paragraph)*

An instrument's strike price or the number of shares used to calculate the settlement amount are not fixed if its terms provide for any potential adjustment, regardless of the probability of such adjustment(s) or whether such adjustments are in the entity's control.

Examples of instruments that meet the strict fixed-for-fixed criteria include:

- A warrant permitting the holder to buy 100 shares of the issuer's stock from the issuer at a fixed price of $15 per share
- A forward contract that requires the issuer to sell (and the counterparty to buy) 100 shares of the issuer's stock for a fixed price of $10 per share
- A convertible debt instrument that permits the holder to convert a specified face amount of the debt instrument into a fixed number of shares of the issuer's stock

The fixed-for-fixed criteria describes a settlement amount that is essentially the intrinsic value of the equity contract. The intrinsic value is the difference between the strike price in an option (or contract price in a forward) and the fair value of the underlying share on a given date. For example, in the warrant above, if the stock price were $18 on the date of exercise, the settlement amount would be $300 (100 shares x [$18 fair value minus $15 strike price]).

With respect to examples 1 through 3 described in the table within section B.3.2, only one of the warrants would be indexed to the issuer's stock. Assume that (1) each contract had a strike price of $10 per share, (2) there are no other features adjusting the number of shares or strike price and (3) the current fair value of a share is $12. The following table illustrates the step 2 analysis of these warrants.

| Warrants | Provisions | Step 2 evaluation |
|---|---|---|
| 1. | The holder may purchase 100 shares, but the warrant is exercisable only if the issuer's revenues exceed $100 million. | The contract meets the fixed-for-fixed criteria as once it becomes exercisable, it is exercised for a fixed number of shares (100 shares) at a fixed strike price ($1,000) with a settlement amount of $200 (100 shares x [$12 fair value minus $10 strike price]). |
| 2. | The holder may purchase (1) 50 shares regardless of the issuer's revenues, (2) 100 shares if the issuer's revenues exceed $100 million or (3) 150 shares if the issuer's revenues exceed $150 million. | The contract does not meet the fixed-for-fixed criteria because it allows for multiple settlement amounts that vary based on revenues of the issuer, which settles for $100, $200 or $300. |
| 3. | The holder may purchase (1) 100 shares if the issuer's revenues exceed $100 million or (2) 150 shares if revenues exceed $150 million. | The contract does not meet the fixed-for-fixed criteria because it allows for multiple settlement amounts that vary based on revenues of the issuer. Which settles for $0, $200 or $300. However, if the contract were to allow for a settlement of only $0 or $200, the settlement alternatives of $0 to $200 could be viewed as an allowable exercise contingency (i.e., revenues viewed as an on/off switch) and not as a variable or adjustment to the settlement amount. |

As discussed above, many equity contracts use ISDA documentation and have terms that may require the settlement amount to change upon specified events (e.g., through a change in either the strike price or the number of shares). In addition, many transactions include antidilution or other protective provisions that may cause the settlement amount to change.

For example, many convertible debt instruments provide for an adjustment to the conversion ratio for any cash dividends (or cash dividends in excess of a specified level). All of those examples violate the strict fixed-for-fixed criteria in the indexation guidance described above. Moreover, the indexation guidance states that it does not matter how likely it is an adjustment will occur or even if the occurrence is entirely within the issuer's control.

Importantly, however, there is an exception under which certain adjustment features that violate the strict fixed-for-fixed criteria may still be considered indexed to the entity's shares, as discussed in section B.3.3.2.

Refer to Question 2 in section B.9 — How is a warrant or conversion option where the conversion ratio changes over time based on a contractual schedule evaluated pursuant to the indexation guidance?

### B.3.3.2 Adjustments solely based on non-levered inputs to a fixed-for-fixed instrument

**Excerpt from Accounting Standards Codification**

**Derivatives and Hedging — Contracts in Entity's Own Equity**

*Scope and Scope Exceptions*

*815-40-15-7D (second part of paragraph)*

... If the instrument's strike price or the number of shares used to calculate the settlement amount are not fixed, the instrument (or embedded feature) shall still be considered indexed to an entity's own stock if the only variables that could affect the settlement amount would be inputs to the fair value of a fixed-for-fixed forward or option on equity shares (provided that paragraph 815-40-15-7A does not preclude such a conclusion).

*815-40-15-7E*

A fixed-for-fixed forward or option on equity shares has a settlement amount that is equal to the difference between the price of a fixed number of equity shares and a fixed strike price. The fair value inputs of a fixed-for-fixed forward or option on equity shares may include the entity's stock price and additional variables, including all of the following:

a. Strike price of the instrument

b. Term of the instrument

c. Expected dividends or other dilutive activities

d. Stock borrow cost

e. Interest rates

f. Stock price volatility

g. The entity's credit spread

h. The ability to maintain a standard hedge position in the underlying shares.

Determinations and adjustments related to the settlement amount (including the determination of the ability to maintain a standard hedge position) shall be commercially reasonable.

*815-40-15-7F*

An instrument (or embedded feature) shall not be considered indexed to the entity's own stock if its settlement amount is affected by variables that are extraneous to the pricing of a fixed-for-fixed option or forward contract on equity shares. An instrument (or embedded feature) shall not be considered indexed to the entity's own stock if either:

a. The instrument's settlement calculation incorporates variables other than those used to determine the fair value of a fixed-for-fixed forward or option on equity shares.

b. The instrument contains a feature (such as a leverage factor) that increases exposure to the additional variables listed in the preceding paragraph in a manner that is inconsistent with a fixed-for-fixed forward or option on equity shares.

*815-40-15-7G*

Standard pricing models for equity-linked financial instruments contain certain implicit assumptions. One such assumption is that the stock price exposure inherent in those instruments can be hedged by entering into an offsetting position in the underlying equity shares. For example, the Black-Scholes-Merton option-pricing model assumes that the underlying shares can be sold short without transaction costs and that stock price changes will be continuous. Accordingly, for purposes of applying Step 2, fair value inputs include adjustments to neutralize the effects of events that can cause stock price discontinuities. For example, a merger announcement may cause an immediate jump (up or down) in the price of shares underlying an equity-linked option contract. A holder of that instrument would not be able to continuously adjust its hedge position in the underlying shares due to the discontinuous stock price change. As a result, changes in the fair value of an equity-linked instrument and changes in the fair value of an offsetting hedge position in the underlying shares will differ, creating a gain or loss for the instrument holder as a result of the merger announcement. Therefore, inclusion of provisions that adjust the terms of the instrument to offset the net gain or loss resulting from a merger announcement or similar event do not preclude an equity-linked instrument (or embedded feature) from being considered indexed to an entity's own stock.

*815-40-15-7H*

Some equity-linked financial instruments contain provisions that provide an entity with the ability to unilaterally modify the terms of the instrument at any time, provided that such modification benefits the counterparty. For example, the terms of a convertible debt instrument may explicitly permit the issuer to reduce the conversion price at any time to induce conversion of the instrument. For purposes of applying Step 2, such provisions do not affect the determination of whether an instrument (or embedded feature) is considered indexed to an entity's own stock.

The indexation guidance states that certain adjustments that otherwise would violate the strict fixed-for-fixed criteria should not preclude a conclusion that an instrument is indexed to the issuer's stock. Adjustments that may be made to the settlement amount that are affected by variables that would be inputs to the fair value of a fixed-for-fixed forward or option on equity shares are acceptable. In addition, certain adjustments that are designed to compensate one of the parties to the instrument for changes in value that are not incorporated into a standard pricing model should not preclude a conclusion that an instrument is indexed to the issuer's stock.

The permitted adjustments to the fixed-for-fixed settlement amount, in most cases, accommodate the terms of an ISDA agreement and, in many cases, the terms of transaction specific agreements. However, some common adjustment terms do not comply with this guidance.

The issuer's counterparty often considers the possibility of certain extraordinary events (e.g., merger events or the issuer's delisting from a securities exchange) in the negotiation process. Those events represent risks that are not easily incorporated into, and may violate, the assumptions that underlie the valuation models for equity contracts, such as the Black-Scholes option-pricing model. For example, the Black-Scholes model, which is often used to estimate the fair value of an option (including the embedded option in a convertible debt instrument), assumes that while the stock price will vary randomly over time, there will be no instantaneous large changes in the price of the stock. This assumption is not necessarily true in the case of a merger event, which can cause a discontinuous price change based on the merger consideration.

As another example, the Black-Scholes model assumes that the underlying markets are liquid and efficient, and the counterparty will be able to hedge the risks of changes in share price at a reasonable cost. Such hedging is typically accomplished by selling borrowed shares (i.e., short selling). Accordingly, application of the Black-Scholes option-pricing model will not result in an appropriate valuation if the underlying shares are not available to be borrowed or the rate at which such borrowings occur is unusually high, which might be the case in certain market dislocations.

Events such as a merger or severe market dislocation are unpredictable and thus unhedgeable. If the counterparty were exposed to those risks during the life of the transaction, it would demand a higher risk premium in pricing the contract, which may be difficult to estimate. Additionally, certain dislocation events may be significantly influenced or controlled by the issuer (e.g., merger events) and the counterparty would likely not be willing to assume the risks resulting from such an event for any price. Therefore, to mitigate the counterparty's exposure, the parties may agree to assume such events will not occur in the initial pricing, and then adjust the terms (and thus settlement amount) of the instrument (or provide for the termination of the equity contract in some cases) to maintain the fair value of the contract before and after the event. As a result, the initial pricing can ignore those events as both parties will maintain their economic position if those events occur.

As discussed in ASC 815-40-15-7E, there are many inputs to the pricing of a fixed-for-fixed equity contract or feature (e.g., entity's stock price, strike price, stock price volatility). In an effort to minimize the potential for abuse, the indexation guidance prohibits the inclusion of a leverage factor in the terms of the instrument. A leverage factor would adjust the settlement amount by a multiple of the change in fair value resulting from one of the events described above (refer to Question 3 in section B.9).

The indexation guidance also states that the determination of whether a triggering event has occurred and the calculation of the resulting adjustment or settlement must be commercially reasonable. For example, the counterparty should apply industry conventions (1) in determining if a standard hedge cannot be maintained or (2) in calculating the amount of an adjustment. If that counterparty chose to be significantly over or under hedged relative to customary industry practices, the determination of whether an adjustment is appropriate and the manner in which the adjustment is calculated must be based on what is considered commercially reasonable and customary in the industry and not the counterparty's specific practices.

Although not explicitly stated in the guidance, since the fixed-for-fixed criteria allows for variables that are inputs to a standard pricing model for an equity option or forward, we believe settlement for the fair value of the instrument that is produced by that model is also acceptable. Refer to the following questions in section B.9:

- Question 3 — Pursuant to the indexation guidance, how should a term in a warrant that, when settling on some early termination event, requires a calculation using a fixed volatility or market volatility with a floor, be considered?
- Question 4 — What are frequent early termination events that should be considered?
- Question 16 — How should an entity's obligation to pay taxes and/or other governmental charges upon settlement of an equity-linked instrument (or embedded feature) be considered when evaluating the instrument (or embedded feature) under the indexation guidance?
- Question 18 — How is a warrant to purchase a fixed percentage of the issuer's outstanding common stock evaluated under the indexation guidance?
- Question 19 — How does an entity apply Step 2 of the indexation guidance to provisions within SPAC warrants that could change the settlement amount depending on the characteristics of the warrant holder?
- Question 20 — How does an entity apply the indexation guidance to earn-out arrangements it entered into in connection with its merger with a SPAC?

### B.3.3.3 Application of Step 2 to an instrument denominated in a foreign currency

**Excerpt from Accounting Standards Codification**

**Derivatives and Hedging — Contracts in Entity's Own Equity**

***Scope and Scope Exceptions***

***815-40-15-7I***

The issuer of an equity-linked financial instrument incurs an exposure to changes in currency exchange rates if the instrument's strike price is denominated in a currency other than the functional currency of the issuer. An equity-linked financial instrument (or embedded feature) shall not be considered indexed to the entity's own stock if the strike price is denominated in a currency other than the issuer's functional currency (including a conversion option embedded in a convertible debt instrument that is denominated in a currency other than the issuer's functional currency). The determination of whether an equity-linked financial instrument is indexed to an entity's own stock is not affected by the currency (or currencies) in which the underlying shares trade.

The indexation guidance prohibits instruments that provide for an exercise or conversion price that is denominated in a currency other than the issuer's functional currency (as defined in ASC 830) from being considered indexed to the entity's stock (e.g., convertible debt or a warrant denominated in a currency that differs from the issuer's functional currency). This guidance was based on the view that the denomination of an instrument (e.g., convertible debt or a warrant) in a foreign currency other than the issuer's functional currency represents currency exposure from an accounting perspective. The currency in which the underlying shares trade does not affect this determination. Refer to ASC 815-40-55-44 and ASC 815-40-55-47 for illustrations of this guidance.

Many convertible debt investors prefer that a convertible debt instrument be denominated in the same currency in which the investor can transact in the underlying shares because the complexity of estimating the value of the instrument and hedging the exposure to changes in share prices is reduced. While the debt may be denominated in a currency other than the functional currency of the issuer for a valid business purpose, the conversion option should be bifurcated as it would not be considered indexed to the issuer's own stock pursuant to the indexation guidance. Importantly, this conclusion is different than that reached under ASC 718-10-25-14A, which states that a share-based payment award with an exercise price denominated in the currency of a market in which a substantial portion of the entity's equity securities trades should be considered an equity award, assuming all other criteria for equity classification are met.

### B.3.3.4 Application of Step 2 when payoff is based on stock of consolidated subsidiary

**Excerpt from Accounting Standards Codification**

**Derivatives and Hedging — Contracts in Entity's Own Equity**

*Scope and Scope Exceptions*

*815-40-15-5C*

Freestanding financial instruments (and embedded features) for which the payoff to the counterparty is based, in whole or in part, on the stock of a consolidated subsidiary are not precluded from being considered indexed to the entity's own stock in the consolidated financial statements of the parent if the subsidiary is a substantive entity. If the subsidiary is not a substantive entity, the instrument or embedded feature shall not be considered indexed to the entity's own stock. If the subsidiary is considered to be a substantive entity, the guidance beginning in paragraph 815-40-15-5 shall be applied to determine whether the freestanding financial instrument (or an embedded feature) is indexed to the entity's own stock and shall be considered in conjunction with other applicable GAAP (for example, this Subtopic) in determining the classification of the freestanding financial instrument (or an embedded feature) in the financial statements of the entity. The guidance in this paragraph applies to those instruments (and embedded features) in the consolidated financial statements of the parent, whether the instrument was entered into by the parent or the subsidiary. The guidance in this paragraph does not affect the accounting for instruments (or embedded features) that would not otherwise qualify for the scope exception in paragraph 815-10-15-74(a). For example, freestanding instruments that are classified as liabilities (or assets) under Topic 480 and put and call options embedded in a noncontrolling interest that is accounted for as a financing arrangement under Topic 480 are not affected by this guidance. For guidance on presentation of an equity-classified instrument (including an embedded feature that is separately recorded in equity under applicable GAAP) within the scope of the guidance in this paragraph, see paragraph 810-10-45-17A.

ASC 815-40-15-5C states that freestanding financial instruments (or embedded features) for which the payoff is based on the stock of a consolidated subsidiary are not precluded from being considered indexed to an entity's own stock in the consolidated financial statements of the parent as long as the subsidiary is a substantive entity. Those instruments should be evaluated to determine whether they meet all conditions in ASC 815-40-15 to be considered indexed to the entity's own equity.

### B.3.3.5 Application of the indexation guidance to contracts that do not meet the definition of a derivative

**Excerpt from Accounting Standards Codification**

**Derivatives and Hedging — Contracts in Entity's Own Equity**

*Scope and Scope Exceptions*

*815-40-15-8A*

If the instrument does not meet the criteria to be considered indexed to an entity's own stock as described in paragraphs 815-40-15-5 through 15-8, it shall be classified as a liability or an asset. See paragraph 815-40-35-4 for subsequent measurement guidance for those instruments. See paragraph 815-40-15-9 for guidance on the interaction with this Subtopic and Subtopics 815-10 and 815-15 for derivative instruments and embedded derivatives.

Companies may issue warrants and other freestanding instruments that do not meet the definition of a derivative pursuant to ASC 815. One example is when private companies issue an equity-linked instrument that requires gross physical settlement. In that circumstance, the contract is not considered net settleable as the shares are not readily convertible to cash. The shares of a public company in a contract also may not be considered readily convertible to cash because the number of shares for the smallest allowed unit on conversion or exercise is high relative to trading volumes (refer to ASC 815-10-55-99) or if a contractual restriction on resale is placed on the settlement shares (refer to ASC 815-10-15-130 through 15-138). When the freestanding instrument is not within the scope of the derivatives guidance, other guidance, such as ASC 815-40, should be considered in determining the appropriate accounting for the instrument.

Instruments with features that are not considered indexed to the issuer's own stock pursuant to the indexation guidance are precluded from being classified in equity. ASC 815-40 requires those instruments to be classified as a liability or an asset and subsequently measured at fair value through earnings, regardless of whether they meet the definition of a derivative.

### B.3.3.6 Interaction of the indexation guidance with other authoritative guidance

Refer to the following Questions in section B.9:

- Question 5 — Does the indexation guidance affect the determination of whether an embedded feature is "clearly and closely related" to the host instrument pursuant to ASC 815?
- Question 6 — How does the indexation guidance interact with the business combination guidance?

## B.3.4 Illustrative examples of the indexation guidance

The indexation guidance includes 20 specific examples to facilitate application of the guidance to various features. These examples should be carefully reviewed when applying the indexation guidance because they include many common terms and features in equity-linked instruments and embedded features, such as:

- An IPO as an exercise contingency
- An adjustment due to a merger announcement
- An adjustment due to the issuer's failure to achieve specified revenue goals
- Settlement based on a volume-weighted average price for a defined period
- Settlement in a variable number of shares within a specified range
- Caps on share prices in calculating settlement amount

- Adjustments for dividends
- Certain tabular make-whole provisions in convertible debt
- Instruments designed to approximate the value of employee stock options

## Excerpt from Accounting Standards Codification

**Derivatives and Hedging — Contracts in Entity's Own Equity**

***Implementation Guidance and Illustrations***

***Example 2: Variability Involving Completion of an Initial Public Offering***

***815-40-55-26***

Entity A issues warrants that permit the holder to buy 100 shares of its common stock for $10 per share. The warrants have 10-year terms; however, they only become exercisable if Entity A completes an initial public offering. The warrants are considered indexed to Entity A's own stock based on the following evaluation:

a. Step 1. The exercise contingency (that is, the initial public offering) is not an observable market or an observable index, so the evaluation of Step 1 does not preclude the warrants from being considered indexed to the entity's own stock. Proceed to Step 2.

b. Upon exercise, the settlement amount would equal the difference between the fair value of a fixed number of the entity's equity shares (100 shares) and a fixed strike price ($10 per share).

***Example 3: Variability Involving Sales Volume***

***815-40-55-27***

Entity A issues warrants that permit the holder to buy 100 shares of its common stock for $10 per share. The warrants have 10-year terms; however, they only become exercisable after Entity A accumulates $100 million in sales to third parties. The warrants are considered indexed to Entity A's own stock based on the following evaluation:

a. Step 1. The exercise contingency (that is, the accumulation of $100 million in sales to third parties) is an observable index. However, it can only be calculated or measured by reference to Entity A's sales, so the evaluation of Step 1 does not preclude the warrants from being considered indexed to the entity's own stock. Proceed to Step 2.

b. Step 2. Upon exercise, the settlement amount would equal the difference between the fair value of a fixed number of the entity's equity shares (100 shares) and a fixed strike price ($10 per share).

***Example 4: Variability Involving Stock Index***

***815-40-55-28***

Entity A issues warrants that permit the holder to buy 100 shares of its common stock for $10 per share. The warrants have 10-year terms; however, they only become exercisable if the Standard & Poor's S&P 500 Index increases 500 points within any given calendar year during that 10-year period. The warrants are not considered indexed to Entity A's own stock based on the following evaluation:

a. Step 1. The exercise contingency (that is, the increase of 500 points in Standard & Poor's S&P 500 Index) is based on an observable index that is not measured solely by reference to the issuer's own operations.

b. Step 2. It is not necessary to evaluate Step 2.

*Example 5: Variability Involving a Commodity Price*

*815-40-55-29*

Entity A issues warrants that permit the holder to buy 100 shares of its common stock in exchange for one ounce of gold. The warrants have 10-year terms; however, they only become exercisable if Entity A completes an initial public offering. The warrants are not considered indexed to Entity A's own stock based on the following evaluation:

a. Step 1. The exercise contingency (that is, the initial public offering) is not an observable market or an observable index, so the evaluation of Step 1 does not preclude the warrants from being considered indexed to the entity's own stock. Proceed to Step 2.

b. Step 2. The settlement amount would not equal the difference between the fair value of a fixed number of the entity's equity shares (100 shares) and a fixed strike price. Although the number of shares that would be issued at settlement is fixed, the strike price varies based on the price of one ounce of gold. The price of gold is not an input to the fair value of a fixed-for-fixed option on equity shares.

*Example 6: Variability Involving Merger Announcement*

*815-40-55-30*

Entity A issues warrants that permit the holder to buy 100 shares of its common stock for $10 per share. The warrants have 10-year terms and are exercisable at any time. However, the terms of the warrants specify that if there is an announcement of a merger involving Entity A, the strike price of the warrants will be adjusted to offset the effect of the merger announcement on the net change in the fair value of the warrants and of an offsetting hedge position in the underlying shares. The strike price adjustment must be determined using commercially reasonable means based on an assumption that the counterparty has entered into a hedge position in the underlying shares to offset the share price exposure from the warrants. That strike price adjustment is not affected by the counterparty's actual hedging position (for example, the strike price adjustment does not differ in circumstances when the counterparty is over-hedged or under-hedged). The warrants are considered indexed to Entity A's own stock based on the following evaluation:

a. Step 1. The instruments do not contain an exercise contingency. Proceed to Step 2.

b. Step 2. The settlement amount would equal the difference between the fair value of a fixed number of the entity's equity shares (100 shares) and a fixed strike price ($10 per share), unless there is a merger announcement. If there is a merger announcement, the settlement amount would be adjusted to offset the effect of the merger announcement on the fair value of the warrants. In that circumstance, the only variables that could affect the settlement amount would be inputs to the fair value of a fixed-for-fixed option on equity shares. For further discussion, see paragraphs 815-40-15-7E and 815-40-15-7G.

*Example 7: Variability Involving Revenue Target*

*815-40-55-31*

Entity A issues warrants that permit the holder to buy 100 shares of its common stock for an initial price of $10 per share. The warrants have 10-year terms and are exercisable at any time. However, the terms of the warrants specify that the strike price is reduced by $0.50 after any year in which Entity A does not achieve revenues of at least $100 million. The warrants are not considered indexed to Entity A's own stock based on the following evaluation:

a. Step 1. The instruments do not contain an exercise contingency. Proceed to Step 2.

b. Step 2. The settlement amount would not equal the difference between the fair value of a fixed number of the entity's equity shares (100 shares) and a fixed strike price. Although the number of shares that would be issued at settlement is fixed, the strike price would be adjusted after any year in which Entity A does not achieve revenues of at least $100 million.] The amount of an entity's annual revenues is not an input to the fair value of a fixed-for-fixed option on equity shares.

*Example 8: Variability Involving Stock Price Cap*

*815-40-55-32*

Entity A purchases net-settled call options that permit it to buy 100 shares of its common stock for $10 per share. However, the maximum appreciation on the call options is capped when Entity A's stock price reaches $15 per share (that is, the counterparty's maximum obligation is $500 [($15 − $10) x 100 shares]). The call options have 10-year terms and are exercisable at any time. The call options are considered indexed to Entity A's own stock based on the following evaluation:

a. Step 1. The instruments do not contain an exercise contingency. Proceed to Step 2.

b. Step 2. The settlement amount would equal the difference between the fair value of a fixed number of the entity's equity shares (100 shares) and a fixed strike price when Entity A's stock price is between the $10 stated exercise price and the $15 price cap. However, whenever Entity A's stock price exceeds $15, the strike price of the call options increases and decreases in amounts equal to the corresponding increases and decreases in Entity A's stock price, such that the intrinsic value of each call option always equals $5. Because the only variable that can affect the settlement amount is the entity's stock price, which is an input to the fair value of a fixed-for-fixed option contract, the call options are considered indexed to the entity's own stock.

*Example 9: Variability Involving Future Equity Offerings and Issuance of Equity-Linked Financial Instruments*

*815-40-55-33*

This Example illustrates the application of the guidance beginning in paragraph 815-40-15-5 for a financial instrument that includes a **down round feature**. Entity A issues warrants that permit the holder to buy 100 shares of its common stock for $10 per share. The warrants have 10-year terms and are exercisable at any time. However, the terms of the warrants specify both of the following:

a. If the entity sells shares of its common stock for an amount less than $10 per share, the strike price of the warrants is reduced to equal the issuance price of those shares.

b. If the entity issues an equity-linked financial instrument with a strike price below $10 per share, the strike price of the warrants is reduced to equal the strike price of the newly issued equity-linked financial instrument.

*815-40-55-34*

The warrants are considered indexed to Entity A's own stock based on the following evaluation:

a. Step 1. The instruments do not contain an exercise contingency. Proceed to Step 2.

b. Step 2. In accordance with paragraph 815-40-15-5D, when classifying a financial instrument with a down round feature, an entity shall exclude that feature when considering whether the instrument is indexed to the entity's own stock for the purposes of applying paragraphs 815-40-15-7C through 15-7I (Step 2). The instrument does not contain any other features to be assessed under Step 2.

*Example 10: Variability Involving Regulatory Approval*

*815-40-55-35*

Entity A issues warrants that permit the holder to buy 100 shares of its common stock for $10 per share. The warrants have 10-year terms and are exercisable at any time. However, the terms of the warrants specify that if Entity A does not obtain regulatory approval of a particular drug compound within 5 years, the holder can surrender the warrants to Entity A for $2 per warrant (settleable in

shares). The contingently puttable warrants are not considered indexed to Entity A's own stock based on the following evaluation:

a. Step 1. The instruments do not contain an exercise contingency. Proceed to Step 2.

b. Step 2. The settlement amount would equal the difference between the fair value of a fixed number of the entity's equity shares (100 shares) and a fixed strike price ($10 per share), unless regulatory approval of a particular drug compound is not obtained within 5 years. If that approval is not obtained within the allotted time period, the holder could elect to surrender the warrants to Entity A in exchange for $2 per warrant. The contingent obligation to settle the warrants by transferring consideration with a fixed monetary value if regulatory approval of a particular drug compound is not obtained within a specified time period does not represent an input to the fair value of a fixed-for-fixed option on equity shares. A freestanding equity-linked instrument that provides for a fixed payoff upon the occurrence of a contingent event which is not based on the issuer's share price is not indexed to an entity's own stock.

***Example 11: Variability Involving a Currency Other Than the Entity's Functional Currency***

***815-40-55-36***

Entity A, whose functional currency is U.S. dollars (USD), issues warrants with a strike price denominated in Canadian dollars (CAD). The warrants permit the holder to buy 100 shares of its common stock for CAD 10 per share. Entity A's shares trade on an exchange on which trades are denominated in CAD. The warrants have 10-year terms and are exercisable at any time. The warrants are not considered indexed to Entity A's own stock based on the following evaluation:

a. Step 1. The instruments do not contain an exercise contingency. Proceed to Step 2.

b. Step 2. The strike price of the warrants is denominated in a currency other than the entity's functional currency, so the warrants are not considered indexed to the entity's own stock.

***Example 12: Variability Involving Dividend Distributions***

***815-40-55-37***

Entity A enters into a forward contract to sell 100 shares of its common stock for $10 per share in 1 year. Historically, Entity A has paid a dividend of $0.10 per quarter on its common shares. Under the terms of the forward contract, if dividends per common share differ from $0.10 during any 3-month period, the strike price of the forward contract will be adjusted to offset the effect of the dividend differential (actual dividend versus $0.10) on the fair value of the instrument. Additionally, the terms of the forward contract provide for an adjustment to the strike price, using commercially reasonable means, to offset the effect of any increased cost of borrowing Entity A's shares in the stock loan market on the fair value of the instrument. The forward contract is considered indexed to Entity A's own stock based on the following evaluation:

a. Step 1. The instrument does not contain an exercise contingency. Proceed to Step 2.

b. Step 2. The only circumstances in which the settlement amount will not equal the difference between the fair value of 100 shares and $1,000 ($10 per share) are if dividends per common share differ from $0.10 during any 3-month period or if there is an increased cost of borrowing Entity A's shares in the stock loan market. The adjustments to the strike price resulting from those events are intended to offset their effects on the instrument's fair value. In those circumstances, the only variables that could affect the settlement amount (dividends and stock borrow cost) would be inputs to the fair value of a fixed-for-fixed forward contract on equity shares.

*Example 13: Variability Involving Average Stock Price*

*815-40-55-38*

Entity A enters into a net-settleable forward contract to sell 100 shares of its common stock in 1 year for an amount equal to $10 per share plus interest calculated at a variable interest rate (Federal Funds rate plus a fixed spread). The share price used to determine the settlement amount is based on the volume-weighted average daily market price of Entity A's common stock for the 30-day period before the settlement date. The forward contract is considered indexed to Entity A's own stock based on the following evaluation:

a. Step 1. The instrument does not contain an exercise contingency. Proceed to Step 2.

b. Step 2. The settlement amount will not equal the difference between the fair value of a fixed number of the entity's equity shares (100 shares) and a fixed strike price. However, the only variables that cause the settlement amount to differ from a fixed-for-fixed settlement amount are the 30-day volume-weighted average daily market price of Entity A's common stock and an interest rate index. The pricing inputs of a fixed-for-fixed forward contract include the entity's stock price and interest rates. Additionally, the floating interest rate feature does not introduce a leverage factor or otherwise increase the effects of interest rate changes on the instrument's fair value.

*Example 14: Variability Involving Interest Rate Index*

*815-40-55-39*

Entity A enters into a forward contract to sell 100 shares of its common stock in 1 year for an amount equal to $10 per share plus interest calculated at a variable interest rate that varies inversely with changes in the London Interbank Offered Rate (LIBOR) (similar to an "inverse floater," as described in paragraphs 815-15-55-170 through 55-172). The forward contract is not considered indexed to Entity A's own stock based on the following evaluation:

a. Step 1. The instrument does not contain an exercise contingency. Proceed to Step 2.

b. Step 2. The settlement amount will not equal the difference between the fair value of a fixed number of the entity's equity shares (100 shares) and a fixed strike price. Although the number of shares that would be issued at settlement is fixed, the strike price varies inversely with changes in an interest rate index. The inverse floating interest rate feature increases the effects of interest rate changes on the instrument's fair value (that is, the feature increases the instrument's fair value exposure to interest rate changes) when compared to the exposure to interest rate changes of a fixed-for-fixed forward contract.

*Example 15: Variability Involving Stock Price Cap and Floor*

*815-40-55-40*

Entity A enters into a net-settled forward contract to sell 100 shares of its common stock in 1 year for $1,000. However, the maximum amount payable to the counterparty at maturity is capped when Entity A's stock price is greater than or equal to $15 per share (that is, Entity A's maximum obligation is $500 [($15 − $10) x 100 shares]). Additionally, the maximum amount receivable from the counterparty at maturity is capped when Entity A's stock price is less than or equal to $5 per share (that is, the counterparty's maximum obligation is $500 [($5 − $10) x 100 shares]). The forward contract is considered indexed to Entity A's own stock based on the following evaluation:

a. Step 1. The instrument does not contain an exercise contingency. Proceed to Step 2.

b. Step 2. The settlement amount would equal the difference between the fair value of a fixed number of the entity's equity shares (100 shares) and a fixed strike price ($1,000) when Entity A's stock price is between $5 and $15. However, whenever Entity A's stock price is greater than or equal to $15 at maturity, the amount payable to the counterparty always equals $500. Additionally, whenever Entity A's stock price is less than or equal to $5 at maturity, the amount

receivable from the counterparty always equals $500. Because the only variable that can affect the settlement amount is the entity's stock price, which is an input to the fair value of a fixed-for-fixed forward contract, the instrument is considered indexed to the entity's own stock.

*Example 16: Variability Involving Cap on Shares Issued*

*815-40-55-41*

Entity A enters into a forward contract to sell a variable number of its common shares in 1 year for $1,000. If Entity A's stock price is equal to or less than $10 at maturity, Entity A will issue 100 shares of its common stock to the counterparty. If Entity A's stock price is greater than $10 but equal to or less than $12 at maturity, Entity A will issue a variable number of its common shares worth $1,000. Finally, if the share price is greater than $12 at maturity, Entity A will issue 83.33 shares of its common stock. The forward contract is considered indexed to Entity A's own stock based on the following evaluation:

a. Step 1. The instrument does not contain an exercise contingency. Proceed to Step 2.

b. Step 2. The settlement amount will not equal the difference between the fair value of a fixed number of the entity's equity shares and a fixed strike price ($1,000). Although the strike price to be received at settlement is fixed, the number of shares to be issued to the counterparty varies based on the entity's stock price on the settlement date. Because the only variable that can affect the settlement amount is the entity's stock price, which is an input to the fair value of a fixed-for-fixed forward contract on equity shares, the instrument is considered indexed to the entity's own stock.

*Example 17: Variability Involving Various Underlyings*

*815-40-55-42*

Entity A enters into a forward contract to sell 100 shares of its common stock for $10 per share in 1 year. Under the terms of the forward contract, the strike price of the forward contract would be adjusted to offset the resulting dilution (except for issuances and repurchases that occur upon settlement of outstanding option or forward contracts on equity shares) if Entity A does any of the following:

a. Distributes a stock dividend or ordinary cash dividend

b. Executes a stock split, spinoff, rights offering, or recapitalization through a large, nonrecurring cash dividend

c. Issues shares for an amount below the then-current market price

d. Repurchases shares for an amount above the then-current market price.

The contractual terms that adjust the forward contract's strike price are eliminating the dilution to the forward contract counterparty that would otherwise result from the occurrence of those specified dilutive events. The adjustment to the strike price of the forward contract is based on a mathematical calculation that determines the direct effect that the occurrence of such dilutive events should have on the price of the underlying shares; it does not adjust for the actual change in the market price of the underlying shares upon the occurrence of those events, which may increase or decrease for other reasons.

*815-40-55-43*

The forward contract is considered indexed to Entity A's own stock based on the following evaluation:

a. Step 1. The instrument does not contain an exercise contingency. Proceed to Step 2.

b. Step 2. The only circumstances in which the settlement amount will not equal the difference between the fair value of 100 shares and $1,000 ($10 per share) are upon the occurrence of any of the following:

    1. The distribution of a stock dividend or ordinary cash dividend

2. The execution of a stock split, spinoff, rights offering, or recapitalization through a large, nonrecurring cash dividend

3. The issuance of shares for an amount below the then-current market price

4. The repurchase of shares for an amount above the then-current market price.

An implicit assumption in standard pricing models for equity-linked financial instruments is that such events will not occur (or that the strike price of the instrument will be adjusted to offset the dilution caused by such events). Therefore, the only variables that could affect the settlement amount in this example would be inputs to the fair value of a fixed-for-fixed option on equity shares.

***Example 18: Variability Involving Forward Contract Settled in a Currency Other Than the Entity's Functional Currency***

*815-40-55-44*

Entity A, whose functional currency is US$, enters into a forward contract that requires Entity A to sell 100 shares of its common stock for 120 euros per share in 1 year. The forward contract is not considered indexed to Entity A's own stock based on the following evaluation:

a. Step 1. The instrument does not contain an exercise contingency. Proceed to Step 2.

b. Step 2. The strike price of the forward contract is denominated in a currency other than the entity's functional currency, so the forward contract is not considered indexed to the entity's own stock.

***Example 19: Variability Involving Contingently Convertible Debt with a Market Price Trigger, Parity Provision, and Merger Provision***

*815-40-55-45*

Entity A issues a contingently convertible debt instrument with a par value of $1,000 that is convertible into 100 shares of its common stock. The convertible debt instrument has a 10-year term and is convertible at any time after any of the following events occurs:

a. Entity A's stock price exceeds $13 per share (market price trigger).

b. The convertible debt instrument trades for an amount that is less than 98 percent of its if-converted value (parity provision).

c. There is an announcement of a merger involving Entity A.

*815-40-55-46*

The terms of the convertible debt instrument also include a make-whole provision. Under that provision, if Entity A is acquired for cash before a specified date, the holder of the convertible debt instrument can convert into a number of shares equal to the sum of the fixed conversion ratio (100 shares per bond) and the make-whole shares. The number of make-whole shares is determined by reference to a table with axes of stock price and time. That table was designed such that the aggregate fair value of the shares deliverable (that is, the fair value of 100 shares per bond plus the make-whole shares) would be expected to approximate the fair value of the convertible debt instrument at the settlement date, assuming no change in relevant pricing inputs (other than stock price and time) since the instrument's inception. The embedded conversion option is considered indexed to Entity A's own stock based on the following evaluation:

a. Step 1. The market price trigger and parity provision exercise contingencies are based on observable markets; however, those contingencies relate solely to the market prices of the entity's own stock and its own convertible debt. Also, the merger announcement exercise contingency is not an observable market or an index. Therefore, Step 1 does not preclude the warrants from being considered indexed to the entity's own stock. Proceed to Step 2.

b. Step 2. An acquisition for cash before the specified date is the only circumstance in which the settlement amount will not equal the difference between the fair value of 100 shares and a fixed strike price ($1,000 fixed par value of the debt). The settlement amount if Entity A is acquired for cash before the specified date is equal to the sum of the fixed conversion ratio (100 shares per bond) and the make-whole shares. The number of make-whole shares is determined based on a table with axes of stock price and time, which would both be inputs in a fair value measurement of a fixed-for-fixed option on equity shares.

***Example 20: Variability Involving Functional Currency Debt Convertible to a Stock That Trades in a Currency Other Than the Entity's Functional Currency***

*815-40-55-47*

Entity A, whose functional currency is the Chinese yuan (CNY), issues a debt instrument denominated in CNY with a par value of CNY 1,000 that is convertible into 100 shares of its common stock. Entity A's shares only trade on an exchange in which trades are denominated in US$. Those shares do not trade on an exchange (or other established marketplace) in which trades are denominated in CNY. The convertible debt instrument has a 10-year term and is convertible at any time. The embedded conversion option is considered indexed to Entity A's own stock based on the following evaluation:

a. Step 1. The embedded conversion option does not contain an exercise contingency. Proceed to Step 2.

b. Step 2. Upon exercise of the embedded conversion option, the settlement amount would equal the difference between the fair value of a fixed number of the entity's equity shares (100 shares) and a fixed strike price denominated in its functional currency (CNY 1,000 fixed par value of the debt). The determination of whether the embedded conversion option is indexed to the entity's own stock is not affected by the currency (or currencies) in which the underlying shares trade.

***Example 21: Variability Involving Securities Issued to Establish a Market-Based Measure of Grantee Stock Option Value***

*815-40-55-48*

Entity A issues a security to investors for purposes of establishing a market-based measure of the grant-date fair value of a grant of stock options issued in a share-based payment transaction. Under the terms of that market-based stock option valuation instrument, Entity A is obligated to make variable quarterly payments to the investors that are a function of the net intrinsic value received by a pool of Entity A's grantees, based on actual stock option exercises by those grantees each period. The market-based stock option valuation instrument has a 10-year term, consistent with the contractual term of the underlying stock options. The market-based stock option valuation instrument is not considered indexed to Entity A's own stock based on the following evaluation:

a. Step 1. The analysis of the exercise contingency (or contingencies) depends on the particular terms and features of the instrument. However, as indicated in Step 2 below, a market-based stock option valuation instrument would not be considered indexed to the entity's own stock.

b. Step 2. The settlement amount will not equal the difference between the fair value of a fixed number of the entity's equity shares and a fixed strike price. The instrument provides for variable quarterly payments to investors that are based on actual stock option exercises for the period. Because a variable that affects the instrument's settlement amount is stock option exercise behavior, which is not an input to the fair value of a fixed-for-fixed option or forward contract on equity shares, the instrument is not considered indexed to the entity's own stock.

### B.3.4.1 Application of Step 2 to instruments with down round features

**Excerpt from Accounting Standards Codification**

Derivatives and Hedging — Contracts in Entity's Own Equity

*Scope and Scope Exceptions*

*815-40-15-5D*

When classifying a financial instrument with a **down round feature**, the feature is excluded from the consideration of whether the instrument is indexed to the entity's own stock for the purposes of applying paragraphs 815-40-15-7C through 15-7I (Step 2).

Derivatives and Hedging — Overall

*Scope and Scope Exceptions*

*815-10-15-75A*

For purposes of evaluating whether a financial instrument meets the scope exception in paragraph 815-10-15-74(a)(1), a **down round feature** shall be excluded from the consideration of whether the instrument is indexed to the entity's own stock.

Earnings Per Share — Overall

*Recognition*

*260-10-25-1*

An entity that presents earnings per share (EPS) in accordance with this Topic shall recognize the value of the effect of a down round feature in an equity-classified freestanding financial instrument and an equity-classified convertible preferred stock (if the conversion feature has not been bifurcated in accordance with other guidance) when the down round feature is triggered. That effect shall be treated as a dividend and as a reduction of income available to common stockholders in **basic earnings per share**, in accordance with the guidance in paragraph 260-10-45-12B. See paragraphs 260-10-55-95 through 55-97 for an illustration of this guidance.

*Initial Measurement*

*260-10-30-1*

As of the date that a down round feature is triggered (that is, upon the occurrence of the triggering event that results in a reduction of the strike price) in an equity-classified freestanding financial instrument and an equity-classified convertible preferred stock (if the conversion feature has not been bifurcated in accordance with other guidance), an entity shall measure the value of the effect of the feature as the difference between the following amounts determined immediately after the down round feature is triggered:

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.

*260-10-30-2*

The fair values of the financial instruments in paragraph 260-10-30-1 shall be measured in accordance with the guidance in Topic 820 on fair value measurement. See paragraph 260-10-45-12B for related earnings per share guidance and paragraphs 505-10-50-3 through 50-3A for related disclosure guidance.

*Subsequent Measurement*

*260-10-35-1*

An entity shall recognize the value of the effect of a down round feature in an equity-classified freestanding financial instrument and an equity-classified convertible preferred stock (if the conversion feature has not been bifurcated in accordance with other guidance) each time it is triggered but shall not otherwise subsequently remeasure the value of a down round feature that it has recognized and measured in accordance with paragraphs 260-10-25-1 and 260-10-30-1 through 30-2. An entity shall not subsequently amortize the amount in additional paid-in capital arising from recognizing the value of the effect of the down round feature.

Entities are not required to consider down round features when determining whether these financial instruments containing a down round feature are indexed to the issuer's own stock pursuant to ASC 815-40. 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.

ASC 815-40 defines a down-round feature as "a feature in a financial instrument that reduces the strike price of an issued financial instrument if the issuer sells shares of its stock for an amount less than the currently stated strike price of the issued financial instrument or issues an equity-linked financial instrument with a strike price below the currently stated strike price of the issued financial instrument. 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. A standard antidilution provision is not considered a down round feature."

Example 17 of the indexation guidance in ASC 815-40-55-42 through 55-43 provides an example of antidilution provisions. It describes an instrument that provides for an adjustment in situations in which the issuer (1) distributes a stock dividend or ordinary cash dividend; (2) executes a stock split, spin-off, rights offering or recapitalization through a large, nonrecurring cash dividend; (3) issues shares for an amount below the then-current fair value; or (4) repurchases shares for an amount above the then-current fair value.

Provisions (3) and (4) compare the price of a subsequent transaction to the then-current market price of the share. If the issuer were to issue shares for less than their then-current fair value, the current investors are economically diluted (because the proceeds of the sale are less than the fair value of the shares issued, the fair value per share is reduced). Likewise, if the entity purchased shares for more than their then-current fair value, existing shareholders are diluted (the entity gives up assets with a fair value in excess of the shares repurchased, thereby reducing the fair value per remaining share).

Down round features may appear to be antidilution features but, generally, down round features provide more than dilution protection. For the avoidance of doubt, the guidance on down round features does not apply to antidilution features. However, provided that adjustments made to an instrument as a result of situations described above reflect only the decrease in fair value resulting from the dilutive transaction, those adjustments would not preclude the instruments from being considered indexed to the issuer's equity as they represent adjustments for discontinuous price movements caused by the issuer's own actions.

*Recognition and measurement*

An entity must recognize the value of the effect of a down round feature in an equity-classified freestanding equity contract 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. 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. However, when applying the treasury stock method for diluted EPS, this amount is added back to income available to common stockholders. Refer to section 3.2.3A our FRD publication, ***Earnings per share***, for further guidance on the effects of instruments with down round features on income available to common stockholders.

This recognition and measurement guidance applies to equity-classified freestanding equity contracts (e.g., warrants) and convertible preferred stock (if the conversion feature has not been bifurcated) with down round features issued by entities that present EPS in accordance with ASC 260. It doesn't apply to convertible debt instruments and freestanding equity contracts that are classified as liabilities.

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 B-1: Warrants with a down round feature**

On 1 January 20X7, Entity A issues warrants that permit the holder to buy 100 common shares of Entity A 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 9 September 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 9 September 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:

| | | |
|---|---|---|
| Retained earnings | $ 40 | |
| 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*

For instruments in the scope of ASC 505-10, entities must disclose terms that change exercise or strike prices of financial instruments, including those related to down round features, as well as the actual changes to exercise or strike prices that occur during the reporting period (but excluding changes due to standard antidilution provisions). Further, when a down round feature is triggered and an entity has recognized its effect pursuant to ASC 260-10-25-1, the entity is required to disclose that fact and the value of the effect of the down round feature.

## B.4 The equity classification guidance (ASC 815-40-25)

### B.4.1 Introduction

An instrument or embedded feature that is considered indexed to the issuer's own stock pursuant to the indexation guidance in ASC 815-40-15 should be evaluated pursuant to the equity classification guidance in ASC 815-40-25 to determine whether it would be classified in equity. The basic accounting model outlined in the equity classification guidance is based on the premise that contracts (or embedded features) that require net cash settlement are assets or liabilities, and contracts that require settlement in shares (or provide the issuer with a choice of settlement in net cash or in shares) are equity instruments.

If the contract provides the issuer with a choice of net cash settlement or settlement in shares, settlement in shares is assumed. If the contract provides the counterparty with a choice of net cash settlement or settlement in shares, net cash settlement is assumed. Within this guidance, settlement in shares includes both:

- Net share settlement where the party in a loss position pursuant to the contract delivers a net number of shares with a fair value equal to the settlement amount
- Gross physical settlement where the party designated in the contract as the buyer delivers the full stated amount of cash to the seller, and the seller delivers the full stated number of shares to the buyer (also referred to as a gross physical settlement as the gross amounts are transferred)

For example, in a physical settlement the issuer either receives cash and delivers shares (as in a forward sales contract or a written call option) or delivers cash and receives shares (as in a purchased call option). The forms of settlement are discussed further in section B.4.2.

Pursuant to the equity classification guidance, if a contract potentially can be net cash settled and that form of settlement is not within the control of the issuer, the contract is precluded from equity classification as either (1) the contract meets the definition of a derivative pursuant to ASC 815, but does not qualify for the exception from derivative accounting pursuant to ASC 815-10-15-74(a) or (2) the contract is not a derivative pursuant to ASC 815, but ASC 815-40 requires liability (or asset) classification. Alternatively, if an issuer is able in all circumstances to settle the contract by net share or physical settlement, the contract is classified in equity pursuant to the equity classification guidance as either (1) the contract meets the definition of a derivative pursuant to ASC 815, but qualifies for the exception from derivative accounting pursuant to ASC 815-10-15-74(a) or (2) the contract is not a derivative pursuant to ASC 815, but ASC 815-40 requires equity classification.

The equity classification guidance focuses on the specific terms of a contract and the legal or regulatory obstacles an issuer could encounter in executing a net share or physical settlement of a contract. Consideration should also be given to whether the counterparty to the instrument can control the issuer's decisions through board representation or other contractual rights.

Certain criteria must be met to conclude that share settlement is within the control of the entity. If any of the following criteria are not met, the equity classification guidance precludes the contract from being classified in equity (or qualifying for an exception from derivative accounting):

- No explicit requirement to settle the contract in cash when registered shares are unavailable
- The issuer has sufficient authorized but unissued shares available to settle the contract considering all other commitments
- The contract contains an explicit limit on the number of shares to be delivered in a share settlement
- There are no required cash payments (with the exception of penalty payments) to the counterparty in the event the issuer fails to make timely filings with the SEC
- There are no required cash payments to the counterparty that are intended to provide the counterparty with a full return of the amount due (i.e., there are no cash-settled top-off or make-whole provisions)

The equity classification guidance is applied without regard to the probability of events occurring that require the issuer to net cash settle. This is sometimes referred to as a theoretically possible threshold for considering if net cash settlement could occur outside the control of the issuer.

## B.4.2 Evaluation of the basic settlement features within a contract

**Excerpt from Accounting Standards Codification**

**Derivatives and Hedging — Contracts in Entity's Own Equity**

*Recognition*

*815-40-25-1*

The guidance in this Section applies for the purpose of determining whether an instrument or embedded feature qualifies for the second part of the scope exception in paragraph 815-10-15-74(a). The first part of the scope exception in paragraph 815-10-15-74(a) is addressed in Section 815-40-15. The initial balance sheet classification of contracts within the scope of this Subtopic generally is based on the concept that:

a. Contracts that require net cash settlement are assets or liabilities.

b. Contracts that require settlement in shares are equity instruments.

*815-40-25-2*

Further, an entity shall observe both of the following:

a. If the contract provides the counterparty with a choice of net cash settlement or settlement in shares, this Subtopic assumes net cash settlement.

b. If the contract provides the entity with a choice of net cash settlement or settlement in shares, this Subtopic assumes settlement in shares.

*815-40-25-3*

Except as noted in the last sentence of this paragraph, the approach discussed in paragraphs 815-40-25-1 through 25-2 does not apply if settlement alternatives do not have the same economic value attached to them or if one of the settlement alternatives is fixed or contains caps or floors. In those situations, the accounting for the instrument (or combination of instruments) shall be based on the economic substance of the transaction. For example, if a freestanding contract, issued together with another instrument, requires that the entity provide to the holder a fixed or guaranteed return such that the instruments are, in substance, debt, the entity shall account for both instruments as liabilities, regardless of the settlement terms of the freestanding contract. However, the approach discussed in paragraphs 815-40-25-1 through 25-2 does apply to contracts that have settlement alternatives with different economic values if the reason for the difference is a limit on the number of shares that must be delivered by the entity pursuant to a net share settlement alternative.

*815-40-25-4*

Accordingly, unless the economic substance indicates otherwise:

a. Contracts shall be initially classified as either assets or liabilities in both of the following situations:

    1. Contracts that require net cash settlement (including a requirement to net cash settle the contract if an event occurs and if that event is outside the control of the entity)

    2. Contracts that give the counterparty a choice of net cash settlement or settlement in shares (physical settlement or net share settlement).

b. Contracts shall be initially classified as equity in both of the following situations:

   1. Contracts that require physical settlement or net share settlement

   2. Contracts that give the entity a choice of net cash settlement or settlement in its own shares (physical settlement or net share settlement), assuming that all the criteria set forth in paragraphs 815-40-25-7 through 25-30 and 815-40-55-2 through 55-6 have been met.

As stated above, the determination of whether a contract or feature within the scope of this guidance is classified as either an asset or liability or as equity depends on the settlement method.

The settlement methods for contracts or features are typically specified in the contract. Many contracts are formalized in several legal documents that comprise a single agreement. For example, an equity contract executed in ISDA documentation usually consists of a Master Agreement, a Confirmation and Equity Derivatives Definitions (refer to section 1.3.1). However, some contracts are documented in forms other than standardized ISDA documentation.

There could be a single settlement method specified or, alternatively, the issuing company or the counterparty may have a choice of settlement methods. The typical settlement alternatives and an example of their application follow:

- Physical settlement (also called gross physical settlement) — The party designated in the contract as the buyer delivers the full stated amount of cash to the seller, and the seller delivers the full stated number of shares to the buyer.
- Net share settlement — The party with a loss delivers to the party with a gain shares with a current fair value equal to the gain.
- Net cash settlement — The party with a loss delivers to the party with a gain a cash payment equal to the gain, and no shares are exchanged.

To illustrate the application of settlement methods, assume that a company enters into a forward transaction with a third party to sell 1,000,000 shares of its common stock at a future date at $10 per share (the current market price). At the settlement date, consider two scenarios:

1. The issuer's share price has increased to $12.50
2. The issuer's share price has declined to $8.00.

The following summarizes the settlement alternatives (which are economically equal) for each scenario:

- Physical settlement — The issuer receives $10,000,000 and delivers 1,000,000 shares of its common stock in both scenarios. In the first scenario, the issuer receives $2,500,000 less than the market value of the stock while in the second scenario, the issuer receives $2,000,000 more. A contract requiring physical settlement is classified as equity pursuant to the equity classification guidance, presuming the detailed requirements are met.
- Net share settlement — The issuer delivers 200,000 shares worth $2,500,000 in the event that the share price increases to $12.50 ($2,500,000/$12.50) and receives 250,000 shares worth $2,000,000 in the event that the share price declines to $8.00 ($2,000,000/$8.00). A contract requiring net share settlement is classified as equity, presuming the detailed requirements of the equity classification guidance are met.
- Net cash settlement — The issuer delivers $2,500,000 in cash in the event that the share price increases to $12.50 ($2.50 increase in share price x 1,000,000 shares) and receives $2,000,000 in cash in the event that the share price declines to $8.00 ($2.00 decline in share price x 1,000,000 shares). A contract requiring net cash settlement is precluded from being classified as equity.

If the contract provided the issuer with a choice of net cash settlement or settlement in shares (physical or net share), the equity classification guidance assumes settlement in shares and the contract is not precluded from being classified in equity. If the contract provides the counterparty with a choice of net cash settlement or settlement in shares, the equity classification guidance assumes net cash settlement and that the contract is an asset or a liability.

Refer to the following Questions in section B.9:

- Question 7 — How do differences in the economic value of multiple settlement alternatives affect the analysis of equity classification?
- Question 8 — How does a penalty in one settlement alternative affect the analysis of equity classification when multiple settlement alternatives exist?
- Question 9 — How is the analysis of equity classification affected if the settlement method differs based on whether the contract is in a gain or loss position?

## B.4.3 Evaluation of any additional provisions that could require net cash settlement

**Excerpt from Accounting Standards Codification**

**Derivatives and Hedging — Contracts in Entity's Own Equity**

*Recognition*

*815-40-25-7*

Contracts that include any provision that could require net cash settlement cannot be accounted for as equity of the entity (that is, asset or liability classification is required for those contracts), except in those limited circumstances in which holders of the underlying shares also would receive cash (as discussed in the following two paragraphs and paragraphs 815-40-55-2 through 55-6).

*815-40-25-8*

Generally, if an event that is not within the entity's control could require net cash settlement, then the contract shall be classified as an asset or a liability. However, if the net cash settlement requirement can only be triggered in circumstances in which the holders of the shares underlying the contract also would receive cash, equity classification is not precluded.

*815-40-25-9*

This Subtopic does not allow for an evaluation of the likelihood that an event would trigger cash settlement (whether net cash or physical), except that if the payment of cash is only required upon the final liquidation of the entity, then that potential outcome need not be considered when applying the guidance in this Subtopic.

Contracts (and embedded features) cannot be accounted for as equity if the contracts include any provision that could require net cash settlement, except in certain circumstances as described below. In evaluating whether there are any circumstances where net cash settlement may be required, an issuer should consider whether there are any circumstances that are outside the issuer's control that could potentially prevent it from settling the contract on a physical or net share basis.

The equity classification guidance states that the probability of occurrence of an event/circumstance is not a factor in making this assessment and should not be considered. This is sometimes referred to as using a "theoretically possible" threshold for evaluating possible future events. In essence, the guidance requires that the issuer determine it is able both contractually and fully within its control to settle an instrument on a physical or net share basis.

If a net cash settlement can be triggered upon an occurrence of an event, the issuer needs to determine whether the occurrence or nonoccurrence of the event is solely within its control. The assessment depends on the entity's governance structure.

For example, actions that management of the issuer and its board of directors could take to avoid net cash settlement are generally considered in the control of the issuer, but actions requiring shareholder approval are considered to be beyond the issuer's control. In practice, there is a distinction between items requiring a shareholder vote (perhaps at the annual meeting or a special vote) and items that are decided by the board of directors, despite the fact that the board represents the shareholders.

The assessment of whether the event or circumstance that can trigger a net cash settlement is within the issuer's control requires professional judgment and could differ depending on the entity's facts and circumstances.

If there is any possibility that the issuer may be unable to share settle (e.g., it has an inadequate number of authorized and unissued shares), net cash settlement is presumed unless directly rebutted in the contract, even when the explicit terms of the contract provide for share settlement as the only allowable means of settlement (whether physical or net share). As nonperformance is assumed to be an unacceptable alternative to the counterparty, the contract is assumed to be cash-settled either through negotiation between the counterparties or legal proceedings.

On the other hand, net cash settlement is not presumed when a contract requires settlement in registered shares and registered shares are not available. In accordance with ASC 815-40-25-10A, requirements to deliver registered shares do not, by themselves, imply that an entity does not have the ability to deliver shares. Instead, the entity must analyze whether the contract explicitly requires settlement in cash when registered shares are unavailable, and only contracts that require settlement in cash in this situation will be precluded from equity classification. Contracts that permit settlement in unregistered shares or are silent about how they will be settled when registered shares are unavailable are not precluded from being classified as equity if all other equity classification criteria in ASC 815-40 are met.

We believe this guidance can be used as a general principle in other situations (e.g., when shares of a particular character, such as listed shares, are required to be settle a contract). Unless a contract explicitly requires cash settlement when shares of the specified character are not available, we believe cash settlement is not presumed.

The equity classification guidance provides limited exceptions for net cash settlement. ASC 815-40-25-8 provides an exception if net cash settlement is triggered by an event that is not within the entity's control and the counterparty is permitted to receive or deliver, upon settlement, the same form of consideration (e.g., cash, debt or other assets) as holders of the shares underlying the contract. Refer to Question 10 in section B.9 for further information on the application of this exception. In addition, ASC 815-40-25-9 provides an exception when cash settlement is required only on final liquidation of the issuer.

The terms of equity contracts should be carefully analyzed to determine whether there are events outside the issuer's control that may require (or be deemed to require) net cash settlement. Contracts executed using standard ISDA documentation (discussed in section B.4.2) permit the counterparty to net cash settle the contract upon the occurrence of events outside the control of the entity (e.g., provisions that cause a technical default or early termination of the contract upon the occurrence of certain events, upon which net cash settlement is required). In practice, issuers address this automatic trigger of net cash settlement by including in the ISDA confirmation language that states that, notwithstanding any other terms or settlement provision in the associated ISDA Master Agreement or Equity Definitions, in all cases the issuer can override those provisions and choose the form of settlement. The effect of those provisions should be carefully considered in determining if the conditions for equity classification are met.

Refer to Question 10 in section B.9 — How does a "net cash settlement upon a change in control" provision, or on nationalization or similar events, affect the determination of whether settlement in shares is within the control of the entity?

Refer to Question 12 in section B.9 — If an equity contract requires settlement in some form of shares other than registered shares (e.g., requires settlement shares of a listed company), do the same considerations regarding the requirement to deliver registered shares apply?

Refer to Question 21 in section B.9 — How is a "buy-in" provision considered when evaluating a warrant under the equity classification guidance in ASC 815-40-25?

Refer to Question 22 in section B.9 — How does an entity apply the equity classification in ASC 815-40-25 to a purchased option on its redeemable preferred stock?

## B.4.4 Additional considerations necessary for equity classification

**Excerpt from Accounting Standards Codification**

**Derivatives and Hedging — Contracts in Entity's Own Equity**

*Recognition*

*815-40-25-10*

Because any contract provision that could require net cash settlement precludes accounting for a contract as equity of the entity (except for those circumstances in which the holders of the underlying shares would receive cash, as discussed in paragraphs 815-40-25-8 through 25-9 and paragraphs 815-40-55-2 through 55-6), all of the following conditions must be met for a contract to be classified as equity:

a. Subparagraph superseded by Accounting Standards Update No. 2020-06.

b. Entity has sufficient authorized and unissued shares. The entity has sufficient authorized and unissued shares available to settle the contract after considering all other commitments that may require the issuance of stock during the maximum period the derivative instrument could remain outstanding.

c. Contract contains an explicit share limit. The contract contains an explicit limit on the number of shares to be delivered in a share settlement.

d. No required cash payment (with the exception of penalty payments) if entity fails to timely file. There is no requirement to net cash settle the contract in the event the entity fails to make timely filings with the Securities and Exchange Commission (SEC).

e. No cash-settled top-off or make-whole provisions. There are no cash settled top-off or make-whole provisions.

f. Subparagraph superseded by Accounting Standards Update No. 2020-06.

g. Subparagraph superseded by Accounting Standards Update No. 2020-06.

Paragraphs 815-40-25-39 through 25-42 explain the application of these criteria to convertible debt and other hybrid instruments.

*815-40-25-10A*

The following conditions are not required to be considered in an entity's evaluation of net cash settlement (that is, if any one of these provisions is in a contract [or the contract is silent on these points], they should not preclude equity classification, except as described below):

a. Whether settlement is required in registered shares, unless the contract explicitly states that an entity must settle in cash if registered shares are unavailable. Requirements to deliver registered shares do not, by themselves, imply that an entity does not have the ability to deliver shares and, thus, do not require a contract that otherwise qualifies as equity to be classified as a liability.

b. Whether counterparty rights rank higher than shareholder rights. If the provisions of the contract indicate that the counterparty has rights that rank higher than the rights of a shareholder of the stock underlying the contract, this provision does not preclude equity classification.

c. Whether collateral is required. A provision requiring the entity to post collateral at any time for any reason does not preclude equity classification.

The equity classification guidance provides four additional conditions (in addition to the basic settlement choice discussed in sections B.4.2 and B.4.3) in ASC 815-40-25-10 that must be met for a contract to be classified as equity. These conditions are not subject to a probability assessment (i.e., the likelihood of an event that would trigger cash settlement is not relevant) and must be met during the entire term of the contract. In the event that a contract fails to meet one or more of the conditions after issuance because of new facts or circumstances, reclassification (or bifurcation of an embedded feature) is required as of the date the requirement is no longer met.

Entities do not need to assess whether a contract permits settlement in unregistered shares. Instead, in circumstances where a contract requires settlement in registered shares, an entity must analyze whether the contract explicitly requires them to settle the contract in cash if registered shares are unavailable. Pursuant to ASC 815-40-25-10A, when a contract requires settlement in registered shares and explicitly states that an entity must settle in cash if registered shares are unavailable, that entity must consider its ability to deliver the registered shares. Contracts that permit settlement in unregistered shares or are silent about how they will be settled when registered shares are unavailable are not precluded from being classified as equity if all other equity classification criteria in ASC 815-40 are met.

Further, entities are not required to assess whether an equity contract requires any collateral or provides the holder with rights that rank higher than shareholder rights in bankruptcy. However, entities should not analogize to the guidance related to collateral under ASC 815-40-25-10A(c) when accounting for other arrangements that are intended to reduce credit risk (e.g., master netting arrangements that permit netting of equity-classified derivative contracts with those classified as assets or liabilities). We believe that master netting arrangements that only permit the netting of equity-classified derivatives with other equity-classified derivatives would not preclude equity classification for the contracts subject to those arrangements.

As provided in ASC 815-40-25-39, the additional conditions described above do not apply when analyzing a potential embedded derivative for bifurcation pursuant to ASC 815 if the hybrid contract is a convertible debt instrument that allows the holder to realize the value of the conversion option only by exercising the option and receiving the entire proceeds in a fixed number of shares or the equivalent amount of cash (at the discretion of the issuer). Convertible preferred stock with a debt host may also qualify for the exception in ASC 815-40-25-39. Refer to section 2.2.4.8 for further discussion.

Refer to Question 11 in section B.9 — How does one determine if an instrument qualifies for the exception included in ASC 815-40-25-39 in analyzing the requirements of the equity classification guidance for embedded conversion options?

### B.4.4.1 Entity has sufficient authorized and unissued shares

**Excerpt from Accounting Standards Codification**

**Derivatives and Hedging — Contracts in Entity's Own Equity**

*Recognition*

*815-40-25-19*

If an entity could be required to obtain shareholder approval to increase the entity's authorized shares to net share or physically settle a contract, share settlement is not controlled by the entity.

*815-40-25-20*

Accordingly, an entity shall evaluate whether a sufficient number of authorized and unissued shares exists at the classification assessment date to control settlement by delivering shares. In that evaluation, an entity shall compare both of the following amounts:

a. The number of currently authorized but unissued shares, less the maximum number of shares that could be required to be delivered during the contract period under existing commitments, including any of the following:

    1. Outstanding convertible debt that is convertible during the contract period
    2. Outstanding stock options that are or will become exercisable during the contract period
    3. Other derivative financial instruments indexed to, and potentially settled in, an entity's own stock.

b. The maximum number of shares that could be required to be delivered under share settlement (either net share or physical) of the contract.

*815-40-25-21*

When evaluating whether there are sufficient authorized and unissued shares available to settle a contract, an entity shall consider the maximum number of shares that could be required to be delivered under a registration payment arrangement to be an existing share commitment, regardless of whether the instrument being evaluated is subject to that registration payment arrangement.

*815-40-25-22*

If the amount in paragraph 815-40-25-20(a) exceeds the amount in paragraph 815-40-25-20(b) and the other conditions in this Subtopic are met, share settlement is within the control of the entity and the contract shall be classified as a permanent equity instrument. Otherwise, share settlement is not within the control of the entity and asset or liability classification is required.

*815-40-25-23*

For purposes of this calculation, if a contract permits both (a) net share and (b) physical settlement by delivery of shares at the entity's option (both alternatives permit equity classification if the other conditions in this Section are met), the alternative that results in the lesser number of maximum shares shall be included in this calculation.

*815-40-25-24*

If a contract is classified as either an asset or a liability because the counterparty has the option to require settlement of the contract in cash, then the maximum number of shares that the counterparty could require to be delivered upon settlement of the contract (whether physical or net share) shall be assumed for purposes of this calculation.

If an issuer does not have sufficient authorized and unissued shares to settle the contract, settlement is assumed to be in cash, resulting in asset or liability classification. The required shareholder approval to increase the issuer's authorized shares to be able to net share or physically settle a contract by issuing shares is not considered to be in the issuer's control. If an entity had an insufficient number of authorized and unissued shares, upon obtaining shareholder approval to increase the number of authorized and issued shares assuming the other conditions are met, reclassification to equity would be required.

This provision may be evaluated differently in jurisdictions, based on the relevant laws. For example, generally the shareholders (as opposed to board of directors) must directly vote on share authorizations in the US. However, that action generally is left to management and/or the board of a company in Canada.

In calculating the maximum number of available authorized and unissued shares, companies must exclude any shares that could be required to be delivered pursuant to all contracts providing the counterparty with an option to share settle (whether physical or net share). This calculation should be performed notwithstanding the fact that such contracts may already be classified as an asset or as a liability. In addition to the items specifically identified in ASC 815-40-25-20, other examples include convertible preferred shares or warrants to purchase convertible securities and share-settled contingent consideration issued in a business combination.

It is not necessary to subtract anticipated voluntary share issuances from the number of authorized but unissued shares, because such issuances are within the control of the issuer. However, any such voluntary issuances should be considered in the periodic reassessment of the classification of the contract when they occur, as discussed previously. Companies that anticipate the issuance of new shares, granting of stock options or issuance of convertible debt should consider obtaining the authorization for those issuances to avoid the reclassification of an equity contract if those events occur.

When analyzing outstanding contracts at a point in time, an issuer may determine that it has insufficient shares to assert share settlement for all the contracts. In those situations, the issuer should allocate the shares available to the various contracts, which likely will result in one or more new contracts being classified (or existing equity contracts reclassified) as an asset or liability. Refer to section B.6 for a discussion of the concept of allocating shares to contracts being analyzed.

Refer to Question 13 in section B.9 — How do the requirements of the NYSE's and NASDAQ's "20% Rule" affect the analysis of equity classification?

### B.4.4.2 Contract contains an explicit share limit

**Excerpt from Accounting Standards Codification**

**Derivatives and Hedging — Contracts in Entity's Own Equity**

*Recognition*

*815-40-25-26*

For certain contracts, the number of shares that could be required to be delivered upon net share settlement is essentially indeterminate. If the number of shares that could be required to be delivered to net share settle the contract is indeterminate, an entity will be unable to conclude that it has sufficient available authorized and unissued shares and, therefore, net share settlement is not within the control of the entity.

*815-40-25-27*

If a contract limits or caps the number of shares to be delivered upon expiration of the contract to a fixed number, that fixed maximum number can be compared to the available authorized and unissued shares (the available number after considering the maximum number of shares that could be required to be delivered during the contract period under existing commitments as addressed in paragraph 815-40-25-20 and including top-off or make-whole provisions as discussed in paragraph 815-40-25-30) to determine if net share settlement is within the control of the entity. A contract termination trigger alone (for example, a provision that requires that the contract will be terminated and settled if the stock price falls below a specified price) does not satisfy this requirement because, in that circumstance, the maximum number of shares deliverable under the contract is not known with certainty unless there is a stated maximum number of shares.

*815-40-25-28*

This paragraph addresses a contract structure that caps the number of shares that must be delivered upon net share settlement but would also provide that any contract valued in excess of that capped amount may be delivered to the counterparty in cash or by delivery of shares (at the entity's option) when authorized, unissued shares become available. The structure requires the entity to use its best efforts to authorize sufficient shares to satisfy the obligation. Under the structure, the number of

shares specified in the cap is less than the entity's authorized, unissued shares less the number of shares that are part of other commitments (see paragraph 815-40-25-20). Use of the entity's best efforts to obtain sufficient authorized shares to settle the contract is within the entity's control. If the contract provides that the number of shares required to settle the excess obligation is fixed on the date that net share settlement of the contract occurs, the excess shares need not be considered when determining whether the entity has sufficient, authorized, unissued shares to net share settle the contract pursuant to paragraph 815-40-25-20. However, the contract may provide that the number of shares that must be delivered to settle the excess obligation is equal to a dollar amount that is fixed on the date of net share settlement (which may or may not increase based on a stated interest rate on the obligation) and that the number of shares to be delivered will be based on the market value of the stock at the date the excess amount is settled. In that case, the excess obligation represents stock-settled debt and shall preclude equity classification of the contract (or, if partial net share settlement is permitted under the contract pursuant to paragraph 815-40-35-11, precludes equity classification of the portion represented by the excess obligation).

Contracts must contain an explicit share limit in order to be classified in equity. If the number of shares that could be required to be delivered upon net share settlement is essentially indeterminate the issuer cannot assert it will be able to settle the contract in shares given its authorized and unissued shares. The probability of the number of settlement shares exceeding the available shares is not considered.

For example, assume that an issuer writes a put option that permits the counterparty to put 100,000 issuer shares to the issuer at $100 per share. The contract permits the issuer to net share settle the contract (i.e., at settlement, the issuer will deliver issuer shares with an aggregate value equal to the excess of $100 over the market value times 100,000). If the market price of the issuer's shares falls to $1 as of the settlement date, the issuer would be required to deliver 9,900,000 shares pursuant to a net share settlement (($99 x 100,000)/$1). If the market price of the shares falls to $0.125, the issuer would be required to deliver 79,900,000 shares pursuant to a net share settlement (($99.875 x 100,000)/$0.125). The number of potential shares continues to increase without limit as the share price approaches zero.

Although the written put option in the above example is classified as a liability pursuant to ASC 480, it would affect the equity classification analysis of other potentially share-settled instruments. If the number of shares that could be required to be delivered to net share settle the contract is indeterminate, an issuer would be unable to conclude that it has sufficient available authorized and unissued shares and, therefore, share settlement or net share settlement of any other instrument would not be within the control of the issuer. As with other potential future events, the probability of the stock price declining to any given point is not considered pursuant to the equity classification guidance.

If a contract limits or caps the number of shares to be delivered upon exercise of the contract to a fixed maximum number, the fixed maximum number can be compared to the available authorized and unissued shares to determine if net share settlement is within the control of the issuer. An absence of such a cap would result in a theoretically unlimited number of shares that could potentially be issued and thus, preclude this contract and potentially other contracts from being classified in equity as it is presumed to absorb all remaining authorized and unissued shares.

However, an issuer may be able to avoid liability or asset classification for some or all of its affected equity contracts by ordering them in terms of which obligations are assumed to be settled first. Depending on which contracts are tainted with inadequate shares for settlement (refer to discussion in section B.6), it may be possible to select an accounting policy that places the uncapped obligation last, thus supporting a conclusion that the issuer would have sufficient shares to settle all other contracts first, before potentially running out of shares for the uncapped contract.

A concern of counterparties in accepting a cap is that they would incur a loss if upon settlement the share settlement results in a number of shares that exceeds the cap. Accordingly, the equity classification guidance in ASC 815-40-25-28 permits issuers to set a cap and if the shares to be issued are more than the cap specified in the agreement, the guidance permits delivery of the remaining shares when the authorized number of shares is increased to accommodate the additional shares to be issued, whenever that will be. That provision provides the investor with some comfort that the issuer will endeavor to settle the excess shares, but not provide a contractual commitment to issue those shares (or equivalent incremental cash).

In addition, equity contracts often include adjustment mechanisms to the number of issuable shares based on specified events (e.g., adjustments based on future stock issuance). If an entity can demonstrate that such events are within the entity's control and all other equity classification criteria are met, we do not object to the conclusion that the share limit condition is met.

Refer to Question 14 in section B.9 — How are contractual adjustments to the number of shares pursuant to an equity contract considered when evaluating the equity classification guidance?

#### *B.4.4.2.1 Multiple share limits*

An indenture may provide for more than one share cap. When evaluating whether an issuer has sufficient authorized and unissued shares to settle a feature (e.g., conversion), it should determine the maximum number of shares that could be issued in every possible settlement scenario, which may require the issuer to clarify the interaction of the various limits. If only one limit exists, the issuer should determine whether the limit covers all possible share delivery requirements associated with the feature.

### B.4.4.3 No required cash payment (with the exception of penalty payments) if entity fails to file timely

**Excerpt from Accounting Standards Codification**

**Derivatives and Hedging — Contracts in Entity's Own Equity**

*Recognition*

*815-40-25-29*

The ability to make timely SEC filings is not within the control of the entity. Accordingly, if a contract permits share settlement but requires net cash settlement in the event that the entity does not make timely filings with the SEC, that contract shall be classified as an asset or a liability.

Certain contracts provide for a required cash settlement of the contract in the event of a failure by the issuer to make timely SEC filings. The ability to make timely SEC filings may appear to be in the control of the issuer, but, because particular filings require the inclusion of financial statements and an audit opinion (for annual statements) or review (for quarterly filings) and possibly the consent of third parties (e.g., auditors or other experts), the ability to make timely filings is not completely within the control of the issuer.

As the guidance does not consider the probability of an event occurring that would require cash settlement, issuers cannot ignore the possibility, however remote, that they would not be able to provide completed financial statements or have obtained the appropriate audit, review or consent. Accordingly, the existence of provisions that mandate net cash settlement of the contract in the event that the issuer does not make timely filings with the SEC would result in an asset or a liability classification for the contract. ASC 815-40-25-10(d) further clarifies that a penalty payment upon a failure to timely file does not preclude equity classification because it does not result in a settlement of the contract. For example, many contingent interest provisions in convertible debt instruments may require additional interest payments in the event the issuer fails to file a timely report with the SEC. Those features do not preclude equity classification of the conversion feature pursuant to ASC 815-40-25.

Some contracts may include requirements, either embedded in the contract or in a separate agreement, to pay certain liquidated damages (rather than settle the entire contract) in the event an issuer cannot register the shares. While this provision requires a potential cash payment, it does not result in the settlement of the equity-linked instrument or feature. Accordingly, this provision does not preclude equity classification pursuant to ASC 815-40-25-29. ASC 825-20, *Financial Instruments — Registration Payment Arrangements,* states that certain registration payment agreements should be recognized as a separate unit of account from the financial instrument subject to that arrangement. Refer to section 5.11 for further discussion.

Refer to Question 15 in section B.9 — How should a registration rights agreement be considered in the analysis of the entity's (1) ability to settle a contract in unregistered shares and (2) potential obligation to make cash payments in the event of a failure to timely file with the SEC?

### B.4.4.4 No cash-settled 'top-off' or 'make-whole' provisions

**Excerpt from Accounting Standards Codification**

**Derivatives and Hedging — Contracts in Entity's Own Equity**

*Recognition*

*815-40-25-30*

A top-off or make-whole provision would not preclude equity classification if both of the following conditions exist:

a. The provision can be net share settled.

b. The maximum number of shares that could be required to be delivered under the contract (including any top-off or make-whole provisions) is both:

   1. Fixed

   2. Less than the number of available authorized shares (authorized and unissued shares less the maximum number of shares that could be required to be delivered during the contract period under existing commitments as discussed in paragraph 815-40-25-20).

If those conditions are not met, equity classification is precluded.

Some contracts include "top-off" or "make-whole" provisions. Such provisions generally are intended to reimburse the counterparty for losses it incurs or to transfer to the issuer gains the counterparty recognizes on the difference between (1) the settlement date value and (2) the value received by the counterparty in subsequent sales of the securities. We generally believe those sales should occur within a relatively short specified time after the settlement date (e.g., typically 30 days). If such a provision can be net share settled, and the maximum number of shares that could be required to be delivered pursuant to the contract is fixed and less than the number of available authorized shares as discussed above, a top-off or make-whole provision would not preclude equity classification. If those conditions are not met, equity classification would be precluded.

For example, assume an issuer enters into a written call option contract that permits the counterparty to purchase from the issuer 100,000 of the issuer's common shares for $10 a share during the six-month period commencing on the contract date. The contract provides the issuer with a choice of net cash or net share settlement. Additionally, the call option contract includes a "make-whole" provision that stipulates what happens if the issuer elects net share settlement and the counterparty sells the shares during the 15 days after the settlement date. Under the provision, the issuer must reimburse the counterparty for any loss the counterparty incurs on subsequent sales (i.e., the proceeds are less than the fair value of the shares on the settlement date of the call option), and the counterparty must transfer any gains it recognizes on subsequent sales (i.e., the proceeds exceed the fair value on the settlement date) to the issuer. The issuer can choose to settle the difference in either cash or shares, but the additional shares it may be required to deliver are limited to 100,000 shares.

Because the provision could be settled in shares at the issuer's choice and the maximum number of shares that could be required to be delivered pursuant to the make-whole provision is capped at 100,000 shares, equity classification is appropriate (assuming the issuer has a sufficient number of authorized and unissued shares). If the issuer cannot elect to settle the make-whole provision (also known as a "top-off" provision) in shares, the call option contract would be classified as an asset or a liability.

We generally believe that a make-whole provision does not violate Step 2 (the fixed-for-fixed criteria discussed in section B.3.3) in assessing whether the instrument is indexed to the issuer's stock, notwithstanding that the number of shares ultimately delivered could be higher or lower (thus the number of shares is not fixed). We generally believe that the indexation guidance was not intended to change the equity classification guidance. Rather, the intent of the indexation guidance is to evaluate the settlement value of the contract to determine whether that value is based on the number of shares underlying the equity contract. That number of shares, which is often fixed, is the subject of the analysis pursuant to the indexation guidance, rather than the potential variability that can emerge in the relatively short term after the settlement date that is contemplated in the make-whole provision pursuant to the equity classification guidance.

## B.5 Initial measurement, subsequent balance sheet classification and measurement, and derecognition

**Excerpt from Accounting Standards Codification**

**Derivatives and Hedging — Contracts in Entity's Own Equity**

*Initial Measurement*

*815-40-30-1*

All contracts within the scope of this Subtopic shall be initially measured at fair value.

**Derivatives and Hedging — Contracts in Entity's Own Equity**

*Subsequent Measurement*

*Overall*

*815-40-35-1*

All contracts shall be subsequently accounted for based on the current classification and the assumed or required settlement method in Section 815-40-15 or Section 815-40-25 as follows.

*Equity Instruments — Permanent Equity*

*815-40-35-2*

Contracts that are initially classified as equity under Section 815-40-25 shall be accounted for in permanent equity as long as those contracts continue to be classified as equity. Subsequent changes in **fair value** shall not be recognized as long as the contracts continue to be classified as equity. Both of the following shall be reported in permanent equity:

a. Contracts that require that the entity deliver shares as part of a physical settlement or a net share settlement

b. Contracts that give the entity a choice of either of the following:

    1. Net cash settlement or settlement in shares (including net share settlement and physical settlement that requires that the entity deliver shares)

    2. Either net share settlement or physical settlement that requires that the entity deliver cash.

*815-40-35-3*

See paragraphs 815-40-35-14 through 35-18 for guidance on an issuer's accounting for modifications or exchanges of freestanding equity-classified written call options that remain equity classified after modification or exchange.

*Assets or Liabilities*

*815-40-35-4*

All other contracts classified as assets or liabilities under Section 815-40-25 or paragraph 815-40-15-8A shall be measured subsequently at fair value, with changes in fair value reported in earnings and disclosed in the financial statements as long as the contracts remain classified as assets or liabilities (see paragraph 815-40-50-1).

*Settlement Assumptions*

*815-40-35-5*

Net share settlement should be assumed for contracts that are classified under Section 815-40-25 as equity instruments that provide the entity with a choice of either of the following:

a. Net share settlement

b. Physical settlement that may require that the entity deliver cash.

*815-40-35-6*

Physical settlement should be assumed for contracts that are classified under Section 815-40-25 as equity instruments that provide the counterparty with a choice of either of the following:

a. Net share settlement

b. Physical settlement that may require that the entity deliver cash.

*Derivatives and Hedging — Contracts in Entity's Own Equity*

*Derecognition*

*815-40-40-1*

If contracts classified as permanent equity are ultimately settled in a manner that requires that the entity deliver cash, the amount of cash paid or received shall be reported as a reduction of, or an addition to, contributed capital.

*815-40-40-2*

If contracts classified as assets or liabilities are ultimately settled in shares, any gains or losses on those contracts shall continue to be included in earnings.

After applying the indexation guidance and equity classification guidance in ASC 815-40, a freestanding contract (or embedded feature) should be classified in one of several ways:

- As an equity instrument (or not bifurcated) if:
  - A freestanding contract (or embedded feature) met the definition of a derivative pursuant to ASC 815, but received an exception from derivative accounting pursuant to ASC 815-10-15-74 (a) after consideration of the guidance in ASC 815-40.
  - A freestanding contract did not meet the definition of a derivative pursuant to ASC 815 but met the requirements for equity classification pursuant to ASC 815-40.

- As an asset or liability (or bifurcated) if:
  - A freestanding contract (or embedded feature) met the definition of a derivative pursuant to ASC 815 but did not receive an exception from derivative accounting pursuant to ASC 815-10-15-74(a) after consideration of the guidance in ASC 815-40.
  - A freestanding contract did not meet the definition of a derivative pursuant to ASC 815 and did not meet the requirements for equity classification pursuant to ASC 815-40.

Generally, a freestanding equity contract should initially be measured at fair value, regardless of its classification. Sometimes, the equity contract may be measured initially at its allocated proceeds if it is issued as part of a basket issuance (e.g., warrant issued in connection with debt). Refer to section 1.2.7 for further guidance on the allocation of proceeds.

For embedded equity-linked features that require bifurcation, the value to be recognized for the bifurcated derivative depends on whether it is an option-based feature or a forward-based feature. Option-based features are bifurcated at their fair value based on the contractual terms. Forward-based features are bifurcated at zero and their terms are adjusted to the implied terms that produce fair value of zero (refer to section 1.2.3.3).

Subsequent measurement will depend on where an equity-linked contract (or bifurcated feature) is classified and why it was classified there:

| Classification | Reason for classification | Subsequent measurement |
|---|---|---|
| Equity | Meets the ASC 815-10 definition of a derivative and qualifies for the exception from derivative accounting when considering ASC 815-40 | Not remeasured unless reclassification is required |
| Equity | Does not meet the definition of a derivative and meets the criteria for equity classification under ASC 815-40 | Not remeasured unless reclassification is required |
| Asset/liability | Meets the definition of a derivative and did not qualify for the exception from derivative accounting under either or both of the indexation guidance in ASC 815-40-15 and the equity classification guidance in ASC 815-40-25 | Fair value with changes in fair value reflected in earnings unless appropriately designated in a hedge |
| Asset/liability | Does not meet the definition of a derivative and fails the indexation guidance in ASC 815-40-15; or meets the indexation guidance in ASC 815-40-15 but fails the equity classification guidance in ASC 815-40-25 | Fair value with changes in fair value reflected in earnings |

As discussed in section B.6, the classification of contracts and features can change over time. Contracts are reassessed at each balance sheet date for the appropriate classification.

Upon settlement or termination, if an equity contract or bifurcated embedded derivative is classified as an asset or liability at fair value, the instrument or bifurcated embedded derivative is marked to its fair value at the settlement date and then the asset is realized or liability settled.

- If cash is received or paid in the settlement, it is recorded as a debit or credit for the amounts transferred.
- Any shares received or delivered are recorded at that balance in equity as treasury stock (if shares are received) or as shares issued (if shares are delivered) with appropriate allocation to common stock at par and the remainder to APIC related to common shares. If the treasury shares are considered retired, separate accounting is performed.

If the instrument is classified as equity, any cash received or paid in the settlement is recorded as a debit or credit for the amounts transferred with offset to APIC. If any shares are received or delivered they are recorded in equity as treasury stock (if shares are received) or as shares issued (if shares are delivered) with appropriate allocation to common stock at par and APIC. If the treasury shares are considered retired, separate accounting is performed.

## B.6 Reclassification of contracts

**Excerpt from Accounting Standards Codification**

**Derivatives and Hedging — Contracts in Entity's Own Equity**

*Subsequent Measurement*

*Reclassification of Contracts*

*815-40-35-8*

The classification of a contract (including freestanding financial instruments and embedded features) shall be reassessed at each balance sheet date. If the classification required under this Subtopic changes as a result of events during the period (if, for example, as a result of voluntary issuances of stock the number of authorized but unissued shares is insufficient to satisfy the maximum number of shares that could be required to net share settle the contract [see discussion in paragraph 815-40-25-20]), the contract shall be reclassified as of the date of the event that caused the reclassification. There is no limit on the number of times a contract may be reclassified.

*815-40-35-9*

If a contract is reclassified from permanent or temporary equity to an asset or a liability, the change in fair value of the contract during the period the contract was classified as equity shall be accounted for as an adjustment to stockholders' equity. The contract subsequently shall be marked to fair value through earnings. If an embedded feature no longer qualifies for the derivatives scope exception under this Subtopic, the feature shall be separated from its host contract and accounted for as a derivative instrument in accordance with Subtopic 815-10 and Subtopic 815-15 (if all of the criteria in paragraph 815-15-25-1 are met).

*815-40-35-10*

If a contract is reclassified from an asset or a liability to equity, gains or losses recorded to account for the contract at fair value during the period that the contract was classified as an asset or a liability shall not be reversed. The contract shall be marked to **fair value** immediately before the reclassification. An **embedded derivative** that qualifies for the derivatives scope exception upon reassessment under this Subtopic that was separated from its host contract and accounted for as a derivative instrument in accordance with Subtopic 815-10 shall be reclassified to equity. The previously bifurcated embedded derivative shall not be recombined with its host contract.

*815-40-35-11*

If a contract permits partial net share settlement and the total notional amount of the contract no longer can be classified as permanent equity, any portion of the contract that could be net share settled as of that balance sheet date shall remain classified in permanent equity. That is, a portion of the contract shall be classified as permanent equity and a portion of the contract shall be classified as an asset, a liability, or temporary equity, as appropriate.

*815-40-35-12*

If an entity has more than one contract subject to this Subtopic, and partial reclassification is required, there may be different methods that could be used to determine which contracts, or portions of contracts, shall be reclassified. Methods that would comply with this Section could include any of the following:

a. Partial reclassification of all contracts on a proportionate basis

b. Reclassification of contracts with the earliest inception date first

c. Reclassification of contracts with the earliest maturity date first

d. Reclassification of contracts with the latest inception or maturity date first

e. Reclassification of contracts with the latest maturity date first.

*815-40-35-13*

The method of reclassification shall be systematic, rational, and consistently applied.

ASC 815-40-35-8 through 35-9 require that the issuer reassess the classification of a contract (both a freestanding financial instrument and an embedded feature) at each balance sheet date. If the classification changes because of events occurring during the reporting period, the contract is reclassified as of the date of the event that caused the reclassification.

To illustrate, assume that an issuer enters into a forward sale contract in which it has a choice of net share or net cash settlement (a partial settlement in shares and cash is not permitted, as discussed in the following section). Assume further that at issuance, the issuer has a sufficient number of authorized and unissued shares to net share settle the contract, the contract contains an explicit limit on the number of shares to be delivered and all other provisions for equity classification are met. Subsequently, because of an issuance of additional shares of stock, the issuer no longer has sufficient authorized and unissued shares to net share settle the contract after considering the explicit limit (a cap on shares to issue).

Pursuant to the equity classification guidance, the issuer should reclassify the contract to an asset or a liability on the date the additional shares were issued. Any changes in fair value during the period the contract was classified as equity should be accounted for as an adjustment to stockholders' equity. If, at a later date, the issuer obtains shareholder authorization and again has sufficient authorized and unissued shares to settle the contract, the contract is reclassified back to equity on the date the approval was obtained. Gains or losses recognized to account for the contract at fair value during the period that the contract was classified as an asset or a liability are not reversed.

**Reclassification upon settlement method election**

Equity-linked instruments or embedded features that provide the issuer with a choice of net share or net cash settlement may have extended settlement periods (e.g., 45 days). In these cases, the issuer may be required to make an irrevocable election at the beginning of the settlement period to settle the instrument or embedded feature in cash or shares. While a provision that provides the issuer with a choice of net cash settlement or settlement in shares (physical or net share) does not initially preclude a contract from being classified in equity, upon the issuer's irrevocable cash settlement election, reclassification of the contract would be required.

## B.6.1 Allocation of shares to contracts for reclassification

An issuer may have more than one contract subject to the equity classification guidance. Some contracts (or portion of contracts) may require asset or liability classification because the issuer does not have sufficient authorized and unissued shares to cover all share settlement obligations under those contracts. In that case, an accounting policy (sometimes referred to as a contract ordering policy as it will order the contracts and then allocate shares to the first, then the second, etc.) may be elected to determine which contracts, or portions of contracts, should be reclassified.

ASC 815-40-35-12 describes several methods that would be appropriate. Although no illustrations are provided, the guidance states that the method of reclassification should be systematic, rational and consistently applied. Although ASC 815-40-35-12 appears to permit for the application of other methods, as indicated by the use of the phrase "could include," to our knowledge, the use of other methods is rare. A company should carefully consider its choice of policy given both current capitalization and future potential transactions.

The determination of how to partially reclassify contracts subject to the equity classification guidance is an accounting policy decision that, as described in ASC 815-40-50-4, should be disclosed pursuant to ASC 235.

## B.6.2 Partial reclassification

If a contract permits partial net share settlement, any portion of the contract that could be net share settled pursuant to the contractual arrangement as of that balance sheet date would remain classified in equity. That is, a portion of the contract could be classified as equity, and a portion of the contract could be classified as an asset or liability, as appropriate. The terms of the contract should be carefully analyzed to determine if the contract allows for partial settlement in one form of consideration with the remaining settlement in another form (i.e., cash).

To illustrate, assume that on 1 January an issuer enters into a forward transaction with a third party, requiring the third party to purchase 1,000,000 of the issuer shares on 31 December at $10 per share (the forward price on 1 January). The contract permits the issuer either to net share or net cash settle the contract at its choice (the contract does not permit physical settlement). The contract also permits partial settlement in either of the settlement choices (i.e., settlement in stock and cash). The contract contains a cap of 1,000,000 shares, and it meets all the other requirements of the indexation guidance and equity classification guidance for equity classification. Assume further that on the date the issuer entered into the contract, the issuer had 1,000,000 authorized and unissued shares and had no other outstanding commitments that may require the issuance of shares.

Pursuant to the equity classification guidance, the contract would be classified in equity at inception (1 January). Equity classification would be maintained provided that the total number of authorized and unissued shares is not less than 1,000,000.

Assume on 30 June the value of the issuer shares increases from $10 to $12. Additionally, on that date the issuer issued an additional 900,000 shares of stock without any increase to the number of authorized shares (thereby reducing the number of available authorized and unissued shares to 100,000). If the contract settles on that date, the issuer would be required to pay $2,000,000 in cash (($12-$10) x 1,000,000) pursuant to a net cash settlement or deliver the equivalent value in shares, requiring the delivery of 166,667 shares ($2,000,000/$12) pursuant to a net share settlement. On 30 June, the contract does not meet the criteria to be classified entirely as equity because there is an insufficient number of authorized and unissued shares. Accordingly, pursuant to the equity classification guidance, the amount that may not be share-settled is required to be reclassified as a liability as of the date the requirements were no longer met (30 June).

The equity classification guidance does not contain detailed guidance on how to determine of the amount to be reclassified in situations such as that above. However, we generally believe that it is consistent with the equity classification guidance to assume that the issuer would settle its obligation by delivering shares to the extent it is able. Therefore, in this example, the value of the shares that the issuer is obligated to deliver that are not authorized (66,667 shares, or approximately $800,000 [66,667 x $12]) would be reclassified as a liability on 30 June (the issuer would debit paid-in capital for $800,000 and credit a liability for the same amount). This approach indicates that 40% of the contract is being recorded as a liability ($800,000 of the $2,000,000 value or alternatively the cash for 66,667 shares of the 166,667 that would be due). Note that this example values the forward contact without regard to discounting for simplicity.

Pursuant to the equity classification guidance, the changes in fair value between 1 January and 30 June attributable to the reclassified portion of the contract would remain in paid-in capital. Changes in fair value attributable to the portion classified as a liability occurring after 30 June would be reflected in current earnings as long as the contract remains classified as a liability.

Assume that on 30 September, the fair value of the issuer's shares had continued to increase from $12 to $15. As a result, if the contract settles on that date, the issuer would be required to pay $5,000,000 in cash (($15-$10) x 1,000,000) pursuant to a net cash settlement or deliver the equivalent value in shares, requiring the delivery of 333,333 shares ($5,000,000/$15) pursuant to a net share settlement. On 30 September, the issuer can net share settle only $1,500,000 of this obligation (100,000 authorized unissued shares x $15) and the remaining obligation of $3,500,000 would have to be satisfied by a net cash payment (and, therefore, should be recorded as a liability). We generally believe calculating the amount to be recorded in earnings could be performed in at least two ways as a policy election.

The simplest method would be to mark the recorded liability to the new fair value. Consequently, on 30 September, the issuer would record a debit to income with a corresponding credit to liabilities for $2,700,000 to record the additional obligation that may not be share-settled (representing both the change in fair value of the previously liability classified portion and the additional liability classification).

A potential alternative would be to recognize that 40% of the contract was classified as a liability at 30 June. That portion of the contract had a fair value of $800,000 at 30 June, and 40% of the contract at 30 September would be $2,000,000 (40% times $5,000,000). That would suggest that the charge to earnings for the change in fair value of the portion of the contract previously classified as a liability would be $1,200,000 ($2,000,000 − $800,000). As a result, $1,500,000 (the remainder to arrive at the total liability of $3,500,000) would be reclassified from equity as a result of an increase in the amount of the contract that could not be covered by existing authorized shares. At 30 September, 70% of the contract would be classified as a liability ($3,500,000 of the $5,000,000, or alternatively the cash for 233,333 shares of the 333,333 that would be due).

If the issuer subsequently authorized the issuance of a sufficient additional number of shares or its share price increased, the issuer would adjust the carrying amount of the liability to its current fair value (the amount that the issuer would have had to pay before the additional shares were authorized) and then reclassify that remeasured carrying amount to equity. The amounts that were previously recorded as a charge to earnings in excess of that final adjustment would not be reversed.

## B.7 Illustrations

The equity classification guidance includes the following examples, based on underlying settlement provisions.

**Excerpt from Accounting Standards Codification**

**Derivatives and Hedging — Contracts in Entity's Own Equity**

***Implementation Guidance and Illustrations***

***Application of this Subtopic to Specific Instruments***

***815-40-55-7***

The following guidance reflects the application of this Subtopic to certain freestanding derivative financial instruments that are indexed to, and potentially settled in, an entity's own stock, specifically:

a. Subparagraph superseded by Accounting Standards Update No. 2020-06.

b. Forward sale contracts, written call options or warrants, and purchased put options

c. Purchased call options

d. Detachable stock purchase warrants

e. Put warrants.

### *Forward Sale Contracts, Written Call Options or Warrants, and Purchased Put Options*

#### *815-40-55-13*

The issuing entity (the seller) agrees to sell shares of its stock to the buyer of the contract at a specified price at some future date. The contract may be settled by physical settlement, net share settlement, or net cash settlement, or the issuing entity or counterparty may have a choice of settlement methods. The guidance in this Subtopic would be applied as follows.

| | One Settlement Method | | | Entity Choice | | | Counterparty Choice | | |
|---|---|---|---|---|---|---|---|---|---|
| | Physical [a] | Net Share | Net Cash | Net Share or Physical[a] | Net Share or Net Cash | Net Cash or Physical[a] | Net Share or Physical[a] | Net Share or Net Cash | Net Cash or Physical[a] |
| **(1) Initial Classification:** | | | | | | | | | |
| Equity [b] | X | X | | X | X | X | X | | |
| Asset or Liability | | | X | | | | | X | X |
| **(2) Initial Measurement, Subsequent Classification and Measurement:** | | | | | | | | | |
| Fair value, permanent equity – no changes in fair value[b] | X | X | | X | X[c] | X[c] | X | | |
| Fair value, asset or liability – adjusted for changes in fair value[d] | | | X | | | | | X[e] | X[e] |

(a) Physical settlement of the contract requires that the entity deliver shares to the holder in exchange for cash.

(b) Equity or temporary equity classification is only appropriate if the conditions in Section 815-40-25 do not require asset or liability classification of the contract.

(c) If the contracts are ultimately settled in net cash, the amount of cash paid or received should be reported as a reduction of, or an addition to, contributed capital.

(d) Subsequent changes in fair value should be reported in earnings and disclosed in the financial statements.

(e) If the contracts are ultimately settled in shares, any gains or losses on those contracts should continue to be included in earnings.

**Note:** In all cases above, the contracts must be reassessed at each reporting period in order to determine whether or not the contract must be reclassified.

### *Purchased Call Options*

#### *815-40-55-14*

The entity (the buyer) purchases call options that provide it with the right, but not the obligation, to buy from the seller, shares of the entity's stock at a specified price. If the options are exercised, the contract may be settled by physical settlement, net share settlement, or net cash settlement, or the issuing entity or the counterparty may have a choice of settlement methods. The entity should follow the preceding table in accounting for purchased call options.

### *Detachable Stock Purchase Warrants*

#### *815-40-55-15*

An entity issues senior subordinated notes with a detachable warrant that gives the holder both the right to purchase 6,250 shares of the entity's stock for $75 per share and the right (that is, a put) to require that the entity repurchase all or any portion of the warrant for at least $2,010 per share at a date several months after the maturity of the notes in about 7 years. The proceeds should be allocated between the debt liability and the warrant based on their relative fair values, and the resulting discount should be amortized in accordance with Subtopic 835-30. The warrants should be considered, in substance, debt and accounted for as a liability because the settlement alternatives for the warrants do not have the same economic value attached to them and they provide the holder with a guaranteed return in cash that is significantly in excess of the value of the share-settlement alternative on the issuance date.

### *Put Warrants*

#### *815-40-55-16*

Put warrants are frequently issued concurrently with debt securities of the entity, are detachable from the debt, and may be exercisable only under specified conditions. The put feature of the instrument may expire under varying circumstances, for example, with the passage of time or if the entity has a public stock offering. Under Subtopic 470-20, a portion of the proceeds from the issuance of debt with detachable warrants must be allocated to those warrants.

*815-40-55-17*

Put warrants are instruments with characteristics of both warrants and put options. The holder of the instrument is entitled to do any of the following:

a. Exercise the warrant feature to acquire the common stock of the entity at a specified price

b. Exercise the put option feature to put the instrument back to the entity for a cash payment

c. Exercise both the warrant feature to acquire the common stock and the put option feature to put that stock back to the entity for a cash payment.

*815-40-55-18*

Because the contract gives the counterparty the choice of cash settlement or settlement in shares, entities should report the proceeds from the issuance of put warrants as liabilities and subsequently measure the put warrants at fair value with changes in fair value reported in earnings as required by Topic 480. That is, a put warrant that embodies an obligation to repurchase the issuer's equity shares, or is indexed to such an obligation, and that requires or may require a transfer of assets is within the scope of that Topic and therefore is to be recognized as a liability.

## B.8 Disclosures for contracts in an entity's own equity

**Excerpt from Accounting Standards Codification**

**Derivatives and Hedging — Contracts in Entity's Own Equity**

*Disclosure*

*815-40-50-1A*

The disclosure guidance in this Section should help a user of financial statements understand the following:

a. Information about the terms and features of contracts in an entity's own equity within the scope of this Subtopic

b. How those instruments have been reflected in the issuer's statement of financial position and statement of financial performance

c. Information about events, conditions, and circumstances that can affect how to assess the amount or timing of an entity's future cash flows but has not yet been reflected in the financial statements.

*815-40-50-2*

The disclosure guidance in this Subtopic applies to freestanding instruments that are potentially indexed to, and potentially settled in, an entity's own equity, regardless of whether the contract meets the criteria to qualify for the scope exception in Sections 815-40-15 and 815-40-25. Some contracts that are classified as assets or liabilities meet the definition of a derivative instrument under the provisions of Subtopic 815-10. The related disclosures that are required by Sections 815-10-50, 815-25-50, 815-30-50, and 815-35-50 also are required for those contracts. Equity-classified contracts under the provisions of this Subtopic are not required to provide the disclosures required by Section 505-10-50, other than those described in paragraph 815-40-50-5.

*Fair Value Disclosures*

*815-40-50-2A*

Changes in the fair value of all contracts classified as assets or liabilities shall be disclosed in the financial statements as long as the contracts remain classified as assets or liabilities.

*Reclassifications and Related Accounting Policy Disclosures*

*815-40-50-3*

Contracts within the scope of this Subtopic may be required to be reclassified into (or out of) equity during the life of the instrument (in whole or in part) pursuant to the provisions of paragraphs 815-40-35-8 through 35-13. An issuer shall disclose contract reclassifications (including partial reclassifications), the reason for the reclassification, and the effect on the issuer's financial statements.

*815-40-50-4*

The determination of how to partially reclassify contracts subject to this Subtopic is an accounting policy decision that shall be disclosed pursuant to Topic 235.

*Interaction with Disclosures About Capital Structure*

*815-40-50-5*

The disclosures required by Section 505-10-50 apply to all contracts within the scope of this Subtopic as follows:

a. In the case of an option or forward contract indexed to the issuer's equity, the pertinent information to be disclosed under Section 505-10-50 about the contract includes all of the following:

    1. The forward rate

    2. The option strike price

    3. The number of issuer's shares to which the contract is indexed

    4. The settlement date or dates of the contract

    5. The issuer's accounting for the contract (that is, as an asset, liability, or equity).

b. If the terms of the contract provide settlement alternatives, those settlement alternatives shall be disclosed under Section 505-10-50, including all of the following:

    1. Who controls the settlement alternatives and a description of those alternatives

    2. The maximum number of shares that could be required to be issued to net share settle a contract, if applicable. Paragraph 505-10-50-3 requires additional disclosures for actual issuances and settlements that occurred during the accounting period.

c. If a contract does not have a fixed or determinable maximum number of shares that may be required to be issued, the fact that a potentially infinite number of shares could be required to be issued to settle the contract shall be disclosed under Section 505-10-50.

d. For each settlement alternative, the amount that would be paid, or the number of shares that would be issued and their fair value, determined under the conditions specified in the contract if the settlement were to occur at the reporting date and how changes in the fair value of the issuer's equity shares affect those settlement amounts (for example, the issuer is obligated to issue an additional X shares or pay an additional Y dollars in cash for each $1 decrease in the fair value of one share) shall be disclosed under Section 505-10-50. (For some issuers, a tabular format may provide the most concise and informative presentation of these data.)

e. The disclosures required by paragraph 505-10-50-11 shall be made for any equity instrument in the scope of this Subtopic that is (or would be if the issuer were a public entity) classified as temporary equity. (That paragraph applies to redeemable stock issued by nonpublic entities, regardless of whether the private entity chooses to classify those securities as temporary equity.)

f. The disclosures required by paragraph 505-10-50-18 also shall be made for an equity-classified contract within the scope of this Subtopic that is entered into in connection with the issuance of convertible preferred stock.

***Issuer's Accounting for Modifications for Exchanges of Freestanding Equity-Classified Written Call Options***

***815-40-50-6***

For a freestanding equity-classified written call option modified or exchanged during any of the periods presented and for which an entity has recognized the effect in accordance with paragraph 815-40-35-17, an entity shall disclose the following:

a. Information about the nature of the modification or exchange transaction (see paragraph 815-40-35-15)

b. The amount of the effect of the modification or exchange (see paragraph 815-40-35-16)

c. The manner in which the effect of the modification or exchange has been recognized (see paragraph 815-40-35-17).

In addition to the disclosure requirements specifically provided for in ASC 815-40, the disclosure requirements of ASC 505 apply to all contracts that are within the scope of ASC 815-40. Further, ASC 815 requires certain disclosures for contracts that are subject to derivative accounting pursuant to ASC 815.

## B.9 Frequently asked questions

The following questions are included in this section:

- Question 1 — How should a contingently issuable contract be considered pursuant to ASC 815-40?
- Question 2 — How is a warrant or conversion option where the conversion ratio changes over time based on a contractual schedule evaluated pursuant to the indexation guidance?
- Question 3 — Pursuant to the indexation guidance, how should a term in a warrant that, when settling on some early termination event, requires a calculation using a fixed volatility or market volatility with a floor, be considered?
- Question 4 — What are frequent early termination events that should be considered?
- Question 5 — Does the indexation guidance affect the determination of whether an embedded feature is "clearly and closely related" to the host instrument pursuant to ASC 815?
- Question 6 — How does the indexation guidance interact with the business combination guidance?
- Question 7 — How do differences in the economic value of multiple settlement alternatives affect the analysis of equity classification?
- Question 8 — How does a penalty in one settlement alternative affect the analysis of equity classification when multiple settlement alternatives exist?
- Question 9 — How is the analysis of equity classification affected if the settlement method differs based on whether the contract is in a gain or loss position?
- Question 10 — How does a "net cash settlement upon a change in control" provision, or on nationalization or similar events, affect the determination of whether settlement in shares is within the control of the entity?

- Question 11 — How does one determine if an instrument qualifies for the exception in ASC 815-40-25-39 in analyzing the requirements of the equity classification guidance for embedded conversion options?
- Question 12 — If an equity contract requires settlement in some form of shares other than registered shares (e.g., requires settlement in shares of a listed company), do the same considerations regarding the requirement to deliver registered shares apply?
- Question 13 — How do the requirements of the NYSE's and NASDAQ's "20% Rule" affect the analysis of equity classification?
- Question 14 — How are contractual adjustments to the number of shares pursuant to an equity contract considered when evaluating the equity classification guidance?
- Question 15 — How should a registration rights agreement be considered in the analysis of the entity's potential obligation to make cash payments in the event of a failure to timely file with the SEC?
- Question 16 — How should an entity's obligation to pay taxes and/or other governmental charges upon settlement of an equity-linked instrument (or embedded feature) be considered when evaluating the instrument (or embedded feature) under the indexation guidance?
- Question 17 — How should an entity analyze bail-in provisions under the indexation guidance?
- Question 18 — How is a warrant to purchase a fixed percentage of the issuer's outstanding common stock evaluated under the indexation guidance?
- Question 19 — How does an entity apply Step 2 of the indexation guidance to provisions within SPAC warrants that could change the settlement amount depending on the characteristics of the warrant holder?
- Question 20 — How does an entity apply the indexation guidance to earn-out arrangements it entered into in connection with its merger with a SPAC?
- Question 21 — How is a "buy-in" provision considered when evaluating a warrant under the equity classification guidance in ASC 815-40-25?
- Question 22 — How does an entity apply the equity classification in ASC 815-40-25 to a purchased option on its redeemable preferred stock?

**Question 1** **How should a contingently issuable contract be considered pursuant to ASC 815-40?**

An issuer may agree to issue an equity contract sometime in the future (e.g., upon the resolution of a contingency). For example, an issuer may agree to issue a warrant within the next two years if cumulative revenues exceed a specified amount. Because the contract that gives rise to the obligation to issue the warrant is outstanding and in the scope of 815-40-15-5 through 15-8, it is considered issued for accounting purposes (refer to ASC 815-40-15-6).

We generally believe there is no substantive difference between (1) a currently issued instrument that contains an exercise contingency and (2) a contractual promise to issue an instrument in the future. For example, there is no substantive difference between the following:

- A commitment today to issue an immediately exercisable warrant anytime in the next two years on the date, if any, when cumulative revenues exceed a specified amount
- A warrant issued today that is contingently exercisable anytime in the next two years after the date that cumulative revenues exceed a specified amount

**Question 2** **How is a warrant or conversion option where the conversion ratio changes over time based on a contractual schedule evaluated pursuant to the indexation guidance?**

The number of shares into which a warrant or conversion option is exercised may change over time according to a contractual schedule. For example, a warrant could permit the purchase of 1,000 shares in Year 1, 1,100 shares in Year 2, and 1,200 shares in Year 3. Those warrants or conversion options, if analyzed pursuant to the indexation guidance, may appear to fail the fixed-for-fixed criteria as the settlement amount varies over time and therefore would not be considered indexed to the issuer's own stock.

However, we generally believe that two views may support a conclusion that those instruments represent a fixed-for-fixed settlement pursuant to the guidance in ASC 815-40-15-7D and 15-7E. Under one view, for any given point in time during a 12-month period, the settlement amount is fixed; even though that settlement amount changes over time, the settlement amount is fixed in advance in terms of the number of shares for any given point in time in the future. Under another view the settlement amount changes simply with the passage of time, and time is an input into an option valuation model. Therefore, we generally believe such an instrument or embedded feature may be considered indexed to the issuer's own stock, provided all the other provisions of the indexation guidance are met.

**Question 3** **Pursuant to the indexation guidance, how should a term in a warrant that, when settling on some early termination event, requires a calculation using a fixed volatility or market volatility with a floor, be considered?**

Equity contracts may include provisions that require, upon an early termination, the calculation of a settlement amount using a specified volatility input. This provision is frequently associated with some form of change in control or other corporate event and may require the calculation of a settlement amount using either the volatility at the inception of the equity contract or a specified volatility established at the inception of the transaction. The feature may require the calculation to consider the greater of a specific volatility or the then-market volatility. Those provisions are more frequently included in privately negotiated and documented transactions than equity contracts using ISDA documentation.

This feature raises questions as to the existence of leverage in the settlement amount. For example, if market-based volatility at inception was 20% and the contractually specified volatility for an early termination calculation was 40%, it could be inferred that there was a 2X leverage factor. Alternatively, it could be inferred that there was a floating leverage factor that, when applied against the market-based volatility at settlement, resulted in 40% volatility as an input to the calculation.

We generally believe that the feature described above would not necessarily violate the indexation guidance. Several examples in the indexation guidance indicate that inputs to the settlement amount can be floored or capped (e.g., Example 15 at ASC 815-40-55-40 regarding a capped share price). Provided the input to the model is not an established multiple of the current market-based input (e.g., two times current volatility) or creating an inverse leverage situation (e.g., Example 14 at ASC 815-40-55-39), we generally believe leverage has not necessarily been introduced to the settlement amount. A floor, as in the example above, does not change in reaction to changes in the current volatility and thus, does not create a leverage situation. For example, if the volatility rose above 40%, the floor remains unchanged. Determining whether leverage violates the indexation guidance is a matter of facts and circumstances requiring professional judgment.

**Question 4** **What are frequent early termination events that should be considered?**

An equity contract will often specify events that can trigger an early termination of the instrument. Those events should be carefully evaluated at the inception of the transaction to determine the classification of the contract as an asset or liability or equity instrument. The following are examples of potential termination events that are often included in equity contracts:

- Hedging disruption — The counterparty is unable to establish, maintain or adjust a hedge position against the equity contract using commercially reasonable means.

- Increased cost of hedging — The counterparty is only able to establish, maintain or adjust a hedge position at a materially increased cost.
- Loss of stock borrow — The counterparty is not able to borrow the shares necessary to maintain a hedge using commercially reasonable efforts at a stock borrowing cost (similar to an interest charge) equal to or less than a defined maximum in the contract.
- Increased cost of stock borrow — The counterparty incurs stock borrow costs that exceed the inception date stock borrowing cost rate.

The counterparty often requires the inclusion of those termination events in the negotiation process. These events represent some of the assumptions that underlie the valuation models for those instruments (e.g., the counterparty will be able to hedge and will be able to borrow stock at reasonable rates) and therefore are underlying assumptions of the counterparty in pricing the transaction. These events are unpredictable and thus unhedgeable. If the counterparty were to be exposed to those risks during the life of the transaction, then the counterparty would have to include a higher risk premium in pricing the contract. By agreeing to terminate the contract and truncate the counterparty's exposure if one of those events were to occur, the parties can price the transaction by ignoring these events as possibilities (as the entity will make the counterparty whole if those events do occur).

In many cases, especially pursuant to the documentation provided by ISDA, the calculation of the termination settlement amounts will comply with the guidance in Step 2 of the indexation guidance. However, as discussed in section B.4, the issuer must also determine that it can choose the form of settlement in all cases in order to classify the contract in equity. The effect of those provisions should be carefully considered in determining if the conditions for equity classification are met.

**Question 5** **Does the indexation guidance affect the determination of whether an embedded feature is "clearly and closely related" to the host instrument pursuant to ASC 815?**

An embedded derivative should be bifurcated if each of the three conditions in ASC 815-15-25-1 is met. ASC 815-15-25-1(a) requires that "the economic characteristics and risks of the embedded derivative instrument are not clearly and closely related to the economic characteristics and risks of the host contract." Some have questioned whether an embedded equity-linked feature would have to be indexed to the issuer's stock pursuant to the indexation guidance before it could be considered "clearly and closely related" to an equity host. An example of this situation would be a conversion option in a preferred share that was considered to have an equity host.

Based on comments by the FASB staff at the 2008 AICPA National Conference on Current SEC & PCAOB Developments, we generally believe that the concept of "clearly and closely related" is a broader economic concept than the prescriptive classification guidance for financial instruments, and thus the indexation guidance should not be considered in a "clearly and closely related" evaluation pursuant to ASC 815-15-25-1(a).

**Question 6** **How does the indexation guidance interact with the business combination guidance?**

Contingent consideration determined in ASC 805 is not afforded an exception from derivative accounting pursuant to ASC 815. Therefore, the indexation guidance should be applied in conjunction with the equity classification guidance, as discussed in ASC 805-30-25-6, when determining how contingent consideration issued in a business combination should be classified.

**Question 7** **How do differences in the economic value of multiple settlement alternatives affect the analysis of equity classification?**

When a contract provides for settlement alternatives that do not have the same economic value or if one of the settlement alternatives is fixed or contains caps or floors, the accounting for the instrument (or combination of instruments) should be based on the economic substance of the transaction. For example, if a freestanding contract, issued together with another instrument, requires that the issuer provide to the holder a fixed or guaranteed return such that the instruments are, in substance, debt, the issuer should account for both instruments as liabilities, regardless of the settlement terms of the freestanding contract.

To illustrate, assume an issuer receives a premium of $200,000 for issuing a call option indexed to its stock that gives the holder the right to purchase 10,000 shares of the issuer's stock in one year at $80 per share. At contract inception, the market value of the issuer's stock is $120 (and a substantial decrease in value is not anticipated within a year based on volatility). The terms of the option provide that the issuer has the right to settle the call option in cash by paying the holder of the option $220,000 or in a physical settlement by receiving $800,000 from the holder of the option and delivering 10,000 shares of its stock.

If the equity classification guidance were applied literally and all other criteria were met, the written call option could be classified as equity because the issuer has the ability to settle the option by physical delivery. However, the substance of the transaction is that the issuer has effectively issued debt as it is unlikely that the issuer would choose physical settlement because the cost for the issuer would be substantially higher than cash settlement (gross settlement at a fair value of $400,000 (10,000 shares with a fair value of $1,200,000 less $800,000 received on exercise) compared to the cash payment of $220,000).

Because the alternatives do not have the same economic value, the accounting should be based on the underlying substance of the transaction (i.e., the alternative with the least economic cost to the issuer would be considered). In this example, the proceeds should be classified as debt with the difference between the $200,000 and the $220,000 recognized as interest expense over the contract period.

In some cases, an apparent uneconomic settlement alternative may be appropriate. For example, a different value may be appropriate when settlement is in unregistered shares (i.e., a reasonable discount to the fair value of a share when used in settlement).

**Question 8** **How does a penalty in one settlement alternative affect the analysis of equity classification when multiple settlement alternatives exist?**

If a settlement alternative includes a penalty that an issuer can avoid pursuant to other settlement alternatives, that penalty requires that the contract to be accounted for based on the economic substance of the transaction. For example, if an issuer is required to deliver a significant additional agreed-upon amount to the counterparty to net share settle a contract rather than to cash settle, the contract should be evaluated as if only cash settlement were required.

**Question 9** **How is the analysis of equity classification affected if the settlement method differs based on whether the contract is in a gain or loss position?**

Certain contracts provide for multiple settlement alternatives depending on whether the contract is in a gain or a loss position. For example, a forward sales contract can require an issuer to pay cash when the contract is in a loss position (a liability) but receive cash or net shares when the contract is in a gain position (an asset). ASC 815-40-25-36 through 25-38 addresses this situation.

**Excerpt from Accounting Standards Codification**

Derivatives and Hedging — Contracts in Entity's Own Equity

*Recognition*

*815-40-25-36*

This guidance addresses two circumstances in which settlement alternatives differ in gain and loss positions:

a. Net cash payment required in loss position

b. Net-stock alternative in loss position.

*815-40-25-37*

A contract indexed to, and potentially settled in, an entity's own stock, with multiple settlement alternatives that require the entity to pay net cash when the contract is in a loss position but receive (a) net stock or (b) either net cash or net stock at the entity's option when the contract is in a gain position shall be accounted for as an asset or a liability.

*815-40-25-38*

A contract indexed to, and potentially settled in, an entity's own stock, within the scope of this Subtopic and with multiple settlement alternatives that require the entity to receive net cash when the contract is in a gain position but pay (a) net stock or (b) either net cash or net stock at the entity's option when the contract is in a loss position shall be accounted for as an equity instrument. This guidance does not apply to a contract that is predominantly a purchased option in which the amount of cash that could be received when the contract is in a gain position is significantly larger than the amount that could be paid when the contract is in a loss position because, for example, there is a small contractual limit on the amount of the loss. Those contracts shall be accounted for as assets or liabilities.

Question 10

**How does a "net cash settlement upon a change in control" provision, or on nationalization or similar events, affect the determination of whether settlement in shares is within the control of the entity? (updated August 2023)**

**Excerpt from Accounting Standards Codification**

Derivatives and Hedging — Contracts in Entity's Own Equity

*Implementation Guidance — Additional Conditions for Equity Classification — Net Cash Settlement and Consideration to Holders of Underlying Shares*

*815-40-55-2*

An event that causes a change in control of an entity is not within the entity's control and, therefore, if a contract requires net cash settlement upon a change in control, the contract generally must be classified as an asset or a liability.

*815-40-55-3*

However, if a change-in-control provision requires that the counterparty receive, or permits the counterparty to deliver upon settlement, the same form of consideration (for example, cash, debt, or other assets) as holders of the shares underlying the contract, permanent equity classification would not be precluded as a result of the change-in-control provision. In that circumstance, if the holders of the shares underlying the contract were to receive cash in the transaction causing the change in control, the counterparty to the contract could also receive cash based on the value of its position under the contract.

*815-40-55-4*

If, instead of cash, holders of the shares underlying the contract receive other forms of consideration (for example, debt), the counterparty also must receive debt (cash in an amount equal to the fair value of the debt would not be considered the same form of consideration as debt).

*815-40-55-5*

Similarly, a change-in-control provision could specify that if all stockholders receive stock of an acquiring entity upon a change in control, the contract will be indexed to the shares of the purchaser (or issuer in a business combination accounted for as a pooling of interests) specified in the business combination agreement, without affecting classification of the contract.

*815-40-55-6*

In the event of nationalization, cash compensation would be the consideration for the expropriated assets and, as a result, a counterparty to the contract could receive only cash, as is the case for a holder of the stock underlying the contract. Because the contract counterparty would receive the same form of consideration as a stockholder, a contract provision requiring net cash settlement in the event of nationalization does not preclude equity classification of the contract.

Generally, rights afforded contract holders that are consistent with those of the holders of the underlying shares do not preclude equity classification. Therefore, the equity classification guidance states that net cash settlement in the event of a change in control would not preclude classification as equity as long as a holder of the shares underlying the contract would also have the right to receive cash because of the change in control.

The guidance requires that the consideration received by the holder of the contract be the same as the consideration received by a shareholder. However, in some cases, shareholders may be offered a choice of consideration. In that case, we generally believe that as long as the contract holder is being offered the same choice, then a contract may still be classified in equity if a contract holder (either as an individual or collectively as a group) receives consideration that is different in nature or proportion from that received by the shareholders as a group. The key consideration is that the counterparty must be treated the same as a shareholder and offered the same choice upon the change in control.

The staffs of the SEC's Division of Corporation Finance and the Office of the Chief Accountant issued a joint statement[78] in April 2021 that highlighted the potential accounting implications of certain terms that are common in warrants issued by SPACs. A SPAC, or special purpose acquisition company, is a blank-check company that raises capital from investors in an IPO to use in the future to acquire a target (a private operating company) that has not been identified at the time of the IPO.

The joint statement provided the staffs' views on common features included in these warrants and their conclusion that certain features require SPACs to classify the warrants as liabilities rather than as equity.

### SEC staff statement — equity classification considerations

The SEC staff statement said the exception in ASC 815-40-25-8 that allows equity classification applies to events that "fundamentally change the ownership or capitalization of an entity, such as a change in control of the entity, or a nationalization of the entity." The terms of SPAC warrants often include a provision that provides for net cash settlement in the event of a tender or exchange offer that is made and accepted by the holders of more than 50% of the outstanding shares underlying the warrants. The SEC staff said that, in the fact pattern it evaluated involving such a provision, the exception didn't apply and the warrants should be classified as liabilities.

[78] SEC Statement on Accounting and Reporting Considerations for Warrants Issued by Special Purpose Acquisition Companies, issued on 12 April 2021 by John Coates, then Acting Director, Division of Corporation Finance, and Paul Munter, then Acting Chief Accountant.

We understand that the issuer in the fact pattern reviewed by the staff had two classes of voting shares outstanding. Consequently, a tender or exchange offer accepted by 50% of the holders of the class of shares underlying the warrant would not result in the exchange of a number of shares that could result in a change in control. As a result, the SPAC could not apply the exception in ASC 815-40-25-8. Refer to the "*SPAC warrants, including public warrants*" section of our Technical Line, ***A closer look at accounting for financial instruments issued by SPACs***, for a further discussion.

**Question 11** **How does one determine if an instrument qualifies for the exception in ASC 815-40-25-39 in analyzing the requirements of the equity classification guidance for embedded conversion options?**

Under ASC 815-40-25-39, the additional conditions in ASC 815-40-25-7 through 25-30 and ASC 815-40-55-2 through 55-6 do not apply to certain convertible instruments when analyzing a potential embedded derivative for bifurcation. ASC 815-40-25-41 states that the convertible instruments that qualify for the exception are limited to those instruments that provide the holder with an option to convert into a fixed number of shares (or an equivalent amount of cash at the discretion of the issuer) and the ability to exercise that option is based on the passage of time or a contingent event.

Refer to section 2.2.4.8 for further discussion of this type of convertible debt instruments.

For convertible instruments that qualify for the exception in ASC 815-40-25-39, the evaluation of whether the embedded conversion option receives an exception from derivative accounting is more limited when evaluating the "classified in equity" portion of the exception. That is, the additional criteria of the equity classification guidance in ASC 815-40-25-7 through 25-30, and the related implementation guidance in ASC 815-40-55-2 through 55-6, are not applicable. The only consideration for these convertible instruments to meet the equity classification criteria is whether the contract requires or permits the issuer to settle in shares pursuant to the general equity classification guidance in ASC 815-40-25-1 through 25-4. However, those convertible instruments must still meet all of the indexation guidance requirements, because there is no limited application for those steps.

**Question 12** **If an equity contract requires settlement in some form of shares other than registered shares (e.g., requires settlement in shares of a listed company), do the same considerations regarding the requirement to deliver registered shares apply?**

Yes. We generally believe that a contractual promise to deliver shares with any particular characteristic (e.g., listed shares) should be evaluated similarly as a required settlement in registered shares. That is, net cash settlement is not presumed, unless the contract explicitly requires cash settlement when shares of the specified character are unavailable.

**Question 13** **How do the requirements of the NYSE's and NASDAQ's "20% Rule" affect the analysis of equity classification?**

In certain circumstances, NYSE and NASDAQ stock exchange rules require shareholder approval before a company can issue its own equity or convertible securities. For example, shareholder approval may be required before issuing common stock or securities convertible into or exercisable for common stock if the number of shares or voting power of the common stock subject to the issuance equals or exceeds 20% of the shares or voting power outstanding before the issuance.

In those situations, it is not uncommon to include a "share cap" in the settlement provisions of an instrument. This share cap typically establishes a limit on the number of shares that can be issued upon settlement at approximately 19.99% to avoid the need to obtain shareholder approval prior to offering the instrument. If a cash payment is required by the company because the number of shares to be delivered exceeds the share cap (deficit shares), the requirements of ASC 815-40-25 would be violated as the company could be required to deliver cash or other assets outside of its control.

Provisions that automatically remove the share cap upon the issuer obtaining shareholder approval should also be evaluated under ASC 815-40-15. For example, assume an instrument has a provision to make clear that the issuer has no obligation of any kind (cash or shares) to settle the portion of the settlement amount related to the deficit shares. However, if and when shareholder approval is obtained, the share cap would be removed and, therefore, the settlement amount would include the deficit shares. As shareholder approval effectively adjusts the settlement amount and is not an input to an option pricing model, the requirements of ASC 815-40-15 would be violated.

**Question 14** **How are contractual adjustments to the number of shares pursuant to an equity contract considered when evaluating the equity classification guidance?**

Many warrants and other equity contracts have contractual features that adjust the number of shares covered by the instrument upon the occurrence of potential future events. For example, the number of shares covered by a warrant usually requires a contractual adjustment if there is a share split or share combination in the future. There may be other features referred to generally as antidilution features that serve to protect the relationship of the contract holder to other equity holders. Such features may also provide other forms of protection, such as price protection on exercising the warrant.

Adjustment features should first be analyzed pursuant to the indexation guidance to determine whether the instrument is considered indexed to the issuer's own shares. If considered appropriately indexed, the contract is assessed pursuant to the equity classification guidance, which includes, among other things, an evaluation as to whether (1) sufficient authorized and unissued shares are available for settlement and (2) the instrument contains an explicit share cap.

Consider that the number of shares issuable could be infinite pursuant to certain adjustment provisions despite the existence of an explicit cap pursuant to either (1) other contractual terms or (2) the current shares covered by the contract. If the action required to trigger the adjustment is within the control of the issuer, that adjustment provision would not be considered in evaluating whether the issuer has sufficient shares. That is, the instrument is capped at the current number of shares until the issuer elects to trigger the adjustment provision.

Consider the two following provisions:

- The number of shares covered by the warrant is adjusted when the issuer or one of its subsidiaries tenders for the shares of the issuer.
- The number of shares covered by the warrant is adjusted when a third party tenders for the shares of the issuer.

In each case, the adjustment to the shares may be potentially infinite given the range of prices at which a tender offer could be made. However, the first provision does not violate the equity classification guidance, as its exercise is within the control of the issuer. In the second example, the issuer has no control over tender offers made by a third party, and thus that instrument should not be classified in equity.

**Question 15** **How should a registration rights agreement be considered in the analysis of the entity's potential obligation to make cash payments in the event of a failure to timely file with the SEC?**

**Excerpt from Accounting Standards Codification**

**Derivatives and Hedging — Contracts in Entity's Own Equity**

*Recognition — General*

*Effect of a Registration Payment Arrangement*

*815-40-25-43*

Subtopic 825-20 requires that an entity recognize and measure a registration payment arrangement (see paragraph 825-20-15-3) as a separate unit of account from the financial instrument(s) subject to that arrangement. Accordingly, under that Subtopic (see paragraphs 825-20-25-2 and 825-20-30-2), a financial instrument that is both within the scope of this Subtopic and subject to a registration payment arrangement shall be recognized and measured in accordance with this Subtopic without regard to the contingent obligation to transfer consideration pursuant to the registration payment arrangement.

A registration payment arrangement does not affect the assessment of a freestanding or embedded equity contract pursuant to the equity classification guidance. That is, the existence and/or settlement of the registration payment arrangement (in cash or other consideration) is not deemed to be a settlement of the related instrument or feature and does not affect the accounting for the referenced instrument.

Registration rights agreements may require the issuer to pay cash in settlement of a calculated liquidated damages amount for failure to register the instrument or underlying shares. ASC 825-20, *Financial Instruments — Registration Payment Arrangements*, discusses registration payment arrangements, which will include most registration rights agreements in security issuances and certain contingent interest features in debt instruments. ASC 825-20 specifies that the contingent obligation to make future payments or otherwise transfer consideration pursuant to a registration payment arrangement, whether issued as a separate agreement or included as a provision of a financial instrument or other agreement, should be separately recognized and measured in accordance with ASC 450. Importantly, ASC 825-20 further clarifies that a financial instrument subject to a registration payment arrangement should be accounted for in accordance with other applicable US GAAP without regard to the contingent obligation to transfer consideration pursuant to the registration payment arrangement. Refer to section 5.11 for further discussion of registration rights agreements.

**Question 16** **How should an entity's obligation to pay taxes and/or other governmental charges upon settlement of an equity-linked instrument (or embedded feature) be considered when evaluating the instrument (or embedded feature) under the indexation guidance?**

Certain state and local jurisdictions impose stamp duties, transfer taxes and/or other charges on parties that engage in certain transactions (e.g., sales, transfers) involving stock or equity contracts.

Equity-linked instruments (e.g., warrants, convertible debt) frequently contain provisions that require the issuer to pay these taxes and/or other governmental charges upon the issuance of shares that result from the settlement of these instruments or embedded features. For example, a warrant agreement often stipulates that when the holder exercises the warrant, the issuer must:

> *"pay all expenses in connection with, and all taxes and other governmental charges that may be imposed with respect to, the issuance or delivery of Warrant Shares upon exercise or conversion of Warrants; provided that the Company shall not be required to pay any tax or governmental charge that may be imposed with respect to any applicable withholding or the issuance or delivery of the Warrant Shares to any Person other than the Holder of the Warrants underlying such Warrant Shares, and no such issuance or delivery shall be made unless and until the person requesting such issuance has paid to the Company the amount of any such tax, or has established to the satisfaction of the Company that such tax has been paid."*

We generally believe that such a provision should not be considered in the indexation analysis if it merely obligates the issuer to pay taxes and/or other governmental charges that it would normally pay upon the issuance of its equity shares within the state and/or local government's jurisdiction.

In contrast, if a contractual provision requires the issuer to pay holder-specific taxes and/or other governmental charges on behalf of the holder and the issuer is not fully reimbursed from the holder (i.e., the settlement amount may be altered), we generally believe the provision should be considered in the indexation analysis and would likely preclude an instrument or embedded feature from being considered indexed to the entity's own stock because the adjustment would not be based on variables that are inputs to the fair value of a fixed-for-fixed forward or option on equity shares (refer to section B.3.3.2 for additional discussion on this assessment).

Whether a contractual provision obligates an issuer to pay taxes and/or other governmental charges beyond those already imposed by the jurisdiction in which the entity operates is a legal determination. Making such a determination is complex and will likely require the involvement of the entity's legal counsel.

**Question 17** **How should an entity analyze bail-in provisions under the indexation guidance?**

The European Union (EU) Bank Recovery and Resolution Directive (BRRD) provides EU Member State bank regulators with the authority to write down liabilities of financial institutions within the scope of the BRRD and/or convert those liabilities into equity of these financial institutions. The BRRD requires that EU banks include a bail-in provision in most of the credit agreements they enter into after 1 January 2016 that are governed by laws outside of the EU.

Potential adjustments resulting from bail-in provisions affect the settlement of equity instruments. However, the SEC staff indicated that it would not object to a conclusion that the bail-in provision under the BRRD would not preclude a contract from being classified in equity under ASC 815-40 if it meets all other criteria in ASC 815-40.

**Question 18** **How is a warrant to purchase common stock that is settled based on a fixed percentage of the issuer's outstanding common stock evaluated under the indexation guidance?**

An entity may issue a warrant to purchase a fixed percentage of its outstanding common stock. For example, a warrant may allow the holder to purchase a variable number of shares equal to 10% of the entity's outstanding common stock on the exercise date. During the life of the warrant, the number of shares of the entity's outstanding common stock changes for various reasons (e.g., new issuances, share repurchases), which would result in a change in the number of shares that the holder is entitled to purchase under the warrant.

This provision would preclude the warrant from being considered indexed to an entity's own stock because the number of outstanding shares that can change the settlement amount of the warrant is not a permissible adjustment pursuant to ASC 815-40-15-7E. That is because the number of outstanding shares is not an input to the fair value of a fixed-for-fixed forward or option on equity shares.

**Question 19** **How does an entity apply Step 2 of the indexation guidance to provisions within SPAC warrants that could change the settlement amount depending on the characteristics of the warrant holder? (added August 2023)**

SPACs issue warrants in various phases of their life cycle. A SPAC typically issues warrants to its sponsor during the formation phase or in connection with the IPO to raise working capital, including funding to cover the cost of the IPO. In its IPO, the SPAC typically sells units consisting of warrants and common stock.

While most of the terms of the warrants issued to the sponsor (private placement warrants) are identical to the terms of the warrants issued to investors in the IPO (public warrants), there are several important differences. For example, while the strike price of both types of warrants is often reduced when there is a change in control of the SPAC and less than 70% of the consideration received by SPAC shareholders in

that transaction is stock listed on an exchange, the adjustments are calculated differently. As another example, the SPAC can redeem public warrants for $0.01 per warrant, effectively forcing holders to exercise them, if the warrants are exercisable and the SPAC's common stock trades above $18 per share for a period of time. Private placement warrants are typically not subject to such a redemption.

Private placement warrants typically become public warrants if they are transferred to a party that is not the sponsor (or its affiliates). In other words, the terms of a private placement warrant would change upon a transfer to a nonaffiliated party.

In their joint statement in April 2021,[79] the staffs of the SEC's Division of Corporation Finance and the Office of the Chief Accountant provided their views on common features included in SPAC warrants and their conclusion that certain features require SPACs to classify the warrants as liabilities rather than as equity.

### SEC staff statement — indexation considerations

The SEC staff said the warrants it reviewed included provisions that could change the settlement amounts depending on the characteristics of the warrant holder (e.g., whether the warrant holder is a SPAC sponsor or an unaffiliated third party). Because the holder of an instrument is not an input to an option pricing model, the SEC staff concluded that the warrants it reviewed couldn't be considered indexed to the entity's own stock under the indexation guidance and, therefore, should be classified as liabilities measured at fair value, with changes in fair value each period recognized in earnings.

Refer to "*SPAC warrants, including public warrants*" section of our Technical Line, ***A closer look at accounting for financial instruments issued by SPACs***, for further discussion.

Question 20 **How does an entity apply the indexation guidance to earn-out arrangements it entered into in connection with its merger with a SPAC? (added August 2023)**

Merging with a SPAC offers private companies a way to go public without conducting an IPO. In the SPAC merger with a target, the sponsor of the SPAC (i.e., an entity that provided the initial capital upon formation of the SPAC) and selling shareholders of the target may not agree on the value of the target. To bridge the gap, they often negotiate earn-out arrangements. Such arrangements may also be used to make the deal more attractive to shareholders of the SPAC (i.e., the investors in the SPAC's IPO) and of the potential target companies. These earn-out arrangements can be executed by:

- Subjecting a portion of the outstanding shares held by the sponsor to an "earnout" provision, with these shares vesting only if certain post-merger stock price levels of the combined company are achieved
- Issuing additional shares of the combined company to the selling shareholders when certain stock price levels of the combined company are achieved

Frequently, the vesting conditions also include the occurrence of certain liquidity events (e.g., a merger of the SPAC (or its successor) with another entity, sale of substantially all of the assets of the SPAC (or its successor)). Earn-out arrangements are typically effective for five to seven years after the SPAC's merger with the target.

[79] SEC Statement on Accounting and Reporting Considerations for Warrants Issued by Special Purpose Acquisition Companies, issued on 12 April 2021 by John Coates, then Acting Director, Division of Corporation Finance, and Paul Munter, then Acting Chief Accountant.

This Q&A discusses the accounting for earn-out arrangements by the combined company in a SPAC merger where the target (an operating company) is determined to be the accounting acquirer and that the merger transaction is accounted for as a reverse recapitalization. For earn-out arrangements in a business combination involving a SPAC (i.e., the SPAC is identified as the accounting acquirer and the target is a business), additional accounting considerations are required pursuant to ASC 805. Refer to "*Earn-out provisions in a business combination*" section of our Technical Line, ***Navigating the requirements for merging with a special purpose acquisition company***, for a further discussion on these earn-out arrangements.

Earn-out arrangements may also be issued to the employees of the target as part of the merger negotiation. For those arrangements, ASC 718 should be considered. For earn-out arrangements that aren't share-based payments under ASC 718, the accounting analysis is the same as it is for other equity contracts (e.g., warrants). Refer to section 4 for more details on the guidance for equity contracts.

Earn-out arrangements are typically considered freestanding financial instruments because they are issued upon the merger transaction, separately and apart from other instruments. Furthermore, an earn-out arrangement often includes multiple settlements based on different triggering events. While the holders will receive shares when each triggering event occurs, the components are not legally transferable by the holders. In these circumstances, the earn-out arrangement is considered a freestanding financial instrument that contains multiple settlement provisions triggered by different events.

Earn-out arrangements generally are not classified as liabilities under ASC 480 because they do not represent obligations that must or may be settled by transferring assets and are not obligations to issue a variable number of shares that meet one of the conditions described in ASC 480-10-25-14.

If an earn-out arrangement is not an ASC 480 liability, it should be evaluated under the indexation guidance (ASC 815-40-15) and the equity classification guidance (ASC 815-40-25) to determine whether it should be classified as a liability or equity. This Q&A focuses on the application of the indexation guidance to earn-out arrangements.

Earn-out arrangements typically have share-price triggers. For example, an earn-out arrangement may require the SPAC (or its successor) to issue 1,000,000 shares to selling shareholders if the volume-weighted average price (VWAP) of the SPAC (or its successor) exceeds $15 per share during the term of the arrangement and an additional 1,000,000 shares if VWAP exceeds $20 per share during the same timeframe.

Earn-out arrangements also typically contain provisions that accelerate settlement upon liquidity events (e.g., a change in control of the SPAC (or its successor)). These provisions could change the number of shares to be issued (i.e., the settlement amount) under the arrangement.

Entities evaluating their earn-out arrangements should pay particular attention to features that change the settlement amount, because some adjustment features can preclude the earn-out arrangement from being considered indexed to an issuer's stock under the indexation guidance and, therefore, require the arrangement to be classified as a liability. Generally, when the settlement amount of an earn-out arrangement changes based on stock price, the arrangement may be considered indexed to an entity's own stock. But provisions that change the settlement amount for other reasons (e.g., a change in control provision that entitles the holder to all remaining unearned shares under the arrangement, regardless of stock price) may preclude the arrangement from being indexed to the entity's own stock.

The following examples illustrate common terms in earn-out arrangements in a SPAC merger, the application of the indexation guidance to those terms and the resulting classification of the arrangements:

**Illustration B-2: Earn-out arrangement — vesting based on share-price triggers**

SPAC A enters into a merger agreement with OpCo X. Under the merger agreement, the SPAC (or its successor) may issue up to 4,000,000 additional Class A shares to the OpCo X selling shareholders if certain share-price thresholds of the combined company are met within five years from the consummation date of the merger. The triggering events are as follows:

- If VWAP over 20 out of 30 consecutive trading days meets or exceeds $12, 1,000,000 shares are issued.
- If VWAP over 20 out of 30 consecutive trading days meets or exceeds $15, another 1,000,000 shares are issued.
- If VWAP over 20 out of 30 consecutive trading days meets or exceeds $18, another 1,000,000 shares are issued.
- If VWAP over 20 out of 30 consecutive trading days meets or exceeds $20, another 1,000,000 shares are issued.

If none of the share-price targets is met within five years of the merger date, the selling shareholders will not be entitled to any additional shares. Therefore, the triggering events are considered exercise contingencies because their occurrences trigger the holder's ability to settle the earn-outs and receive shares.

An exercise contingency based on the Class A share price is permissible under Step 1 of the indexation guidance. In Step 2 of the analysis, the settlement amount changes solely based on the share price of the Class A stock. Because share price is an input to the fair value of a fixed-for-fixed forward or option on equity shares, this arrangement is considered indexed to an entity's own stock. If the criteria for equity classification under ASC 815-40-25 are also met, this earn-out arrangement would be classified in equity.

**Illustration B-3: Earn-out arrangement — a change in control triggers full vesting**

SPAC A enters into a merger agreement with OpCo X. Under the merger agreement, the SPAC (or its successor) may issue up to 4,000,000 additional Class A shares to the OpCo X's selling shareholders if certain share-price thresholds of the combined company are met within five years from the consummation date of the merger. The triggering events are as follows:

- If VWAP over 20 out of 30 consecutive trading days meets or exceeds $12, 1,000,000 shares are issued.
- If VWAP over 20 out of 30 consecutive trading days meets or exceeds $15, another 1,000,000 shares are issued.
- If VWAP over 20 out of 30 consecutive trading days meets or exceeds $18, another 1,000,000 shares are issued.
- If VWAP over 20 out of 30 consecutive trading days meets or exceeds $20, another 1,000,000 shares are issued.
- If there is a change in control during the five-year period, all 4,000,000 shares will immediately be issued to the selling shareholders.

If none of the share price targets above is met within five years from the merger date, the selling shareholders will not be entitled to any additional shares, unless there is a change-in-control transaction. If the SPAC (or its successor) undergoes a change-in-control transaction, which includes (1) a sale of all or substantially all of the SPAC's (or its successor's) assets or (2) any merger of the SPAC (or its successor) with another company, all of the additional shares will be issued, regardless of whether any share-price triggers were met.

All of these triggering events are considered exercise contingencies because their occurrences trigger the holder's ability to settle the earn-outs and receive shares. Because the exercise contingencies are based on either the share price of the SPAC (or its successor) or a change in control of the SPAC (or its successor), they are permissible under Step 1.

In Step 2 of the analysis, the settlement amount under this arrangement changes not only based on the share price of the Class A shares but also on whether there is a change in control of the SPAC (or its successor) over the next five years. Because a change-in-control event is not an input to the fair value of a fixed-for-fixed forward or option on equity shares, this arrangement would not be considered indexed to an entity's own stock under Step 2. Therefore, the earn-out arrangement is classified as a liability.

**Illustration B-4: Earn-out arrangement — a change in control with a minimum price trigger**

SPAC A enters into a merger agreement with OpCo X. Under the merger agreement, the SPAC (or its successor) may issue up to 4,000,000 additional Class A shares to the OpCo X selling shareholders if certain share-price thresholds of the combined company are met within five years from the consummation date of the merger. The triggering events are as follows:

- If VWAP over 20 out of 30 consecutive trading days meets or exceeds $12, 1,000,000 shares are issued.
- If VWAP over 20 out of 30 consecutive trading days meets or exceeds $15, another 1,000,000 shares are issued.
- If VWAP over 20 out of 30 consecutive trading days meets or exceeds $18, another 1,000,000 shares are issued.
- If VWAP over 20 out of 30 consecutive trading days meets or exceeds $20, another 1,000,000 shares are issued.
- If there is a change in control during the five-year period, and the per-share transaction price meets or exceeds $12, the entire 4,000,000 shares will immediately be issued to the selling shareholders.

If none of the share-price targets above is met within five years from the merger date, the selling shareholders will not be entitled to any additional shares, unless there is a change-in-control transaction at a price that meets or exceeds $12 per share. If the SPAC (or its successor) undergoes a change-in-control transaction, which includes (1) a sale of all or substantially all of the SPAC (or its successor) 's assets or (2) any merger of the SPAC (or its successor) with another company, and the per-share price received by the shareholders of the SPAC (or its successor) in the change-in-control transaction meets or exceeds $12, all of the shares will be issued, regardless of whether any share-price triggers above $12 were met.

Similar to the conclusion reached for Illustration B-3 above, this arrangement would not be precluded from equity classification under Step 1 of the indexation guidance.

In Step 2 of the analysis, the settlement amount under this arrangement changes not only based on the share price of the Class A shares but also on whether there is a change in control of the SPAC (or its successor) over the next five years. Because a change in control is not an input to the fair value of a fixed-for-fixed forward or option on equity shares, this arrangement would not be considered indexed to an entity's own stock under Step 2. Therefore, the earn-out arrangement must be classified as a liability.

**Illustration B-5: Earn-out arrangement — vesting based on change in control price triggers**

SPAC A enters into a merger agreement with OpCo X. Under the merger agreement, the SPAC (or its successor) may issue up to 4,000,000 additional Class A shares to the OpCo X selling shareholders if certain share-price thresholds of the combined company are met within five years from the consummation date of the merger. The triggering events are as follows:

- If VWAP over 20 out of 30 consecutive trading days meets or exceeds $12, 1,000,000 shares are issued.
- If VWAP over 20 out of 30 consecutive trading days meets or exceeds $15, another 1,000,000 shares are issued.
- If VWAP over 20 out of 30 consecutive trading days meets or exceeds $18, another 1,000,000 shares are issued.
- If VWAP over 20 out of 30 consecutive trading days meets or exceeds $20, another 1,000,000 shares are issued.
- If there is a change in control during the five-year period, the per-share price in the change-in-control transaction will be used to determine whether the price targets have been met and, if so, the number of shares that will be issued.

If none of the share-price targets above is met within five years from the merger date, the selling shareholders will not be entitled to any additional shares, unless there is a change-in-control transaction at a per-share price that meets or exceeds those targets. That is, if the SPAC (or its successor) undergoes a change-in-control transaction, which includes (1) a sale of all or substantially all of the SPAC's (or its successor's) assets or (2) any merger of the SPAC (or its successor) with another company, the number of shares to be issued (if any) will be based on the per-share price determined to be received by the shareholders of the SPAC (or its successor) in the transaction.

For example, if the per-share price in the change-in-control transaction is $19, the SPAC (or its successor) will issue 3,000,000 shares to the selling shareholders. If 1,000,000 shares were issued before the change-of-control transaction because the $12 VWAP trigger had been met, an additional 2,000,000 shares would be issued upon the change-in-control transaction for exceeding both the $15 and $18 targets.

Similar to the conclusion reached for Illustration B-3 above, this arrangement would not be precluded from equity classification under Step 1 of the indexation guidance.

In Step 2 of the analysis, it is important to determine whether the settlement amount varies solely based on the Class A share price. In this example, the number of shares to be issued is determined based on the VWAP and the per-share price.

It is also important to determine whether the per-share price in a change-in-control transaction represents the fair value or an approximation of the fair value of a Class A share. For example, if the calculation of the per-share price in a change-in-control transaction includes the shares that would be issued under the earn-out arrangement, that price may represent the fair value of a Class A share. If, however, the per-share price calculation excludes the shares that would be issued under the earn-out arrangement, that price may not represent the fair value of a Class A share. In that case, the arrangement would not be considered indexed to an entity's own stock, and the earn-out arrangement would be classified as a liability.

A warrant agreement may specify whether the per-share price calculation in a change-of-control transaction should include the shares issuable under an earn-out arrangement, but it is often unclear how that price should be determined. When that is the case, combined entities should seek the advice of legal counsel in determining the most appropriate interpretation.

**Question 21** **How is a "buy-in" provision considered when evaluating a warrant under the equity classification guidance in ASC 815-40-25? (added September 2024)**

Warrant agreements may include buy-in provisions that compensate warrant holders when the issuer fails to deliver in a timely manner the underlying stock upon the holders' exercise of warrants. Specifically, a buy-in provision is triggered when both of the following occur:

- The issuer fails to deliver the underlying shares (the warrant shares) within a specified number of trading days (e.g., by the close of three trading days) after the exercise date
- The holder is required to purchase shares of the issuer's common stock in the market in satisfaction of a sale by the holder of the warrant shares that the holder anticipated receiving upon such exercise.

When a buy-in provision is triggered, the warrant agreement typically requires the issuer to compensate the holder for any losses it incurred for the purchase and sale transactions described above. The loss amount is prescribed as the excess of the price of the shares purchased by the holder in the marketplace over the sale price of the warrant shares that the issuer was required to deliver to the holder in connection with the warrant exercise and that the holder had sold to a third party (which gives rise to a share delivery obligation by the holder). In this case, the issuer is still required to deliver the warrant shares or otherwise is required to reinstate the portion of the warrant for which the holder's exercise was not honored. In other situations, the holder may have an option to require the issuer to pay the price of the shares it has purchased in the marketplace. When that happens, the portion of warrant that was exercised would be terminated. Under the equity classification guidance in ASC 815-40-25, an equity contract that requires cash settlement outside of the control of the issuer is classified as an asset or a liability. When a warrant agreement has a buy-in provision, the issuer needs to evaluate this provision to determine whether equity classification of the warrant would be precluded.

If a buy-in provision only requires cash compensation for the loss incurred, and the warrant remains outstanding (either the warrant shares are still required to be delivered or the portion of the warrant is reinstated), the cash compensation is generally considered a penalty, not a settlement of the warrant. In this case, the warrant may not be precluded from qualifying for equity classification under ASC 815-40-25.

If a buy-in provision requires the issuer to pay the amount of the purchase price for the shares the holder has purchased in the marketplace and terminate the portion of the warrant that was exercised, the cash payment represents a settlement of the warrant. In this case, the issuer must determine whether a failure to deliver the warrant shares that triggers the cash payment is in the issuer's control. If the failure to deliver is not within the issuer's control, the warrant would be classified as a liability under ASC 815-40-25. Determining whether a failure to deliver is within the control of the issuer will require the consideration of the warrant terms and facts and circumstances, including:

- The parties (e.g., the issuer or the transfer agent) specified in the buy-in provision whose failure would trigger a cash payment
- If a third party's failure could trigger a cash payment whether that party represents an agent of the issuer

We generally believe that if a third party is considered as an agent of the issuer, the third party's failure to deliver would be considered the issuer's failure to deliver. If such a failure to deliver results in a cash

payment for the loss incurred, it would not preclude equity classification for the warrant under ASC 815-40-25 because it would be considered the issuer's failure.

When a buy-in provision is considered a settlement of the warrant, the indexation guidance in ASC 815-40-15 should also be considered. The buy-in provision is designed to make sure that the issuer fulfills its delivery obligations upon the exercise of the warrant, and the holder is in the same economic position in accordance with the original terms. We generally do not view the buy-in provision as an adjustment to the settlement amount of the warrant and, therefore, it would not preclude the warrant from being considered indexed to the issuer's equity.

Question 22 **How does an entity apply the equity classification guidance in ASC 815-40-25 to a purchased put option on its redeemable preferred stock? (added September 2024)**

Questions may arise about whether an entity that has purchased a put option on its own shares (e.g., preferred stock) should consider the terms of the underlying stock, specifically any redemption features, in evaluating the classification of the put option under ASC 815-40-25. That is, if the entity can exercise its put option to issue the underlying stock and may then be required to pay cash to the holders of the underlying stock if they redeem the stock by exercising their redemption right embedded in the stock, does that mean that the purchased put option effectively requires net cash settlement under ASC 815-40-25 and therefore should be classified as an asset?

ASC 815-40-25 does not provide specific guidance to address this question. However, ASC 815-10-15-76 states that:

> "Temporary equity is considered stockholders' equity for purposes of the scope exception in paragraph **815-10-15-74(a)** even if it is required to be displayed outside of the permanent equity section."

ASC 815-10-15-74(a) provides that contracts issued or held by a reporting entity that are both (1) indexed to its own stock pursuant to ASC 815-40-15 and (2) classified in stockholders' equity in its statement of financial position pursuant to ASC 815-40-25 are not considered derivative instruments in the scope of ASC 815. That is, such contracts should be classified in equity, assuming the contracts are not required to be classified as an asset or liability under other applicable guidance (e.g., ASC 480).

In accordance with ASC 815-10-15-76, even if an underlying stock to an equity contract is classified as temporary equity because the stock contains redemption features (e.g., written put option) that may require the entity to redeem the stock for cash outside of its control, equity classification for the contract is not precluded (assuming the instrument is not subject to ASC 480).

Assuming the option is considered indexed to the issuer's own stock, based on discussions with the SEC staff, we generally believe that the entity is not required to consider the redemption features embedded in the underlying stock in evaluating the classification of the purchased put option under ASC 815-40-25. However, if the facts and circumstances suggest that the substance of the purchased put option is for the holders of the underlying stock to redeem the stock issued after the issuer exercises its purchased put option, that fact should be considered. This evaluation will require significant judgment based on the facts and circumstances of the arrangement.

# C SEC guidance on redeemable equity instruments

## C.1 Summary and overview

Although they are issued in the form of equity, the SEC requires certain redeemable equity instruments to be distinguished from permanent capital. The positions of the SEC and its staff on the accounting for certain redeemable equity instruments are in the following guidance, which has been codified in ASC 480-10-S99. We refer to this guidance throughout this publication as the "redeemable equity guidance."

- Financial Reporting Releases and Codifications 211, *Redeemable Preferred Stock* (ASR 268)
- Staff Accounting Bulletin No. 64 Topic 3.C, *Redeemable Preferred Stock* (SAB Topic 3.C)
- EITF Topic D-98, *Classification and Measurement of Redeemable Securities* (Topic D-98)

Under the redeemable equity guidance, instruments not otherwise required to be classified as liabilities pursuant to ASC 480 and for which redemption could be required (1) at a fixed or determinable date, (2) at the option of the holder or (3) upon the occurrence of certain contingent events (e.g., an IPO, change in control, liquidation event or achievement of a performance condition) not solely within the control of the issuer are in the scope of the redeemable equity guidance. Importantly, as described later, the SEC staff does not consider probability in determining whether the instrument will become redeemable in applying the redeemable equity guidance. If the redemption of the equity instrument is certain to occur, the instrument is generally classified as a liability pursuant to ASC 480.

The redeemable equity guidance applies to all redeemable equity instruments, including common stock, preferred stock, NCI and equity components of certain financial instruments, such as convertible debt.

The SEC requires instruments in the scope of this guidance to be classified as temporary (or mezzanine) equity between liabilities and stockholders' equity to highlight the future cash obligations attached to these types of securities and thus distinguish them from permanent equity. Instruments classified as temporary equity cannot be included in any subtotals that imply it is considered equity.

While certain exceptions exist, the initial carrying amount of a redeemable equity security should generally be its fair value on the date of issuance. However, the subsequent measurement varies based on whether the instrument is currently redeemable or it is probable that the instrument will become redeemable.

Changes to the carrying amount of a redeemable security are generally treated in the same manner as dividends on nonredeemable stock. The impact to EPS depends on the type of security (preferred or common), the basis for the redemption amount (i.e., fair value, fixed amount or formulaic amount), and whether or not the security represents an NCI.

## C.2 Scope

**Excerpt from Accounting Standards Codification**

**Distinguishing Liabilities from Equity — Overall**

*SEC Materials*

*480-10-S99-3A*

*Background*

1. This SEC staff announcement provides the SEC staff's views regarding the application of Accounting Series Release No. 268, *Presentation in Financial Statements of "Redeemable Preferred Stocks."* [*Footnote reference omitted*.]

*Scope*

2. ASR 268 requires preferred securities that are redeemable for cash or other assets to be classified outside of permanent equity if they are redeemable (1) at a fixed or determinable price on a fixed or determinable date, (2) at the option of the holder, or (3) upon the occurrence of an event that is not solely within the control of the issuer. As noted in ASR 268, the Commission reasoned that "[t]here is a significant difference between a security with mandatory redemption requirements or whose redemption is outside the control of the issuer and conventional equity capital. The Commission believes that it is necessary to highlight the future cash obligations attached to this type of security so as to distinguish it from permanent capital."

3. Although ASR 268 specifically describes and discusses preferred securities, the SEC staff believes that ASR 268 also provides analogous guidance for other redeemable equity instruments including, for example, common stock, derivative instruments, noncontrolling interests FN2, securities held by an employee stock ownership plan FN3, and share-based payment arrangements with employees FN4. [*Extraneous material omitted*.]

FN2 The Master Glossary defines **noncontrolling interest** as "The portion of equity (net assets) in a subsidiary not attributable, directly or indirectly, to a parent. A noncontrolling interest is sometimes called a minority interest." ASR 268 applies to redeemable noncontrolling interests (provided the redemption feature is not considered a freestanding option within the scope of Subtopic 480-10). Where relevant, specific classification and measurement guidance pertaining to redeemable noncontrolling interests has been included in this SEC staff announcement.

FN3 ASR 268 applies to equity securities held by an employee stock ownership plan (whether or not allocated) that, by their terms, can be put to the registrant (sponsor) for cash or other assets. Where relevant, specific classification and measurement guidance pertaining to employee stock ownership plans has been included in this SEC staff announcement.

FN4 As indicated in Section 718-10-S99, ASR 268 applies to redeemable equity-classified instruments granted in conjunction with share-based payment arrangements with employees. Where relevant, specific classification and measurement guidance pertaining to share-based payment arrangements with employees has been included in this SEC staff announcement.

## C.2.1 Applicability to public companies

We generally believe that although it is not entirely clear, the SEC staff's guidance in ASC 480-10-S99-3A should be applied to financial statements that are prepared in accordance with the SEC's Regulation S-X. We generally believe that, while it is not required, the application of this guidance is preferable for the financial statements of nonpublic companies.

## C.2.2 Items within the scope of ASC 480-10-S99

ASC 480-10-S99 applies to equity-classified securities that are not otherwise required to be classified as liabilities by ASC 480 (e.g., it does not apply to mandatorily redeemable instruments) and that are redeemable for cash or other assets either (1) at a fixed or determinable date (2) at the option of the holder or (3) upon the occurrence of an event that is not solely within the control of the issuer. Refer to section C.3 for determining whether an instrument is required to be classified outside of permanent equity.

Preferred stock, common stock, NCI, securities held by an employee stock ownership plan (ESOP) and share-based payment arrangements with employees are all subject to ASC 480-10-S99's requirements.

## C.2.3 Noncontrolling interests

The redeemable equity guidance in ASC 480-10-S99 generally applies to NCI that are redeemable but not considered mandatorily redeemable. Noncontrolling interests that are mandatorily redeemable should be accounted for as a liability. However, for certain mandatorily redeemable NCI classified as a liability under ASC 480 that receive an exception from the measurement provisions of that guidance, the measurement guidance in ASC 480-10-S99 would apply pursuant to ASC 480-10-15-7E. Refer to section C.2.5 for further discussion.

Refer to section A.4 for further guidance on mandatorily redeemable instruments.

## C.2.4 Equity-classified instruments potentially settleable in shares

The redeemable equity guidance focuses on circumstances where issuers may be required to settle equity-classified instruments for cash or other assets. Instruments with features that require or provide the issuer the option to settle in shares generally do not require temporary equity classification. However, in those cases, the issuer should have the ability to settle in shares pursuant to the equity classification guidance in ASC 815-40-25. If share settlement cannot be assured, ASC 815-40-25 presumes that cash settlement will be required and, therefore, the instrument should be within the scope of the redeemable equity guidance.

For example, a conversion feature in equity-classified, convertible preferred stock for which conversion is not within the control of the issuer should be analyzed to determine whether the issuer could satisfy its obligation to deliver shares upon exercise of the conversion feature. If the issuer could not satisfy its obligation to deliver shares upon conversion, the instrument should be classified in temporary equity because it would be presumed the issuer would be required to settle the instrument in cash, as if it were a redemption feature.

### Interaction of ASC 480-10-S99-3A and ASU 2020-06

ASC 480-10-S99-3A(3)(b) states that this temporary equity guidance does not apply to freestanding options and forward contracts classified as equity under ASC 815-40. In addition, ASC 480-10-S99-3A(6) states the SEC staff's view that an entity is required to use the equity classification criteria in ASC 815-40-25 to evaluate whether there are situations that would force it to settle equity instruments in cash and thus require temporary equity classification for these instruments. It is unclear how the changes in the equity classification criteria in ASC 815-40-25 will affect the application of the SEC staff guidance for determining whether to classify equity instruments as temporary or permanent equity (i.e., whether an entity can apply the classification guidance, as amended by ASU 2020-06, when evaluating ASC 480-10-S99-3A or whether it must apply the legacy equity classification guidance that predates ASU 2020-06).

For example, an entity that is required to settle a preferred share redemption in registered shares may have classified its redeemable preferred stock as temporary equity using the legacy guidance in ASC 815-40-25 because share settlement could not be assured. Consequently, the preferred stock is classified in temporary equity under ASC 480-10-S99-3A. Under the new guidance in ASC 815-40-25, the entity only has to assess whether it is explicitly required to settle the redemption in cash if registered shares are not available. Because the entity is not explicitly required to settle the redemption in cash if registered shares are not available, the entity could classify its preferred stock in permanent equity, assuming the other criteria in ASC 815-40-25 are met.

If the SEC staff doesn't clarify its guidance, diversity in practice may develop. Readers should monitor any developments in this area.

Refer to Appendix B for further guidance on evaluating whether share settlement can be assured to occur pursuant to ASC 815-40-25.

Refer to Question 1 in section C.7 — Are shares that are by themselves not redeemable, but are convertible into other shares that are redeemable, within the scope of the redeemable equity guidance?

## C.2.5 Freestanding financial instruments classified as assets or liabilities

**Excerpt from Accounting Standards Codification**

**Distinguishing Liabilities from Equity — Overall**

***SEC Materials***

***480-10-S99-3A***

***Scope***

3(a) *Freestanding financial instruments classified as assets or liabilities.* Freestanding financial instruments that are classified as assets or liabilities pursuant to Subtopic 480-10 or other applicable GAAP (including those that contain separated derivative assets or derivative liabilities) are not subject to ASR 268. FN5 Mandatorily redeemable equity instruments for which the relevant portions Subtopic 480-10 have been deferred are subject to ASR 268.

FN5 An equity instrument subject to potential redemption under a freestanding written put option is not subject to ASR 268 (since the put option liability is considered a separate unit of account). However, as discussed in paragraph 3(b), when an embedded written put option has been separated from a hybrid financial instrument with an equity host contract, the host equity instrument is subject to ASR 268.

Freestanding financial instruments classified as assets or liabilities based on the guidance in ASC 480 or other applicable US GAAP are not within the scope of the redeemable equity guidance.

While mandatorily redeemable equity instruments are required to be classified as liabilities pursuant to ASC 480, certain mandatorily redeemable instruments, such as (1) redeemable NCI that are redeemable only upon liquidation of a subsidiary issuer and (2) mandatorily redeemable NCI issued before 5 November 2003, are addressed by the scope exception provided in ASC 480-10-15-7E.

- Noncontrolling interests that are redeemable only upon liquidation of a subsidiary issuer generally would not require temporary equity classification if the redemption were truly triggered by a final liquidation (refer to discussion at section C.2.10).
- Noncontrolling interests classified in equity in the consolidated financial statements are in the scope of the redeemable equity guidance, with an exception for those NCI that are redeemably only upon liquidation of the subsidiary issuer. In addition, the redeemable equity measurement guidance applies to mandatorily redeemable NCI issued before 5 November 2003 that are classified as liabilities in the financial statements of the subsidiary.

Refer to Appendix A for further guidance on the applicability of ASC 480.

## C.2.6 Freestanding derivatives and hybrid instruments classified in stockholders' equity

**Excerpt from Accounting Standards Codification**

**Distinguishing Liabilities from Equity — Overall**

***SEC Materials***

***480-10-S99-3A***

***Scope***

3(b) *Freestanding derivative instruments classified in stockholders' equity.* Freestanding derivative instruments that are classified in stockholders' equity pursuant to Subtopic 815-40 are not subject to ASR 268. FN6 Equity-classified freestanding financial instruments that were previously classified outside of permanent equity under Subtopic 815-40 are now classified as assets or liabilities pursuant to Subtopic 480-10. However, Subtopic 815-40 continues to apply to embedded derivatives indexed to, and potentially settled in, a company's own stock. Accordingly, when a hybrid financial instrument that is not classified in its entirety as an asset or liability under Subtopic 480-10 or other applicable GAAP contains an embedded derivative within the scope of Subtopic 815-40, the registrant should consider the applicability of ASR 268 to:

- The hybrid financial instrument when the embedded derivative *is not* separated under Subtopic 815-15, or
- The host contract when the embedded derivative *is* separated under Subtopic 815-15.

FN6 A freestanding derivative instrument would not meet the conditions in Subtopic 815-40 to be classified as an equity instrument if it was subject to redemption for cash or other assets on a specified date or upon the occurrence of an event that is not within the control of the issuer.

Freestanding derivatives (e.g., warrants, forward arrangements, purchased call options) that qualify for equity classification pursuant to ASC 815-40 are not subject to the redeemable equity guidance.

Equity-classified hybrid instruments (generally common shares or preferred shares) that contain potentially cash-settled embedded features should be evaluated to determine whether temporary equity classification is required, even if the embedded feature is bifurcated. The redeemable equity guidance does not affect the accounting for embedded features that are required to be bifurcated pursuant to ASC 815 and accounted for as derivative assets or liabilities.

Cash-settled redemption features are the most common type of embedded features that trigger temporary equity classification. However, in certain circumstances instruments that may be share-settled would be assumed to be cash-settled when the issuer is not assured to be able to settle the instrument in shares. In those cases, the instruments would be classified in temporary equity.

## C.2.7 Equity instruments subject to registration payment arrangements

**Excerpt from Accounting Standards Codification**

**Distinguishing Liabilities from Equity — Overall**

***SEC Materials***

***480-10-S99-3A***

***Scope***

3(c) *Equity instruments subject to registration payment arrangements.* The determination of whether an equity instrument subject to a registration payment arrangement (as defined in Paragraph 825-20-15-3) is subject to ASR 268 should be made without regard to the existence of the registration payment arrangement (that is, the registration payment arrangement is a separate unit of account). However, in determining the applicability of ASR 268 to an equity instrument with any other related arrangement, a conclusion that the related arrangement is a separate unit of account should not be based on an analogy to Paragraph 815-10-25-16.

Registration payment arrangements represent contingent obligations to make future payments or otherwise transfer consideration in the event certain instruments are not registered as agreed and may be either a separate agreement or embedded as a provision within a financial instrument. The contingent obligation to transfer consideration pursuant to the registration payment arrangement should not be considered in applying the redeemable equity guidance because that obligation is recognized separately and accounted for pursuant to ASC 825-20 *Financial Instruments — Registration Payment Arrangements*. Refer to section 5.11 for further guidance on the accounting for registration payment arrangements.

## C.2.8 Share-based payment awards

**Excerpt from Accounting Standards Codification**

**Distinguishing Liabilities from Equity — Overall**

***SEC Materials***

***480-10-S99-3A***

***Scope***

3(d) *Share-based payment awards.* Equity-classified share-based payment arrangements with employees are not subject to ASR 268 due solely to either of the following:

- Net cash settlement would be assumed pursuant to Paragraphs 815-40-25-11 through 25-16 solely because of an obligation to deliver registered shares. FN7
- A provision in an instrument for the direct or indirect repurchase of shares issued to an employee exists solely to satisfy the employer's statutory tax withholding requirements (as discussed in Paragraph 718-10-25-18).

FN7 See footnote 84 of Section 718-10-S99.

Equity-classified share-based payment arrangements may be subject to the SEC staff's redeemable equity guidance.

Refer to section 5.3 of our FRD publication, ***Share-based payment***, for further guidance related to the application of the redeemable equity guidance to share-based payments.

## C.2.9 Convertible debt instruments that contain a separately classified equity component

**Excerpt from Accounting Standards Codification**

**Distinguishing Liabilities from Equity — Overall**

*SEC Materials*

*480-10-S99-3A*

*Scope*

3(e) *Convertible debt instruments that contain a separately classified equity component.* Other applicable GAAP may require a convertible debt instrument to be separated into a liability component and an equity component. FN8 In these situations, the equity-classified component of the convertible debt instrument should be considered redeemable if at the balance sheet date the issuer can be required to settle the convertible debt instrument for cash or other assets (that is, the instrument is currently redeemable or convertible for cash or other assets). For these instruments, an assessment of whether the convertible debt instrument will become redeemable or convertible for cash or other assets at a future date should not be made. For example, a convertible debt instrument that is not redeemable at the balance sheet date but could become redeemable by the holder of the instrument in the future based on the passage of time or upon the occurrence of a contingent event is not considered currently redeemable at the balance sheet date.

FN8 See Subtopics 470-20 and 470-50; and Paragraph 815-15-35-4.

As described in section 2.2, the accounting for certain types of convertible debt may require certain amounts to be classified in equity, including:

- Convertible debt issued with a substantial premium that is classified in equity pursuant to ASC 470-20
- Convertible debt with a previously bifurcated conversion feature that no longer requires bifurcation that has been reclassified to equity pursuant to ASC 815-15-35-4
- Convertible debt that has been modified or exchanged but not considered extinguished and results in an increase in the fair value of the embedded conversion feature pursuant to ASC 470-50-40-15

Depending on the terms of the convertible instrument, an issuer may be required to settle the instrument (or a portion thereof) for cash or other assets. Accordingly, amounts recorded in equity may be considered redeemable and thus classified in temporary equity. Refer to section C.3.1 for further discussion.

## C.2.10 Consideration of 'deemed liquidation' provisions

**Excerpt from Accounting Standards Codification**

**Distinguishing Liabilities from Equity — Overall**

*SEC Materials*

*480-10-S99-3A*

*Scope*

3(f) *Certain redemptions upon liquidation events.* Ordinary liquidation events, which involve the redemption and liquidation of all of an entity's equity instruments for cash or other assets of the entity, do not result in an equity instrument being subject to ASR 268. In other words, if the payment of cash or other assets is required only from the distribution of net assets upon the final liquidation or termination of an entity (which may be a less-than-wholly-owned consolidated subsidiary), then that potential event need not be considered when applying ASR 268. Other transactions are considered deemed liquidation events. For example, the contractual provisions of an equity instrument may require its redemption by the issuer upon the occurrence of a change-in-control that does not result in the liquidation or termination of the issuing entity, a delisting of the issuer's securities from an exchange, or the violation of a debt covenant. Deemed liquidation events that require (or permit at the holder's option) the redemption of only one or more particular class of equity instrument for cash or other assets cause those instruments to be subject to ASR 268. However, as a limited exception, a deemed liquidation event does not cause a particular class of equity instrument to be classified outside of permanent equity if all of the holders of equally and more subordinated equity instruments of the entity would always be entitled to also receive the same form of consideration (for example, cash or shares) upon the occurrence of the event that gives rise to the redemption (that is, all subordinate classes would also be entitled to redeem).

Ordinary liquidation provisions that involve the redemption and liquidation of all equity securities for cash or other assets (i.e., upon final liquidation of the issuer) are not in the scope of ASC 480-10-S99 and should be viewed differently than "deemed liquidation" events.

ASC 480-10-S99-3A provides that deemed liquidation events (which are usually defined in the governance documents establishing the terms of the equity instrument and do not result in the final liquidation or termination of the entity), such as a change in control, that require one or more particular classes or types of equity securities to be redeemed should result in those securities being classified outside of permanent equity unless all of the holders of equally and more subordinated equity instruments of the entity would be entitled to receive the same form of consideration upon the occurrence of the event.

To apply this limited exception, an entity's governing documents should be specific that all equity holders are entitled to the same form of consideration (e.g., cash, assets, shares) in any deemed liquidation event. The provisions of the redeemable instrument, the entity's corporate governance structure and all applicable laws should be carefully considered.

## C.2.11 Redemptions covered by insurance proceeds

**Excerpt from Accounting Standards Codification**

**Distinguishing Liabilities from Equity — Overall**

***SEC Materials***

***480-10-S99-3A***

***Scope***

3(g) *Certain redemptions covered by insurance proceeds.* As a limited exception that should not be analogized to, an equity instrument that becomes redeemable upon the death of the holder (at the option of the holder's heir or estate FN9) or upon the disability of the holder is not subject to ASR 268 if the redemption amount will be funded from the proceeds of an insurance policy that is currently in force and which the registrant has the intent and ability to maintain in force.

FN9 If an equity instrument is required to be redeemed for cash or other assets upon the death of the holder, the instrument is classified as a liability pursuant to Subtopic 480-10 even if an insurance policy would fund the redemption.

The SEC staff has provided an exception permitting permanent classification of a security that is optionally redeemable (not mandatorily redeemable pursuant to ASC 480) upon the death of the holder if the redemption will be funded from the proceeds of an insurance policy that currently is in force and for which the issuer has the intent and ability to maintain in force. The SEC staff has indicated that this is a narrow exception that should not be applied by analogy to other transactions.

## C.2.12 Redemptions limited to proceeds from sale of equity and exchanged for a permanent equity security

Although not stated in the redeemable equity guidance, the SEC staff has stated that permanent equity classification is acceptable in circumstances where the issuer has an unconditional right, coupled with the present intent and ability, to satisfy the redemption by exchanging the redeemable security for a permanent equity security (considering the requirements in ASC 815-40-25 to ensure that the issuer has the ability to settle in shares) or limiting the redemption to the cash proceeds to be received from a new permanent equity offering, with appropriate disclosure. [80]

## C.2.13 Certain equity securities held by an ESOP

The Internal Revenue Service requires that certain employer securities held by an ESOP that are not "readily tradable"[81] must contain a put option that permits the ESOP participants to put the securities to the employer, subject to certain legal restrictions. Accordingly, employers that issue equity-classified securities that are not considered "readily tradable" to an ESOP will generally classify those securities in temporary equity. Because the put option is typically probable of becoming redeemable (e.g., it is exercisable by the passage of time), issuers would need to consider the general subsequent measurement guidance for redeemable equity securities as discussed in section C.4.1.2.

[80] As noted in the "SEC Staff Interpretations in Registrant Matters Involving Accounting and Auditing Issues" presented at the 1992 AICPA National Conference on Current SEC Developments.

[81] The term "readily tradable" is defined by the IRS with reference to the term "publicly traded" in the Code of Federal Regulations (CFR), Title 26, Section 54.4975-7(b)(1)(iv).

## C.3 Classification

**Excerpt from Accounting Standards Codification**

**Distinguishing Liabilities from Equity — Overall**

*SEC Materials*

*480-10-S99-3A*

*Classification*

4. ASR 268 requires equity instruments with redemption features that are not solely within the control of the issuer to be classified outside of permanent equity (often referred to as classification in "temporary equity"). The SEC staff does not believe it is appropriate to classify a financial instrument (or host contract) that meets the conditions for temporary equity classification under ASR 268 as a liability. FN10

   FN10 At the June 14, 2007 EITF meeting, the SEC Observer stated that a financial instrument (or host contract) that otherwise meets the conditions for temporary equity classification may continue to be classified as a liability provided the financial instrument (or host contract) was classified and accounted for as a liability in fiscal quarters beginning before September 15, 2007 and has not subsequently been modified or subject to a remeasurement (new basis) event.

5. Determining whether an equity instrument is redeemable at the option of the holder or upon the occurrence of an event that is solely within the control of the issuer can be complex. The SEC staff believes that all of the individual facts and circumstances surrounding events that could trigger redemption should be evaluated separately and that the possibility that *any* triggering event that is not *solely* within the control of the issuer could occur—without regard to probability—would require the instrument to be classified in temporary equity.

In evaluating whether an instrument should be classified as part of temporary equity, the SEC staff believes that each event that could trigger redemption should be evaluated separately.

Any possibility that a triggering event not solely within the control of the issuer could force the issuer to redeem the equity instrument for cash or other assets — regardless of the probability that the event will occur — requires the instrument to be classified outside of permanent equity. The holder's ability to control the circumstances under which the issuer could be required to redeem the equity security is not considered in the analysis. That is, the event does not need to be in the control of the holder. It must be only outside the control of the issuer.

For example, the SEC staff consistently has required stock that is redeemable for cash or other assets upon a change in control of the issuer (i.e., change in control is generally not within the control of the issuer) to be classified outside of permanent equity, regardless of the likelihood of a change in control. The SEC staff's view also applies to stock with other redemption features outside the control of the issuer, including those redemption features triggered by future events such as the following:

- Termination of an employment relationship with the holder
- Delisting of the issuer's shares from a stock exchange
- Failure to maintain compliance with debt covenants
- Failure to have a registration statement declared effective by the SEC by a designated date
- A reduction in the issuer's credit rating
- The failure to achieve specified performance targets

Certain redemption features may be, contractually, within the control of the issuer (such as an issuer's call right). However, to the extent the holder of the instrument controls the issuer, that redemption feature cannot be assumed to be within the control of the issuer. In those cases, the holder has the ability to cause the issuer to exercise the redemption feature and the instrument should be classified outside of permanent equity. The individual facts and circumstances should be considered when evaluating whether certain redemption features are within the control of the issuer.

The redeemable equity guidance focuses on circumstances in which the issuer, beyond its control, may be obligated to redeem outstanding equity instruments for cash or other assets. Accordingly, to the extent the issuer has the option and ability to settle the redemption in its own shares, temporary equity classification may not be required.

As discussed in section C.2.4, for instruments that may be settled in shares, an issuer should carefully evaluate the requirements in ASC 815-40-25 to determine whether the issuer controls the actions or events necessary to issue the maximum number of shares that could be required to be delivered under share settlement. Consistent with the evaluation made pursuant to the redeemable equity guidance, the assessment made in evaluating the requirements in ASC 815-40-25 should be made without regard to probability.

Importantly, even without the contractual provision for cash (or other assets) redemption, temporary equity classification would be required pursuant to the guidance in ASC 815-40-25 if share settlement is not assured (i.e., cash settlement would be presumed to occur). Refer to section B.4.4 for additional guidance.

Registrants should evaluate all of the individual facts and circumstances in determining how an equity security should be classified. The SEC staff's examples provided in ASC 480-10-S99-3A and in certain SEC staff speeches (described in this section) should be carefully considered in making this evaluation.

Refer to Question 2 in section C.7 — What are examples of instances in which classification of a security outside of permanent equity is and is not appropriate?

## C.3.1 Convertible debt instruments that contain a separately classified equity component

As discussed in section C.2.9, the accounting for convertible debt may result in amounts recognized in equity. Those amounts recorded in equity (or a portion thereof) may require temporary equity classification if the instrument is currently redeemable or convertible.

The equity-classified component should be considered redeemable if at the balance sheet date the issuer can be required to settle the convertible debt instrument for cash or other assets (i.e., the instrument is currently redeemable or convertible for cash or other assets).

Classification of that amount in temporary equity is required only if the instrument is currently redeemable or convertible at the balance sheet date for cash or other assets. The likelihood of a convertible debt instrument becoming redeemable or convertible for cash or other assets at a future date is not relevant. This approach differs from the application of ASC 480-10-S99-3A to all other instruments within its scope, which requires temporary equity classification if there is any possibility that cash settlement of an equity instrument could be required outside the control of the issuer.

For example, consider a convertible debt instrument that is not redeemable at the balance sheet date, but becomes redeemable by the holder based on the passage of time or upon the occurrence of a contingent event that has not yet occurred. This instrument is not considered currently redeemable at the balance sheet date and, therefore, temporary equity classification of all or a portion of the equity component is not required. Additionally, depending on the terms of the conversion feature, the debt may be convertible only at certain times. In those circumstances the equity component (or a portion thereof) may alternate between temporary and permanent equity from period to period.

Importantly, temporary equity classification should be considered only if the issuer could be required to settle a portion of the equity component for cash (i.e., the possibility of cash settlement is outside the issuer's control) at the balance sheet date. If the issuer has a choice to settle in cash or shares, provided the issuer has the ability to settle in shares and meets all of the requirements in ASC 815-40-25, temporary equity classification would not be required. The following table summarizes the application of the SEC staff's guidance to certain common convertible instruments involving cash upon conversion:

| Instrument description[82] | If convertible as of the balance sheet date[83] | If redeemable as of the balance sheet date (i.e., subject to a currently exercisable put option) |
|---|---|---|
| Instrument B — Convertible into all cash or all shares at the option of the issuer | Temporary equity classification may not be necessary if, on conversion, the issuer has the ability to choose a method that avoids cash settlement | Temporary equity classification is required if the redemption amount exceeds the accrued liability component |
| Instrument C — Convertible into cash up to the principal amount with any excess conversion spread in cash or shares at the option of the issuer | Temporary equity classification is required if the amount required to be settled in cash (i.e., the principal amount) exceeds the accrued liability component | Temporary equity classification is required if the redemption amount exceeds the accrued liability component |
| Instrument X — Convertible into any combination of cash or shares at the option of the issuer | Temporary equity classification may not be necessary if, on conversion, the issuer has the ability to choose a method that avoids cash settlement | Temporary equity classification is required if the redemption amount exceeds the accrued liability component |

## C.3.2 Noncontrolling interests

Noncontrolling interest holders may have rights requiring either the issuing subsidiary or its parent to redeem the NCI at the option of the holder or upon the occurrence of a contingent event. Provided (1) the rights are considered embedded in the NCI (regardless of whether or not bifurcated) and (2) the NCI is not considered mandatorily redeemable in accordance with ASC 480, those redemption features should be evaluated to determine whether the NCI should be classified in temporary equity.

## C.4 Measurement

ASC 480-10-S99-3A provides general initial and subsequent measurement guidance for instruments within its scope, in addition to specific guidance on the following types of instruments:

- Share-based payments and certain employee stock ownership plans
- NCI
- Convertible debt
- Host equity contracts

[82] Instrument A is not discussed in the table as its conversion option is bifurcated and thus would not result in any amount recorded in equity.

[83] Consideration should be given to the requirements of ASC 815-40-25 to evaluate whether the issuer has the ability to settle in shares. Additionally, the issuer should also consider whether the holder of the instrument has the ability to control the issuer's decision to settle the conversion feature in cash or shares through the holder's control of the board of directors.

## C.4.1 General

**Excerpt from Accounting Standards Codification**

**Distinguishing Liabilities from Equity — Overall**

*SEC Materials*

*480-10-S99-3A*

*Measurement*

12. *Initial measurement*. The SEC staff believes the initial carrying amount of a redeemable equity instrument that is subject to ASR 268 should be its issuance date fair value, except as follows: FN12

    FN12 SAB Topic 3C, *Redeemable Preferred Stock*, states that the initial carrying amount of redeemable preferred stock should be its fair value at date of issue. The SEC staff believes this guidance should also be applied to other similar redeemable equity instruments. Consistent with Paragraph 820-10-30-3, the transaction price will generally represent the initial fair value of the equity instrument when the issuance occurs in an arm's-length transaction with an unrelated party and there are no other unstated rights or privileges.

12(e) For host equity contracts (see paragraph 3(b)), the initial amount presented in temporary equity should be the initial carrying amount of the host contract pursuant to Section 815-15-30. Similarly, the initial amount presented in temporary equity for a preferred stock instrument that contains a beneficial conversion feature or is issued with other instruments should be the amount allocated to the instrument in its entirety pursuant to Subtopic 470-20 less any beneficial conversion feature recorded at the issuance date.

13. *Subsequent measurement*. The SEC staff's views regarding the subsequent measurement of a redeemable equity instrument that is subject to ASR 268 are included in paragraphs 14–16. Paragraphs 14 and 15 discuss the general views regarding subsequent measurement. Paragraph 16 discusses the application of those general views in the context of certain types of redeemable equity instruments.

14. If an equity instrument subject to ASR 268 is currently redeemable (for example, at the option of the holder), it should be adjusted to its maximum redemption amount at the balance sheet date. If the maximum redemption amount is contingent on an index or other similar variable (for example, the fair value of the equity instrument at the redemption date or a measure based on historical EBITDA), the amount presented in temporary equity should be calculated based on the conditions that exist as of the balance sheet date (for example, the current fair value of the equity instrument or the most recent EBITDA measure). The redemption amount at each balance sheet date should also include amounts representing dividends not currently declared or paid but which will be payable under the redemption features or for which ultimate payment is not solely within the control of the registrant (for example, dividends that will be payable out of future earnings). FN13

    FN13 See also Section 260-10-45.

15. If an equity instrument subject to ASR 268 is not currently redeemable (for example, a contingency has not been met), subsequent adjustment of the amount presented in temporary equity is unnecessary if it is not probable that the instrument will become redeemable. If it is probable that the equity instrument will become redeemable (for example, when the redemption depends solely on the passage of time), the SEC staff will not object to either of the following measurement methods provided the method is applied consistently:

    a. Accrete changes in the redemption value over the period from the date of issuance (or from the date that it becomes probable that the instrument will become redeemable, if later) to the earliest redemption date of the instrument using an appropriate methodology, usually the interest method. Changes in the redemption value are considered to be changes in accounting estimates.

b. Recognize changes in the redemption value (for example, fair value) immediately as they occur and adjust the carrying amount of the instrument to equal the redemption value at the end of each reporting period. This method would view the end of the reporting period as if it were also the redemption date for the instrument.

16. The following additional guidance is relevant to the application of the SEC staff's views in paragraphs 14 and 15:

e. For a redeemable equity instrument other than [share based payment arrangements, employee stock ownership plans and convertible debt instruments], regardless of the accounting method applied in paragraphs 14 and 15, the amount presented in temporary equity should be no less than the initial amount reported in temporary equity for the instrument. That is, reductions in the carrying amount of a redeemable equity instrument from the application of paragraphs 14 and [15] are appropriate only to the extent that the registrant has previously recorded increases in the carrying amount of the redeemable equity instrument from the application of paragraphs 14 and 15.

### C.4.1.1 Initial measurement

Except for share-based payment arrangements and employee stock ownership plans (refer to section C.4.4), NCI (refer to section C.4.2) and the equity-classified component of convertible debt instruments (refer to section C.4.3), the initial carrying value of a redeemable equity security classified in temporary equity should generally be its issuance date fair value (generally the proceeds from issuance), except as stated in the next paragraph. While the specific terms of the redemption feature should be reflected in the initial fair value measurement, the redemption amount itself is not determinative as to the amount that should be initially recorded in temporary equity. For example, if an entity issues preferred stock for $1,000 (fair value) that is redeemable at the option of the holder at any time for $750, the amount initially classified in temporary equity would be $1,000.

If a redeemable equity instrument is issued with other freestanding instruments, the initial carrying value of the amount classified in temporary equity should be the redeemable equity instrument's allocated proceeds based on the guidance in ASC 470-20 (refer to section 1.2.7). If an embedded feature is bifurcated from the redeemable equity instrument, the amount initially recorded in temporary equity should be based on the guidance in ASC 815 (generally the bifurcated feature is allocated its full fair value and the residual is allocated to the host equity instrument).

In addition, refer to section 3.3 for a discussion on the accounting for share issuance costs.

### C.4.1.2 Subsequent measurement

With the exception of share-based payment arrangements and employee stock ownership plans (refer to section C.4.4), NCI (refer to section C.4.2) and the equity-classified component of convertible debt instruments (refer to section C.4.3), the subsequent measurement of a redeemable instrument depends on whether the instrument is currently redeemable or it is probable that the instrument will become redeemable. Importantly, the probability that a security "will become redeemable" is different than the probability that a security "will be redeemed." For example, consider a preferred security that is redeemable at the option of the holder after five years. While there may be uncertainty as to whether the security will be redeemed, there is no uncertainty as to whether the security will become redeemable as the mere passage of time will cause the security to become redeemable.

In a speech at the 2005 AICPA conference,[84] the SEC staff said that this probability assessment should not consider the likelihood that other options held by the holder may be exercised first:

> "When applying this guidance to a security with both a conversion option and a redemption option like the one described earlier, some have argued that it is not probable that the security will become currently redeemable because of the likelihood that the holder will exercise the conversion option first. We have objected to this view because the exercise of the conversion option was controlled entirely by the holder. Absent that action by the holder, the security will become redeemable following only the passage of time. The probability assessment that is required by Topic D-98 would not factor in the likelihood that other options held by the holder may or may not be exercised first. Thus, the instrument that I have described would be considered to be probable of becoming currently redeemable regardless of the likelihood of earlier conversion."

When a redeemable equity instrument is denominated in a foreign currency, additional consideration should be given on accounting for the effects of foreign currency exchange rate movements to such instruments. Neither ASC 830 nor ASC 480-10-S99-3A provides specific guidance. Judgment is generally required to determine whether and, if so, how the carrying amount of the redeemable equity instrument should be adjusted to account for the effect of currency exchange rate movements. Refer to Question 3.8 of our FRD publication, ***Foreign currency matters***, for additional guidance.

#### *C.4.1.2.1 Securities that are currently redeemable*

If redeemable currently, the amount recorded in temporary equity should be adjusted to its maximum redemption amount at each balance sheet date. If the maximum redemption amount is not a fixed amount (e.g., fair value, based on an index or based on a formula), the amount reported should be calculated based on the conditions that exist as of the balance sheet date. The carrying amount should also be adjusted to include dividends not currently declared or paid, but that would be payable under the redemption features if the redemption were to occur as of the balance sheet date.

#### *C.4.1.2.2 Securities that are not currently redeemable but probable of becoming redeemable in the future*

If the security is probable of becoming redeemable, the issuer may elect to consistently follow either of the following accounting methods to measure redeemable securities:

- Method 1 — Changes in the redemption value are accreted over the period from the date of issuance (or the date that it is probable that the instrument will become redeemable) to the earliest redemption date using an appropriate methodology, usually the interest method. Changes in the redemption amount are considered to be changes in accounting estimates.
- Method 2 — Changes in the redemption value are recognized immediately as they occur and the carrying value of the security is adjusted to equal what the redemption amount would be as if redemption were to occur at the reporting date based on the conditions that exist as of that date. This method would view the end of the reporting period as if it were also the redemption date for the security.

While either of the above methods is acceptable, we generally believe issuers should evaluate the specific facts and circumstances of the applicable redemption feature and the level of subjectivity and assumptions necessary and apply the method that best represents the economics of the instrument.

To the extent a security is redeemable at a fixed date in the future for a fixed amount, Method 1 may be the most appropriate method. However, if either the redemption date or amount (or both) is variable yet reasonably estimable, applying Method 1 may be more difficult. In those cases, the issuer may need to make a number of assumptions and update them during the accretion period to derive an accretion pattern that is representative of the underlying economics.

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[84] Mark Northan, 2005 — Refer to the SEC website at **http://www.sec.gov/news/speech/spch120505mn.htm.**

For example, assume a preferred security is issued on 1 January 20X1, and is redeemable at a future date at 10% of the issuer's net income during the year prior to redemption and it is probable the instrument will become redeemable. If the issuer followed Method 1, at each reporting period, the issuer would need to estimate (1) when the redemption option is expected to be exercised and (2) net income for the year prior to exercise. The redemption value would then be appropriately accreted (e.g., if two years have elapsed over an estimated four-year period prior to becoming redeemable, one-half of the excess of the estimated redemption amount over the initial carrying amount would be accreted). Under Method 2, the issuer would assume the redemption amount were equal to the amount that would be redeemable if the instrument were redeemed on that date (provided that amount exceeded the initial carrying amount).

#### *C.4.1.2.2.1 Events that prevent an instrument from becoming redeemable*

An event outside the holder's control may prevent the instrument from becoming redeemable. In that situation, we generally believe the likelihood of that intervening event occurring should be considered in determining whether the instrument is probable of becoming redeemable (and thus whether any subsequent measurement is required).

Frequently, redeemable securities automatically convert into non-redeemable common stock upon an IPO. The redemption terms of those securities also provide the holders with the right to redeem the securities if the IPO is not effective by a stated date. Based on the individual facts and circumstances, including the likelihood of the intervening event (e.g., automatic conversion upon an IPO) occurring prior to the redemption date, an issuer may be able to conclude that it is not probable that the security will become redeemable.

#### *C.4.1.2.2.2 Securities that are redeemable upon a majority vote by shareholders*

Certain shares may be redeemable upon a majority vote of the holders. Because the shares are redeemable upon a majority vote by the holders, which is outside the company's control, the shares should be classified in temporary equity. The instrument is not a liability pursuant to ASC 480 because it is not mandatorily redeemable.

The vote by the holders to redeem their shares is not a contingency but instead an action by the holders to exercise their right to redeem the shares. Therefore, the issuer should elect one of the methods described in paragraph 15 of ASC 480-10-S99-3A to subsequently measure the shares.

#### *C.4.1.2.2.3 Securities with multiple redemption features (added August 2023)*

Securities that are classified as temporary equity may have multiple redemption features. We generally believe that only redemption features that cause the securities to be classified as temporary equity and that cause the securities to be currently redeemable or probable of becoming redeemable should be considered when subsequently measuring these securities. If more than one such redemption feature causes the securities to be either currently redeemable or probable of becoming redeemable, the issuer should determine the redemption amount for each feature and measure the securities at the highest of those amounts.

**Illustration C-1: Multiple redemption features**

Company A issues 1,000 shares of Series A preferred stock (Series A) on 1 January 20X1 at their par amount of $1,000. The holders of Series A can put their shares to Company A for $1,100 beginning on 1 January 20X3 (i.e., redemption is based solely on the passage of time). The Company can also call Series A for $1,200 upon an IPO. Assume that none of the redemption features requires bifurcation under ASC 815-15.

Company A determines that Series A is not a liability under ASC 480. Because the call option is in the company's control, this feature would not cause Series A to be classified as temporary equity. However, the time-based redemption feature causes Series A to be classified as temporary equity and to be considered probable of becoming redeemable. Therefore, Company A will begin to subsequently remeasure Series A to its redemption amount. Company A has selected Method 1 (discussed above) for subsequent measurement and will accrete Series A from 1 January 20X1 through 31 December 20X2 to the $1,100 time-based redemption amount.

**Illustration C-2: Multiple redemption features — maximum of the redemption amounts**

Assume the same facts as above, except that Series A can also be put by holders to Company A upon a change in control of Company A for $1,200. Company A determines that a change in control is not in its control and is probable of occurring. Assume that none of the redemption features requires bifurcation under ASC 815-15.

In this situation, both the time-based and change in control redemption features cause Series A to be classified as temporary equity. Further, both features cause Series A to be considered probable of becoming redeemable. As a result, Company A will use the maximum redemption amount of $1,200 for the subsequent measurement of Series A, which is the greater of the time-based redemption amount of $1,100 and the change in control redemption amount of $1,200. Company A has selected Method 2 (discussed above) for subsequent measurement and will adjust the carrying amount of Series A to $1,200 on the next reporting date.

#### *C.4.1.2.2.4 Redeemable host equity contract with bifurcated derivatives (added August 2023)*

Redeemable equity instruments (e.g., preferred stock) may contain embedded features that require bifurcation as derivatives under ASC 815-15. In such cases, when the embedded derivative is separated, the host equity contract is subject to the redeemable equity guidance. Furthermore, according to paragraph 12(e) of ASC 480-10-S99-3A, the initial amount of the temporary equity is the initial carrying amount of the host contract pursuant to ASC 815-15-30.

However, ASC 480-10-S99-3A does not provide guidance on the subsequent measurement of a redeemable host equity contract classified in temporary equity. We generally believe that the subsequent measurement of the host equity contract should take into account the fair value of the bifurcated derivative — that is, the carrying amount of the host equity contract should be accreted to its redemption amount less the fair value of any liability-classified bifurcated derivatives. Given that the guidance is not clear, other views may also be acceptable. Regardless of the approach used, the amount presented in temporary equity should not be less than the initial amount reported in temporary equity for the instrument.

Refer to Question 5 in section C.7 — How should the equity component, recognized in connection with a modification of the conversion option in convertible debt, be presented in temporary equity when the debt instrument also contains embedded derivatives (other than the conversion option) that have been bifurcated?

#### *C.4.1.2.2.5 Securities that are redeemable by the issuer and the holder (added August 2023)*

If both the holder of a redeemable equity instrument (e.g., preferred stock) and the issuer have rights to redeem the instrument, and the issuer's redemption right can be exercised before the holder's redemption right, it is important to note that the issuer's right to redeem does not affect the assessment of whether the redeemable equity instrument is probable of becoming redeemable. SAB Topic 3.C, *Redeemable Preferred Stock*, (included in the Codification as ASC 480-10-S99-2) specifies that the measurement of redeemable preferred stock applies regardless of whether the stock can be voluntarily redeemed by the issuer before the mandatory redemption date or whether the holder has the ability to convert the shares into another class of securities.

### *C.4.1.2.3 Securities that are not currently redeemable and not probable of becoming redeemable in the future*

If an equity instrument subject to the SEC staff's guidance on redeemable equity instruments is not initially redeemable and it is not probable it will become redeemable (e.g., it is not probable a contingency that triggers redemption will be met), the instrument should be classified in temporary equity, but an adjustment of the initial carrying amount is not necessary until it is probable that the security will become redeemable. In that case, disclosure should be made of the reasons why it is not considered probable that the security will become redeemable.

### *C.4.1.2.4 Assessing whether an instrument is 'probable of becoming redeemable'*

The use of the word "probable" is consistent with that in ASC 450, which defines probable as "the future event or events are likely to occur." The guidance in ASC 450 should be followed in determining probability for purposes of applying the redeemable equity guidance when assessing whether a redeemable equity instrument that is not currently redeemable is probable of becoming redeemable.

### *C.4.1.2.5 Accounting for the adjustments to temporary equity*

Except for adjustments to the carrying amount of NCI (refer to section C.4.2), separately classified equity components (refer to section C.4.3) and share-based payments (refer to section C.4.4), increases in the carrying amount of instruments in temporary equity are effected by charges against retained earnings (or in the absence of retained earnings, APIC) and may affect EPS, as discussed in section C.5. Decreases in the carrying amount are recognized only to the extent that increases to the amount initially recognized in temporary equity were previously recorded. That is, the carrying amount of redeemable securities should not be lower than the initial carrying amount recognized.

Refer to Question 3 in section C.7 — May the fair value option pursuant to ASC 825 be elected for an instrument subject to the redeemable equity guidance?

## C.4.2 Noncontrolling interests

**Excerpt from Accounting Standards Codification**

**Distinguishing Liabilities from Equity — Overall**

*SEC Materials*

*480-10-S99-3A*

*Initial measurement*

12(c) For noncontrolling interests, the initial amount presented in temporary equity should be the initial carrying amount of the noncontrolling interest pursuant to Section 805-20-30.

*Subsequent measurement*

16(c) For noncontrolling interests, the adjustment to the carrying amount presented in temporary equity is determined after the attribution of net income or loss of the subsidiary pursuant to Subtopic 810-10.

16(e) For a redeemable equity instrument other than [share based payment arrangements, employee stock ownership plans and convertible debt instruments], regardless of the accounting method applied in paragraphs 14 and 15, the amount presented in temporary equity should be no less than the initial amount reported in temporary equity for the instrument. That is, reductions in the carrying amount of a redeemable equity instrument from the application of paragraphs 14 and [15] are appropriate only to the extent that the registrant has previously recorded increases in the carrying amount of the redeemable equity instrument from the application of paragraphs 14 and 15.

ASC 480-10-S99-3A requires redeemable NCI to be initially recognized in temporary equity at the initial carrying amount of the NCI determined in accordance with ASC 805-20-30. That guidance applies to business combinations and requires the acquirer to measure the NCI in the acquiree at fair value on the acquisition date. Refer to section 4.6 of our FRD publication, ***Business combinations***, for further discussion on the initial recognition of NCI in a business combination.

ASC 480-10-S99-3A does not address the initial measurement of a redeemable NCI if it is not created as part of a business combination subject to the guidance in ASC 805. For example, consider when a parent sells a 5% NCI. The transaction may be within the scope of ASC 810, and if so, is accounted for as an equity transaction under ASC 810-10-45-21A through 45-24. In this case the carrying amount of the noncontrolling interest should be increased to reflect the change in the noncontrolling interest's ownership in the subsidiary's net assets (that is, the ending amount attributed to the noncontrolling interest should reflect its ownership of the subsidiary's net assets inclusive of any consideration received by the subsidiary). That carrying amount may not represent the fair value of the NCI upon the transaction. However, if the NCI is redeemable and subject to ASC 480-10-S99-3A, we generally believe that the redeemable NCI should be initially measured at fair value. Whether any adjustment to bring the initial carrying amount of the NCI under ASC 810 to fair value will affect EPS will depend on facts and circumstances.

Refer to section A.2.4 of our FRD publication, ***Business combinations***, for further discussion on the initial recognition of NCI in an asset acquisition. Also, refer to section 13 of our FRD publication, ***Consolidation***, when the subsidiary is a variable interest entity, and refer to section 18 of that publication for further discussion on the accounting for subsequent changes in the ownership interest under ASC 810.

The redeemable equity guidance complements the requirements in ASC 810-10-45-18 through 45-21 for SEC registrants. As a result, an issuer should first attribute net income or loss of the subsidiary to the NCI pursuant to ASC 810-10. Although the redeemable equity guidance states in paragraph 16(e) that the amount presented in temporary equity should be no less than the initial amount reported in temporary equity for the instrument, that guidance is effectively nullified for NCI to the extent the decrease is from the attribution of losses (or potentially the distribution of dividends). After following that guidance, the issuer should consider the provisions of ASC 480-10-S99 to determine whether any further adjustments are necessary to the carrying value of redeemable NCI.

There is no limit to the increases that can be recorded on top of the ASC 810-10 NCI carrying amount. However, decreases are limited to previously recorded increases made pursuant to the redeemable equity guidance. As a result, the NCI should not be adjusted below its ASC 810-10 carrying amount. The amount presented in temporary equity should be the greater of the NCI balance determined pursuant to the NCI guidance or the amount determined pursuant to paragraphs 12-15 and 16(e) of the redeemable equity guidance. Accordingly, issuers should maintain measurement information under each approach. Many do this by maintaining the ASC 480-10-S99 adjustments in a separate account that is grouped with the NCI when presenting the statement of financial position.

Refer to section 5.10 for a discussion of equity contracts on NCI and section 5.10.2.4.1 for a discussion of the measurement of redeemable NCI. In addition, refer to Question 4 in section C.7 — Are adjustments to the carrying value of redeemable NCI in accordance with ASC 480-10-S99 included in the gain or loss calculation when the subsidiary with the noncontrolling interest is deconsolidated?

## C.4.3 Convertible debt instruments that contain a separately classified equity component

**Excerpt from Accounting Standards Codification**

**Distinguishing Liabilities from Equity — Overall**

*SEC Materials*

*480-10-S99-3A*

*Initial measurement*

12(d) For convertible debt instruments that contain a separately classified equity component, an amount should initially be presented in temporary equity only if the instrument is currently redeemable or convertible at the issuance date for cash or other assets (see paragraph 3(e)). The portion of the equity-classified component that is presented in temporary equity (if any) is measured as the excess of (1) the amount of cash or other assets that would be required to be paid to the holder upon a redemption or conversion at the issuance date over (2) the carrying amount of the liability-classified component of the convertible debt instrument at the issuance date.

*Subsequent measurement*

16(d) For convertible debt instruments that contain a separately classified equity component, an amount should be presented in temporary equity only if the instrument is currently redeemable or convertible at the balance sheet date for cash or other assets (see paragraph 3(e)). The portion of the equity-classified component that is presented in temporary equity (if any) is measured as the excess of (1) the amount of cash or other assets that would be required to be paid to the holder upon a redemption or conversion at the balance sheet date over (2) the carrying amount of the liability-classified component of the convertible debt instrument at the balance sheet date. FN15

FN15 ASR 268 does not impact the application of other applicable GAAP to the accounting for the liability component or the accounting upon derecognition of the liability and/or equity component.

An amount classified in equity that is associated with a convertible debt instrument may require temporary equity classification (refer to section C.3.1) if the instrument is currently redeemable or convertible at the balance sheet date. The portion that is presented in temporary equity (if any) should be measured as (1) the amount of cash that would be required to be paid to the holder upon redemption or conversion at the balance sheet date in excess of (2) the current carrying amount of the liability-classified component of the convertible debt instrument. For example, if a convertible debt instrument is currently redeemable at the option of the holder for $1,000 in cash and the liability-classified component of the instrument is carried at $950, $50 of the equity-classified component should be presented as temporary equity.

We generally believe the equity component discussed in ASC 480-10-S99-3A excludes any related deferred tax effects of the convertible debt issuance recognized in equity. That is, the amount subject to reclassification pursuant to the SEC staff's redeemable equity guidance is not the net equity component after considering deferred tax implications, because any tax liabilities are payable to the taxing authorities, not to the investor.

Adjustments recorded to the carrying amounts of the equity component of convertible debt included in temporary equity pursuant to this guidance should be recorded against APIC. There should be no EPS effect for the initial classification to temporary equity or any subsequent adjustments.

Refer to Question 5 in section C.7 — How should the equity component, recognized in connection with a modification of the conversion option in convertible debt, be presented in temporary equity when the debt instrument also contains embedded derivatives (other than the conversion option) that have been bifurcated?

## C.4.4 Share-based payments and employee stock ownership plans

**Excerpt from Accounting Standards Codification**

**Distinguishing Liabilities from Equity — Overall**

*SEC Materials*

*480-10-S99-3A*

*Initial measurement*

12(a) For share-based payment arrangements with employees, the initial amount presented in temporary equity should be based on the redemption provisions of the instrument and the proportion of consideration received in the form of employee services at initial recognition. For example, upon issuance of a fully vested option that allows the holder to put the option back to the issuer at its intrinsic value upon a change in control, an amount representing the intrinsic value of the option at the date of issuance should be presented in temporary equity.

12(b) For employee stock ownership plans where the cash redemption obligation relates only to a market value guarantee feature, the registrant may elect as an accounting policy to present in temporary equity either (i) the entire guaranteed market value amount of the equity securities or (ii) the maximum cash obligation based on the fair value of the underlying equity securities at the balance sheet date.

*Subsequent measurement*

16(a) For share-based payment arrangements with employees, the amount presented in temporary equity at each balance sheet date should be based on the redemption provisions of the instrument and should take into account the proportion of consideration received in the form of employee services (that is, the pattern of recognition of compensation cost pursuant to Topic 718). FN14

FN14 See also the Interpretative Response to Question 2 in Section E of Section 718-10-S99.

16(b) For employee stock ownership plans where the cash redemption obligation relates only to a market value guarantee feature, the registrant may elect as an accounting policy to present in temporary equity either (i) the entire guaranteed market value amount of the equity securities or (ii) the maximum cash obligation based on the fair value of the underlying equity securities at the balance sheet date.

Refer to sections 2.1.3 and 5.3 of our FRD publication, ***Share-based payment***, for further guidance on employee stock ownership plans and temporary equity considerations for share-based payment arrangements, respectively.

## C.4.5 Redeemable convertible preferred stock with down round features

In accordance with ASC 260, the value of the effect of a down round feature in an equity-classified convertible preferred stock (if that conversion feature has not been bifurcated in accordance with other guidance) is recognized when the down round feature is triggered (i.e., when the exercise price is reduced). Refer to section B.3.4.1 for more information on the definition of a down round, and refer to section 3.2.3A of our FRD publication, ***Earnings per share***, for further guidance on the EPS considerations of convertible preferred stock with down round features.

Assume a redeemable convertible preferred stock that contains a down round feature is classified in temporary equity and is required to be subsequently remeasured under ASC 480-10-S99-3A. Upon recognition of the value of the effect of the down round feature, the issuer would record the following entry:

| | | | | |
|---|---|---|---|---|
| Retained earnings | $ | XX | | |
| Additional paid-in capital | | | $ | XX |

There are differing views on whether the APIC recorded upon recognizing the value of the effect of a down round feature should be included in the carrying amount of the redeemable instrument in its subsequent measurement under ASC 480-10-S99-3A or be recorded in APIC as a separate unit of account from the redeemable instrument.

Based on discussions with the SEC staff, we understand that the staff would not object to accounting for the APIC separately from the redeemable convertible preferred stock. However, the staff would object to including the APIC in temporary equity as part of the basis of the redeemable convertible preferred stock that is subject to ASC 480-10-S99-3A. That is, any subsequent remeasurement adjustments to the preferred stock must be made without consideration to the amount recognized in APIC when the down round feature was triggered.

If the instrument is subsequently redeemed, any amount reported in APIC related to the redeemable convertible preferred stock should be derecognized in connection with the redemption.

## C.4.6 Reclassifications between temporary equity and permanent equity

**Excerpt from Accounting Standards Codification**

**Distinguishing Liabilities from Equity — Overall**

*SEC Materials*

*480-10-S99-3A*

*Reclassifications into Permanent Equity*

18. If classification of an equity instrument as temporary equity is no longer required (if, for example, a redemption feature lapses, or there is a modification of the terms of the instrument), the existing carrying amount of the equity instrument should be reclassified to permanent equity at the date of the event that caused the reclassification. Prior financial statements are not adjusted. Additionally, the SEC staff believes that it would be inappropriate to reverse any adjustments previously recorded to the carrying amount of the equity instrument (pursuant to paragraphs 14–16) in conjunction with such reclassifications.

Over the life of an instrument, there may be changes in circumstances that require changes in its classification between temporary and permanent equity. The redeemable equity guidance specifically addresses circumstances in which a security may no longer be required to be classified in temporary equity. For example, preferred shareholders holding shares that are redeemable by the issuer may lose their ability to force redemption if they lose control of the board of directors or equity instruments may become nonredeemable upon expiration of the redemption option. In those cases, the instrument should be reclassified from temporary equity to permanent equity.

The carrying amount of the security should be reclassified to permanent equity at the date of the event that caused reclassification. Amounts recorded in accordance with the redeemable equity guidance while the instrument was classified in temporary equity should not be reversed upon the reclassification of an instrument from temporary equity to permanent equity.

The redeemable equity guidance does not provide specific guidance on reclassifications of instruments from permanent into temporary classification. We believe one reasonable approach would be to reclassify the security at its fair value as of the date of the event that caused reclassification. By analogy to the guidance in ASC 815-40-35-9 on reclassifying a contract from permanent equity to an asset or liability, under this approach any difference between the fair value of the security to be recorded in temporary equity and the previous carrying value of the security recorded in permanent equity would be accounted for as an adjustment to shareholder's equity (i.e., APIC). There may be other acceptable methods.

## C.5 Earnings per share

**Excerpt from Accounting Standards Codification**

**Distinguishing Liabilities from Equity — Overall**

*SEC Materials*

*480-10-S99-3A*

*Earnings per Share*

20. *Preferred stock instruments issued by a parent (or single reporting entity).* Regardless of the accounting method selected in paragraph 15 and the redemption terms (that is, fixed price or fair value), the resulting increases or decreases in the carrying amount of a redeemable instrument other than common stock should be treated in the same manner as dividends on nonredeemable stock and should be effected by charges against retained earnings or, in the absence of retained earnings, by charges against paid-in capital. Increases or decreases in the carrying amount should reduce or increase income available to common stockholders in the calculation of earnings per share and the ratio of earnings to combined fixed charges and preferred stock dividends. Additionally, Paragraph 260-10-S99-2, provides guidance on the accounting at the date of a redemption or induced conversion of a preferred stock instrument.

21. *Common stock instruments issued by a parent (or single reporting entity).* Regardless of the accounting method selected in paragraph 15, the resulting increases or decreases in the carrying amount of redeemable common stock should be treated in the same manner as dividends on nonredeemable stock and should be effected by charges against retained earnings or, in the absence of retained earnings, by charges against paid-in capital. However, increases or decreases in the carrying amount of a redeemable common stock should not affect income available to common stockholders. Rather, the SEC staff believes that to the extent that a common shareholder has a contractual right to receive at share redemption (in other than a liquidation event that meets the exception in paragraph 3(f)) an amount that is other than the fair value of the issuer's common shares, then that common shareholder has, in substance, received a distribution different from other common shareholders. Under Paragraph 260-10-45-59A, entities with capital structures that include a class of common stock with different dividend rates from those of another class of common stock but without prior or senior rights, should apply the two-class method of calculating earnings per share. Therefore, when a class of common stock is redeemable at other than fair value, increases or decreases in the carrying amount of the redeemable instrument should be reflected in earnings per share using the two-class method. FN17 For common stock redeemable at fair value FN18, the SEC staff would not expect the use of the two-class method, as a redemption at fair value does not amount to a distribution different from other common shareholders. FN19

    FN17 The two-class method of computing earnings per share is addressed in Section 260-10-45. The SEC staff believes that there are two acceptable approaches for allocating earnings under the two-class method when a common stock instrument is redeemable at other than fair value. The registrant may elect to: (a) treat the entire periodic adjustment to the instrument's carrying amount (from the application of paragraphs 14–16) as being akin to a dividend or (b) treat only the portion of the periodic adjustment to the instrument's carrying amount (from the application of paragraphs 14–16) that reflects a redemption in excess of fair value as being

akin to a dividend. Under either approach, decreases in the instrument's carrying amount should be reflected in the application of the two-class method only to the extent they represent recoveries of amounts previously reflected in the application of the two-class method.

FN18 Common stock that is redeemable based on a specified formula is considered to be redeemable at fair value if the formula is designed to equal or reasonably approximate fair value. The SEC staff believes that a formula based solely on a fixed multiple of earnings (or other similar measure) is not considered to be designed to equal or reasonably approximate fair value.

FN19 Similarly, the two-class method is not required when share-based payment awards granted to employees are redeemable at fair value (provided those awards are in the form of common shares or options on common shares). However, those share-based payment awards may still be subject to the two-class method pursuant to Section 260-10-45.

22. *Noncontrolling interests*. Paragraph 810-10-45-23 indicates that changes in a parent's ownership interest while the parent retains control of its subsidiary are accounted for as equity transactions, and do not impact net income or comprehensive income in the consolidated financial statements. Consistent with Paragraph 810-10-45-23, an adjustment to the carrying amount of a noncontrolling interest from the application of paragraphs 14–16 does not impact net income or comprehensive income in the consolidated financial statements. Rather, such adjustments are treated akin to the repurchase of a noncontrolling interest (although they may be recorded to retained earnings instead of additional paid-in capital). The SEC staff believes the guidance in paragraphs 20 and 21 should be applied to noncontrolling interests as follows:

    a. *Noncontrolling interest in the form of preferred stock instrument*. The impact on income available to common stockholders of the parent arising from adjustments to the carrying amount of a redeemable noncontrolling interest other than common stock depends upon whether the redemption feature in the equity instrument was issued, or is guaranteed, by the parent. If the redemption feature was issued, or is guaranteed, by the parent, the entire adjustment under paragraph 20 reduces or increases income available to common stockholders of the parent. Otherwise, the adjustment is attributed to the parent and the noncontrolling interest in accordance with Paragraphs 260-10-55-64 through 55-67.

    b. *Noncontrolling interest in the form of common stock instrument*. Adjustments to the carrying amount of a noncontrolling interest issued in the form of a common stock instrument to reflect a fair value redemption feature do not impact earnings per share. Adjustments to the carrying amount of a noncontrolling interest issued in the form of a common stock instrument to reflect a non-fair value redemption feature do impact earnings per share; however, the manner in which those adjustments reduce or increase income available to common stockholders of the parent may differ. FN20 If the terms of the redemption feature are fully considered in the attribution of net income under Paragraph 810-10-45-21, application of the two-class method is unnecessary. If the terms of the redemption feature are not fully considered in the attribution of net income under Paragraph 810-10-45-20, application of the two-class method at the subsidiary level is necessary in order to determine net income available to common stockholders of the parent.

        FN20 Subtopic 810-10 does not provide detailed guidance on the attribution of net income to the parent and the noncontrolling interest. The SEC staff understands that when a noncontrolling interest is redeemable at other than fair value some registrants consider the terms of the redemption feature in the calculation of net income attributable to the parent (as reported on the face of the income statement), while others only consider the impact of the redemption feature in the calculation of income available to common stockholders of the parent (which is the control number for earnings per share purposes).

23. *Convertible debt instruments that contain a separately classified equity component*. For convertible debt instruments subject to ASR 268 (see paragraph 3(e)), there should be no incremental earnings per share accounting from the application of this SEC staff announcement. Subtopic 260-10 addresses the earnings per share accounting.

The EPS effect of subsequent measurement adjustments to the carrying amount of redeemable securities pursuant to ASC 480-10-S99-3A is based primarily on the form of the redeemable security and nature of the redemption feature. Changes in the carrying amount of such securities generally affect income available to common shareholders (i.e., the EPS numerator). Such securities can be grouped into four categories:

- Preferred securities issued by a parent (or a single reporting entity)
- Common securities issued by a parent (or a single reporting entity)
- NCI issued in the form of preferred securities
- NCI issued in the form of common securities

In addition to the discussion below, refer to section 3.2.2 of our FRD publication, ***Earnings per share***, for further guidance on the EPS treatment of redeemable equity instruments.

## C.5.1 Preferred securities issued by a parent (or a single reporting entity)

Subsequent measurement adjustments recorded pursuant to ASC 480-10-S99-3A related to redeemable preferred securities issued by a parent or a single reporting entity should be treated in the same manner as dividends on nonredeemable stock. Therefore, increases and decreases in the carrying amount of redeemable preferred securities should be reflected as adjustments to income available to common shareholders in the calculation of EPS. Redeemable securities cannot be reduced below their initial carrying amounts in temporary equity.

## C.5.2 Common securities issued by a parent (or a single reporting entity)

Subsequent measurement adjustments recorded pursuant to ASC 480-10-S99-3A related to redeemable common securities issued by a parent or a single reporting entity should be treated in the same manner as dividends on nonredeemable stock and should be effected by charges against retained earnings or, in the absence of retained earnings, by charges against APIC. If the redeemable common shareholders have a contractual right to receive at share redemption an amount other than fair value (e.g., a fixed amount or a formulaic amount) of the issuer's common shares, those redeemable common shareholders have, in substance, received a different distribution than other common shareholders (i.e., a preferential dividend). Paragraph 21 in ASC 480-10-S99-3A notes that under ASC 260-10-45-59A, "entities with capital structures that include a class of common stock with different dividend rates from those of another class of common stock but without prior or senior rights, should apply the two-class method of calculating earnings per share."

If the redemption right is at fair value, adjustments to the carrying value of the redeemable securities do not affect the EPS calculation because the redemption does not constitute a preferential distribution for that holder — the holder is receiving an amount no different than if selling the security in the market and the company is receiving fair value for the consideration distributed. Common stock that is redeemable based on a specified formula is considered to be redeemable at fair value if the formula is designed to approximate fair value. However, the SEC staff believes that a formula based solely on a fixed multiple of earnings (or other similar measure) is not considered to be designed to equal or reasonably approximate fair value. Likewise, even if a formula adjusts to a current multiple we generally believe that issuer-specific and instrument-specific facts and circumstances should be carefully considered before concluding that a formula would be expected to result in a fair value price at each measurement date.

Common securities that are redeemable at something other than fair value require the use of the two-class method pursuant to ASC 260 noted in footnote 17 to ASC 480-10-S99-3A. The SEC staff believes that in those circumstances there are two acceptable approaches for allocating earnings between the different classes of shareholders pursuant to the two-class method:

(1) Treat the entire periodic adjustment to the security's carrying amount like a dividend

(2) Treat only the portion of the periodic adjustment to the security's carrying amount that reflects a redemption in excess of fair value like a dividend

Under either approach, decreases in the instrument's carrying amount should be reflected in the computation of EPS only to the extent they represent recoveries of amounts previously reflected in the computation of EPS. These alternative approaches are accounting policy elections that should be applied consistently and disclosed as an accounting policy in the notes to the financial statements.

## C.5.3 Noncontrolling interests issued in the form of preferred securities

When a consolidated subsidiary has issued redeemable preferred securities to outside holders, such interests represent NCI. Adjustments to the carrying amount of redeemable noncontrolling interests require careful consideration of their effect on the parent company's EPS calculation. To the extent the parent has issued or guaranteed the redemption feature of the subsidiary's preferred security, the adjustment is included as an adjustment to income available to common shareholders of the parent. In substance, the parent has issued the redemption feature and, as such, it is accounted for in the same manner as if the parent had issued redeemable preferred stock.

When the redemption feature of a subsidiary's preferred stock has not been issued or guaranteed by the parent, the adjustment in the carrying amount is allocated between the parent and its NCI in accordance with the example in ASC 260-10-55-64 through 55-67.

Refer to sections 3.2.2 and 6.1 in our FRD publication, ***Earnings per share***, for further guidance.

## C.5.4 Noncontrolling interests issued in the form of common securities

Adjustments to the carrying amount of noncontrolling common stock instruments for potential fair value redemptions do not affect EPS. However, adjustments for noncontrolling common stock instruments redeemable at other than fair value (i.e., a fixed amount) do affect EPS. When adjustments of those redeemable equity securities affect EPS, the SEC staff notes that some registrants adjust net income attributable to the parent (as reported on the face of the income statement) for changes in the carrying amount of the redeemable equity securities. Other registrants do not adjust net income attributable to the parent and only consider the effect of the redemption feature in the calculation of income available to common stockholders of the parent (which may be disclosed on the face of the income statement under the SEC staff's guidance). These two alternatives affect presentation and disclosure only, but do not affect the amount of reported EPS. These alternative approaches are accounting policy elections and should be applied consistently.

Consistent with the guidance for common stock instruments issued by the parent and based on discussions with the SEC staff, we generally believe that the registrant may elect to either:

(1) Treat the entire periodic adjustment to the security's carrying amount like a dividend

(2) Treat only the portion of the periodic adjustment to the security's carrying amount that reflects a redemption in excess of fair value like a dividend

Under either approach, decreases in the instrument's carrying amount pursuant to the redeemable equity guidance should affect the computation of EPS only to the extent they represent recoveries of amounts previously reflected in the computation of EPS.

Refer to section 3.2.2 in our FRD publication, ***Earnings per share***, for further guidance on the EPS effects of redeemable equity instruments.

## C.6 Disclosures

**Excerpt from Accounting Standards Codification**

**Distinguishing Liabilities from Equity — Overall**

*SEC Materials*

*480-10-S99-3A*

*Disclosures*

24. ASR 268 and SEC Regulation S-X require certain disclosures about redeemable equity instruments. In addition, the SEC staff expects the following disclosures to be provided in the notes to the financial statements:

    a. A description of the accounting method used to adjust the redemption amount of a redeemable equity instrument (as discussed in paragraphs 14–16).

    b. When a registrant elects to accrete changes in the redemption amount of a redeemable equity instrument in accordance with paragraph 15(a), the redemption amount of the equity instrument as if it were currently redeemable.

    c. For a redeemable equity instrument that is not adjusted to its redemption amount, the reasons why it is not probable that the instrument will become redeemable.

    d. When charges or credits discussed in paragraphs 20 and 22(a) are material, a reconciliation between net income and income available to common stockholders.

    e. The amount credited to equity of the parent upon the deconsolidation of a subsidiary (as discussed in paragraph 19).

In addition to the specific disclosure requirements highlighted in paragraph 24 of ASC 480-10-S99-3A, the general disclosures required for capital stock (e.g., pursuant to ASC 505-10-50, *Equity — Disclosure*s) are required for all issuers, including nonpublic entities that choose not to apply the redeemable equity guidance. For public companies, ASC 480-10-S99-1 also requires disclosure of the aggregate amount of redemption obligations in each of the subsequent five years from the date of the most recent balance sheet. While there is no specific guidance for computing the redemption amounts for redeemable securities without scheduled maturity dates, we generally believe that instead of estimating future earnings or anticipating holders' actions, the redemption provisions could be disclosed instead of estimating future earnings or anticipating holders' actions.

The redeemable equity guidance requires the changes in each redeemable stock issue to be explained in a footnote separately from the statement of changes in stockholders' equity, because the SEC staff does not believe redeemable stock should be included with permanent equity. The SEC staff permits including redeemable stock in the statement of changes in stockholders' equity if the statement is appropriately titled (e.g., "Statement of Changes in Redeemable Preferred Stock, Common Stock and Other Stockholders' Equity") and if redeemable instruments are not included in any total.[85]

[85] Wayne Carnall, 2009, https://www.thecaq.org/wp-content/uploads/2019/03/june-23-2009.pdf.

## C.7 Frequently asked questions

The following Questions are included in this section:

- Question 1 — Are shares that are by themselves not redeemable, but are convertible into other shares that are redeemable, within the scope of the redeemable equity guidance?
- Question 2 — What are examples of instances in which classification of a security outside of permanent equity is and is not appropriate?
- Question 3 — May the fair value option pursuant to ASC 825 be elected for an instrument subject to the redeemable equity guidance?
- Question 4 — Are adjustments to the carrying value of redeemable NCI in accordance with ASC 480-10-S99 included in the gain or loss calculation when the subsidiary with the noncontrolling interest is deconsolidated?
- Question 5 — How should the equity component, recognized in connection with a modification of the conversion option in convertible debt, be presented in temporary equity when the debt instrument also contains embedded derivatives (other than the conversion option) that have been bifurcated?

### Question 1

**Are shares that are by themselves not redeemable, but are convertible into other shares that are redeemable, within the scope of the redeemable equity guidance?**

Although not specifically addressed by the redeemable equity guidance, we generally believe that issuers should follow the classification and measurement provisions of the redeemable equity guidance in accounting for equity shares that, although not redeemable, enable the holder to acquire redeemable instruments of the issuer (at the election of the holder, on a future date or upon the occurrence of an event that is not solely within the control of the issuer).

For example, convertible preferred stock may not be redeemable, but enables the holder to convert the instrument into common shares that are puttable to the issuer. We generally believe that the redeemable equity guidance applies to the convertible preferred stock (even before exercise or the first available conversion date) because the redeemable equity guidance precludes permanent equity classification for instruments that are redeemable outside the issuer's control.

In measuring the EPS impact of nonredeemable equity shares that enable the holder to acquire redeemable securities and are classified in temporary equity, issuers should follow the EPS considerations within the redeemable equity guidance.

Refer to section 3.2.2 of our FRD publication, ***Earnings per share***, for further guidance on the EPS effect of redeemable equity securities.

### Question 2

**What are examples of instances in which classification of a security outside of permanent equity is and is not appropriate?**

Registrants should evaluate all of the individual facts and circumstances in determining how an equity security should be classified.

**Examples of situations in which temporary equity classification may be appropriate**

**Scenario A** — Preferred stock redeemable at option of holder or upon occurrence of event outside issuer's control, but payable in cash or shares at the option of the issuer

## Excerpt from Accounting Standards Codification

**Distinguishing Liabilities from Equity — Overall**

*SEC Materials*

*480-10-S99-3A*

*Classification*

6. *Example 1*. A preferred security that is not required to be classified as a liability under other applicable GAAP may be redeemable at the option of the holder or upon the occurrence of an event that is not solely within the control of the issuer. Upon redemption (in other than a liquidation event that meets the exception in paragraph 3(f)), the issuer may have the choice to settle the redemption amount in cash or by delivery of a variable number of its own common shares with an equivalent value. For this instrument, the guidance in Section 815-40-25 should be used to evaluate whether the issuer controls the actions or events necessary to issue the maximum number of common shares that could be required to be delivered under share settlement of the contract. If the issuer does not control settlement by delivery of its own common shares (because, for example, there is no cap on the maximum number of common shares that could be potentially issuable upon redemption), cash settlement of the instrument would be presumed and the instrument would be classified as temporary equity.

To the extent the issuer has the option and ability to settle the redemption in its own shares, temporary equity classification may not be required. However, for instruments that may be settled in shares, an issuer should carefully evaluate the requirements in ASC 815-40-25 to evaluate whether it controls the actions or events necessary to issue the maximum number of shares that could be required to be delivered under share settlement. Refer to section C.2.4 for a discussion of the interaction of ASC 480-10-S99-3A and ASU 2020-06.

**Scenario B** — Preferred stock callable by issuer and preferred stock holders control the board

## Excerpt from Accounting Standards Codification

**Distinguishing Liabilities from Equity — Overall**

*SEC Materials*

*480-10-S99-3A*

*Classification*

7. *Example 2*. A preferred security that is not required to be classified as a liability under other applicable GAAP may have a redemption provision that states it may be called by the issuer upon an affirmative vote by the majority of its board of directors. While some might view the decision to call the security as an event that is within the control of the company because the governance structure of the company is vested with the power to avoid redemption, if the preferred security holders control a majority of the votes of the board of directors through direct representation on the board of directors or through other rights, the preferred security is redeemable at the option of the holder and classification in temporary equity is required. In other words, any provision that requires approval by the board of directors cannot be assumed to be within the control of the issuer. All of the relevant facts and circumstances should be considered.

Questions frequently arise about whether temporary equity classification is required when the holder of a nonredeemable instrument controls the issuer and could require the issuer to redeem the otherwise nonredeemable instrument. We do not believe it is necessary to consider circumstances beyond those pursuant to the existing terms of the instrument and contractual or other rights held currently by the investor.

Careful analysis of the relevant facts and circumstances is necessary, particularly when a company establishes a board or a committee comprised of independent members who are given the authority to determine whether to exercise a call option or determine the form of consideration (e.g., cash, shares) used to settle a redemption option that is out of the issuer's control. In certain cases, the SEC staff has viewed such decisions to be out of the issuer's control if the holders of the instrument being evaluated have control over which independent members are elected and, thus, can make sure the independent members' decisions are consistent with the holders' interest.

**Scenario C** — Preferred stock redeemable by the holder upon a change in control that is outside the issuer's control

**Excerpt from Accounting Standards Codification**

**Distinguishing Liabilities from Equity — Overall**

***SEC Materials***

***480-10-S99-3A***

***Classification***

8. *Example 3*. A preferred security that is not required to be classified as a liability under other applicable GAAP may contain a deemed liquidation clause that provides that the security becomes redeemable if the common stockholders of the issuing company (that is, those immediately prior to a merger or consolidation) hold, immediately after such merger or consolidation, common stock representing less than a majority of the voting power of the outstanding common stock of the surviving corporation. This change-in-control provision would require the preferred security to be classified in temporary equity if a purchaser could acquire a majority of the voting power of the outstanding common stock without company approval, thereby triggering redemption.

The presence of a cash-settled redemption provision that is contingent upon a change in control that is outside of the issuer's control would require classification outside of permanent equity. While there may be certain circumstances (e.g., state or other corporate law) in which a change in control may occur only after acceptance or approval of the board of directors, generally the occurrence of a change in control is considered to be outside the control of the issuer (e.g., because a third party could acquire a majority of the voting power in common stock without ever seeking the approval of the issuer).

A careful evaluation of what constitutes a change in control pursuant to the terms of the arrangement is required to determine whether it is within the issuer's control, particularly when only certain change in control provisions trigger the redemption. For example, if the only change in control that triggers redemption is one in which the issuer itself participates (e.g., through the issuance of a controlling number of new shares rather than simply the investor accumulating existing shares) and the issuer is able to control the issuance of new shares, that change in control provision would not trigger temporary equity classification.

Pursuant to some change in control provisions, the holder is entitled to receive only the consideration that was used by the third party effecting the change in control (e.g., cash or securities issued by an acquirer). Some believe that because the redemption of the instrument for cash is not at the option of the holder and because the holder will receive (outside of its control) consideration used to effect the change in control, the securities should be classified as permanent equity. We generally believe that although the holder of the instrument will not control the type of consideration to be received upon redemption of the securities, cash redemption could be triggered by a change in control, which would be considered to be outside the control of the issuer. Accordingly, the securities should be classified outside of permanent equity. However, permanent equity classification may be appropriate if all holders of equally and more subordinated equity securities would always be contractually entitled to also receive the same form of consideration (e.g., cash or shares) upon the occurrence of the change in control.

**Scenario D** — Preferred stock redeemable at the option of the holder upon occurrence of events not in issuer's control

**Excerpt from Accounting Standards Codification**

**Distinguishing Liabilities from Equity — Overall**

***SEC Materials***

***480-10-S99-3A***

***Classification***

9. *Example 4*. An equity instrument may contain provisions that allow the holder to redeem the instrument for cash or other assets upon the occurrence of events that are not solely within the issuer's control. Such events may include:

   - The failure to have a registration statement declared effective by the SEC by a designated date
   - The failure to maintain compliance with debt covenants
   - The failure to achieve specified earnings targets
   - A reduction in the issuer's credit rating.

Since these events are not solely within the control of the issuer, the equity instrument is required to be classified in temporary equity.

The SEC staff requires stock redeemable upon a change in control that is outside the control of the issuer to be classified outside of permanent equity, regardless of the likelihood of a future change in control. The SEC staff's position also applies to stock with other redemption features outside the control the issuer, including those redemption features triggered by future events such as delisting of the issuer's shares from a stock exchange, failure to maintain compliance with debt covenants, failure to have a registration statement declared effective by the SEC by a designated date, a reduction in the issuer's credit rating or the failure to achieve specified performance targets.

**Scenario E** — Preferred stock callable by the issuer and containing a contingent control feature that is not within the control of the issuer

The SEC staff has noted that it is important to consider possible interactions whereby a combination of rights creates a security that is puttable or contingently puttable at the option of the holder. In a speech in 2009,[86] the SEC staff presented a fact pattern in which an entity issues a preferred share that is callable at the option of the entity and provides a contingent control feature in which the preferred shareholders can take control of the entity upon failure to pay dividends, thereby permitting the preferred shareholders to exercise the issuer's call feature. However, the staff acknowledged that not all contingent protective rights would result in temporary equity classification. We generally believe inherent in the fact pattern is the conclusion that it is not within the issuer's control to have the ability to pay the preferred stock's stated dividend. The staff said the following:

> "[T]he SEC staff guidance on redeemable shares also notes that there may be situations in which control by the governance structure of an entity, such as the Board of Directors, may be insufficient to demonstrate that a settlement option is within the company's control. These are often situations in which specific shareholders have the ability to seize control of the governance structure and require redemption of their interests in a preferential manner using another feature of the instrument. A typical example is a provision whereby a class of preferred shareholders can take

[86] Brian W. Fields, 2009 — Refer to the SEC website at http://www.sec.gov/news/speech/2009/spch120709bwf.htm.

control of the Board upon failure to pay dividends and thereby exercise a preexisting embedded call option on their preferred stock. Unless there were a third provision that makes the call inoperable when the preferred shareholders are in control, the shares would be classified in temporary equity because the combination of the contingent control right and the call could be used in the same manner as a put option by the preferred shareholder. Of course, whenever the analysis becomes this involved a healthy attention to appropriate disclosure is probably in order."

**Scenario F —** Multiple classes of preferred stock that are redeemable for cash or other assets upon the occurrence of an event (e.g., a change in control)

Frequently, private companies[87] issue multiple classes of preferred stock (e.g., Class A through Class E) over time to raise capital. These shares often contain the same contractual features that make them redeemable upon the occurrence of an event, including an event that may be initiated by the company.

If the occurrence of the event is outside the control of the issuer, all classes of preferred stock should be classified as temporary equity. However, if the event must be initiated by the issuer, the issuer should consider whether the holders have the ability to control the issuer's decision to initiate the event.

If a single class of preferred shareholders could require the issuer to initiate the event (e.g., through its majority representation on the board), the event is generally not considered to be within the issuer's control. In this case, temporary equity classification is generally required for all classes of preferred stock, including classes that do not control the issuer.

If no single class of preferred holders has the ability to control the decision to initiate the event, but some or all of the classes of preferred shareholders can control the decision collectively, the determination of whether temporary equity classification is required for some or all classes should be based on individual facts and circumstances. One fact to consider is whether the holders of the different classes would be aligned in their decision making and act in concert to vote and initiate the event. The terms and economic characteristics of each class of preferred stock (e.g., dividend provision, voting rights, liquidation preferences) should be evaluated in making that determination.

**Scenario G —** Shares are redeemable but redemption is contractually limited (added August 2023)

An SEC registrant may issue shares that are redeemable at the option of the holder, but its governing documents may limit the number of shares that the holder can redeem. An example of this is in the case of a SPAC, which typically issues Class A shares in the IPO that become redeemable by the holder upon its liquidation or acquisition of a target. However, the governing documents of SPACs typically do not permit a redemption of the Class A shares if such a redemption would cause the company's net tangible assets to decline below a certain threshold (i.e., less than $5 million). In this case, the SPAC (an SEC registrant) is required to consider the SEC staff's guidance in ASC 480-10-S99-3A on redeemable equity securities to determine the classification of Class A shares (i.e., temporary equity or permanent equity). Because the Class A shares contain redemption rights that make them certain to become redeemable by the holder and no exceptions in ASC 480-10-S99-3A apply, Class A shares have to be classified in temporary equity in the SPAC's financial statements and are subject to the subsequent measurement guidance in ASC 480-10-S99-3A (refer to section C.4). We believe that the unit of account that the SPAC should use in the assessment is at the individual share level (i.e., each share is redeemable and there is no way to identify the shares that may not be redeemable because of the contractual limit).

[87] Private companies often apply the redeemable equity guidance voluntarily because they may anticipate having a public offering.

Historically, some SPACs classified only a portion of the Class A shares in temporary equity, partially because they viewed the unit of account to be the pool of the Class A shares, not the individual share. At the 2021 AICPA and CIMA Conference on Current SEC and PCAOB Developments,[88] the SEC staff clarified its view that each share should be presented outside of permanent equity and said that it disagrees with the view that the pool of the class of shares is the unit of account rather than each individual share.

An entity should consider the staff's view when evaluating the classification of redeemable shares when redemption is contractually limited.

**Examples of situations in which permanent equity classification may be appropriate**

**Scenario H** — Preferred stock is automatically redeemed upon issuer's decision to sell substantially all assets and preferred stockholders do not control the board

**Excerpt from Accounting Standards Codification**

**Distinguishing Liabilities from Equity — Overall**

*SEC Materials*

*480-10-S99-3A*

*Classification*

10. *Example 5.* A preferred security may have a provision that the decision by the issuing company to sell all or substantially all of a company's assets and a subsequent distribution to common stockholders triggers redemption of the security. In this case, the security would be appropriately classified in permanent equity if the preferred stockholders cannot trigger or otherwise require the sale of the assets through representation on the board of directors, or through other rights, because the decision to sell all or substantially all of the issuer's assets and the distribution to common stockholders is solely within the issuer's control. In other words, if there could not be a "hostile" asset sale whereby all or substantially all of the issuer's assets are sold, and a dividend or other distribution is declared on the issuer's common stock, without the issuer's approval, then classifying the security in permanent equity would be appropriate.

**Scenario I** — Preferred stock is automatically redeemed upon merger or consolidation (either of which would require board approval) and preferred stockholders do not control the board

**Excerpt from Accounting Standards Codification**

**Distinguishing Liabilities from Equity — Overall**

*SEC Materials*

*480-10-S99-3A*

*Classification*

11. *Example 6.* A preferred security may have a provision that provides for redemption in cash or other assets if the issuing company is merged with or consolidated into another company, and pursuant to state law, approval of the board of directors is required before any merger or consolidation can occur. In that case, assuming the preferred stockholders cannot control the vote of the board of directors through direct representation or through other rights, the security would be appropriately classified in permanent equity because the decision to merge with or consolidate into another company is within the control of the issuer. Again, all of the relevant facts and circumstances should be considered when determining whether the preferred stockholders can control the vote of the board of directors.

[88] 2021 AICPA & CIMA Conference on Current SEC and PCAOB Developments — Compendium of significant accounting and reporting issues.

**Question 3** **May the fair value option pursuant to ASC 825 be elected for an instrument subject to the redeemable equity guidance?**

**Excerpt from Accounting Standards Codification**

**Distinguishing Liabilities from Equity — Overall**

*SEC Materials*

*480-10-S99-3A*

*Measurement*

17. *Application of the fair value option*. Measurement of a redeemable equity instrument (or host contract) subject to ASR 268 at fair value through earnings in lieu of the measurement guidance provided in paragraphs 14–16 is not appropriate. FN16

    FN16 Paragraph 825-10-15-5(f) prohibits the election of the fair value option for financial instruments that are, in whole or in part, classified in stockholder's equity (including temporary equity).

Historically, the staff had not objected to the presentation of redeemable securities as debt, if such presentation were made on a consistent basis. However, Statement 159, *The Fair Value Option for Financial Assets and Financial Liabilities Including an amendment of FASB Statement No. 115*, prohibited an issuer from electing the fair value option for instruments classified in whole or in part as a component of shareholders' equity (including temporary equity). As a result, in 2007 the SEC staff stated it would no longer accept liability classification for instruments that met the conditions for temporary equity classification pursuant to the redeemable equity guidance. Transition guidance was provided in paragraph 39 of EITF D-98 as follows:

> The SEC staff announcement … should be applied prospectively to all affected financial instruments (or host contracts) that are entered into, modified, or otherwise subject to a remeasurement (new basis) event in the registrant's first fiscal quarter beginning after September 15, 2007. Subsequent to initial adoption of the guidance in paragraph 38, a registrant should not initially apply hedge accounting or initially elect the fair value option for an affected financial instrument (or host contract) that continues to be classified on the balance sheet as a liability. That is, while an existing financial instrument (or host contract) that otherwise meets the conditions for classification as temporary equity may continue to be classified as a liability when the guidance in paragraph 38 is adopted prospectively, that financial instrument (or host contract) would not be eligible for initial application of the fair value option under Statement 159 or initial adoption of hedge accounting in fiscal quarters beginning after September 15, 2007. As an alternative to prospective application, a registrant may retrospectively apply the guidance … to all prior financial reporting periods in accordance with paragraphs 7-10 of Statement 154. Regardless of the method of transition, the disclosures in paragraph 24 of Statement 154 should be provided. Earlier adoption is permitted.

**Question 4** **Are adjustments to the carrying value of redeemable NCI in accordance with ASC 480-10-S99 included in the gain or loss calculation when the subsidiary with the noncontrolling interest is deconsolidated?**

**Excerpt from Accounting Standards Codification**

**Distinguishing Liabilities from Equity — Overall**

*SEC Materials*

*480-10-S99-3A*

*Deconsolidation of a Subsidiary*

19. Section 810-10-40 provides guidance on the measurement of the gain or loss that is recognized in net income when a parent deconsolidates a subsidiary. As indicated in Paragraph 810-10-40-5, that gain or loss calculation is impacted by the carrying amount of any noncontrolling interest in the former subsidiary. Since adjustments to the carrying amount of a noncontrolling interest from the application of paragraphs 14–16 do not initially enter into the determination of net income, the SEC staff believes that the carrying amount of the noncontrolling interest that is referred to in Paragraph 810-10-40-5 should similarly not include any adjustments made to that noncontrolling interest from the application of paragraphs 14–16. Rather, previously recorded adjustments to the carrying amount of a noncontrolling interest from the application of paragraphs 14–16 should be eliminated in the same manner in which they were initially recorded (that is, by recording a credit to equity of the parent).

**Question 5** **How should the equity component, recognized in connection with a modification of the conversion option in convertible debt, be presented in temporary equity when the debt instrument also contains embedded derivatives (other than the conversion option) that have been bifurcated?**

We generally believe the issuer would classify as temporary equity an amount equal to the excess, if any, of (1) the amount required to be paid to the holder upon redemption, over (2) the sum of the liability-classified components (including any amounts related to bifurcated derivatives) of the single legal instrument issued. Under this approach, the total cash redemption requirement would be displayed on the face of the balance sheet outside of permanent equity. We generally believe deducting the combination of the liability component and bifurcated derivatives from the redemption amount to derive the temporary equity amount in this analysis is reasonable given the SEC staff's view that a bifurcated derivative may be presented with the debt host on the balance sheet, despite being accounted for separately pursuant to ASC 815. Other views may also be acceptable.

For example, assume an issuer modifies a convertible debt instrument one year after its issuance by lowering the conversion price, which results in an increase of $80 in the fair value of the conversion option. There are no other changes to the debt terms. The modification did not result in an extinguishment of the debt instrument. Pursuant to ASC 470-50-40-15, the issuer reduces the carrying amount of the convertible debt by $80 to account for the increase in the fair value of the conversion option, with a corresponding increase in APIC.

Assume further that the instrument is redeemable at any time at its par amount of $1,000 and also has a bifurcated derivative with a fair value of $50 at the time of modification. The following are the carrying values of the various components as of the modification date:

| | | |
|---|---|---|
| Debt (liability) component[89] | $ | 850 |
| Derivative liability | | 50 |
| Equity component | | 80 |

[89] For simplicity, the accretion of the discount on the liability component created when the bifurcated derivative was initially recognized is ignored.

In this example the sum of the balance sheet liabilities would be $900, in which case $100 would need to be classified in the mezzanine to result in a carrying amount of $1,000 in the liability and mezzanine sections of the balance sheet. However, because only $80 is recorded in equity upon debt modification, questions have been raised as to whether the amount reclassified from equity to temporary equity may exceed the amount recognized in equity for the modification of conversion option.

The SEC staff guidance requires that a portion of the equity-classified component be presented in temporary equity. Read literally, that guidance could indicate that the amount to be reclassified into the mezzanine should be capped at the amount initially recorded in equity pursuant to the debt modification guidance because a "portion" of any amount cannot be more than the entire amount (i.e., reclassification to the mezzanine is capped at $80 in the example). Alternatively, the guidance could be interpreted to require the redemption amount to be presented outside of permanent equity, which, in this example, would require $100 to be presented in temporary equity, even though that amount exceeds the amount initially recognized in equity related to the conversion option pursuant to the debt modification guidance.

We generally believe either approach is acceptable as an accounting policy election with appropriate disclosure. If the amount reclassified to temporary equity was capped at the initial amount recognized in equity related to the conversion option, we generally believe disclosure of the total redemption amount and the difference between that amount and the amounts recognized on the balance sheet would be appropriate.

Subsequent to the debt modification, if the derivative liability's fair value increased to $150, no amount would be classified in the mezzanine, as $1,000 of liabilities would be reported on the balance sheet (the sum of the liability component of $850 and the derivative liability of $150).

# D Summary of important changes

The following highlights important changes to this FRD since the August 2023 edition:

**Section 2: Debt**

- Section 2.2.6.8 was updated to provide an illustration of the accounting for a sale of future royalty payments.
- Section 2.5.1.2 was updated to provide further interpretive guidance on the accounting for the extinguishment of convertible debt with an equity component.

**Section 3: Common shares, preferred shares and other equity-related topics**

- Section 3.2.5.1.1 was added to provide interpretive guidance on accounting for financing arrangements in SPAC transactions.

**Section 5: Selected transactions**

- Section 5.10.2.7 was updated to clarify our interpretive guidance on the classification of redeemable or convertible equity units issued by an operating partnership that is consolidated by a parent REIT.
- Section 5.16.3 was added to provide interpretive guidance on the accounting for a call spread with a "flat" volatility input.

**Appendix B: Contracts in an entity's own equity**

- Section B.9 — Question 21 was added to provide interpretive guidance on how a "buy-in" provision is considered when evaluating a warrant under ASC 815-40-25.
- Section B.9 — Question 22 was added to provide interpretive guidance on how an entity applies the guidance in ASC 815-40-25 to a purchased put option with an underlying stock that is redeemable.

# E Glossary

Throughout this booklet, we use the following terms and conventions:

| Term used in the section | Concept and/or historical authoritative guidance |
|---|---|
| Conversion option and conversion feature | The written call option embedded in a convertible instrument and are used interchangeably both within our guidance and the authoritative guidance. |
| Convertible debt and convertible stock | Generic reference to a convertible instrument. This publication uses "debt" or "bond" or "note" to mean a nonconvertible debt instrument. The modifier "convertible" is used to signify a convertible instrument, unless the context is clear, without regard to whether it is share convertible or cash convertible. |
| Down round feature | A feature in a financial instrument that reduces the strike price of an issued financial instrument if the issuer sells shares of its stock for an amount less than the currently stated strike price of the issued financial instrument or issues an equity-linked financial instrument with a strike price below the currently stated strike price of the issued financial instrument. 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. A standard antidilution provision is not considered a down round feature. |
| Equity classification guidance | Guidance determining whether an equity contract or equity-linked feature (e.g., conversion and share redemption features) would be classified in stockholders' equity if it were freestanding; primarily the former EITF 00-19, *Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock*. Generally codified under ASC 815-40-25. |
| Equity contract or equity-linked contract | Generic reference to describe any freestanding financial instrument (but not the stock itself) whose value is based on (indexed to or potentially settled in) a company's own stock. Refers to all instruments that require analysis for classification either as an asset or liability under ASC 815 or ASC 480. |
| Equity derivative | Reference to an equity contract that meets the definition of a derivative under ASC 815 and is classified as an asset or liability. |
| Equity redemption feature | Redemption feature (i.e., an issuer call option or an investor put option) embedded in equity-host contract. |
| Equity-classified contract | An equity contract that has been determined to qualify for classification as equity (as opposed to an asset or liability). |

| Term used in the section | Concept and/or historical authoritative guidance |
|---|---|
| Freestanding financial instrument | A financial instrument that is separately accounted from other financial instruments or equity transactions, as defined under ASC 480, *Distinguishing Liabilities from Equity*. |
| General conversion guidance | Guidance addressing share convertible instruments; primarily the former APB Opinion No. 14, *Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants,* and any related interpretive guidance. Generally codified under the "General" subheadings throughout ASC 470-20, *Debt — Debt with Conversion and Other Options*. |
| Indexation guidance | Guidance considered when determining whether an equity contract or equity-related feature (e.g., conversion and share redemption features) is "indexed to its own stock"; primarily the former EITF 07-5, *Determining Whether an Instrument (or Embedded Feature) Is Indexed to an Entity's Own Stock*. Generally codified in ASC 815-40-15. |
| ISDA (International Swaps and Derivatives Association) | A trade organization of participants in the market for over-the-counter financial instruments. It has created standard contracts (the ISDA Master Agreement, ISDA Equity Definitions, Confirmation) for financial instruments that are frequently used in practice. |
| Net cash settlement | Upon maturity or upon the exercise by either party to the contract, the party with a loss delivers to the party with a gain a cash payment equal to the gain, and no shares are exchanged. |
| Net settlement | Upon maturity or upon the exercise of either party to the contract, the contract may be settled net (as opposed to physically settled). Net settlement can include either or a combination of net share settlement or net cash settlement. |
| Net share settlement | Upon maturity or upon the exercise by either party to the contract, the party with a loss delivers to the party with a gain shares with a current fair value equal to the gain. |
| Physical settlement | Upon maturity or upon the exercise by either party to the contract, the party designated in the contract as the buyer delivers the full stated amount of cash to the seller, and the seller delivers the full stated number of shares to the buyer. Also referred to as gross settlement or gross physical settlement. |
| Redeemable securities | Equity instruments may be redeemable at the option of the holder or have redemption provisions that are outside the control of the issuer. |

# F Abbreviations used in this publication

| Abbreviation | FASB Accounting Standards Codification |
|---|---|
| ASC 210 | FASB ASC Topic 210, *Balance Sheet* |
| ASC 220 | FASB ASC Topic 220, *Income Statement — Reporting Comprehensive Income* |
| ASC 230 | FASB ASC Topic 230, *Statement of Cash Flows* |
| ASC 235 | FASB ASC Topic 235, *Notes to Financial Statements* |
| ASC 250 | FASB ASC Topic 250, *Accounting Changes and Error Corrections* |
| ASC 260 | FASB ASC Topic 260, *Earnings Per Share* |
| ASC 310 | FASB ASC Topic 310, *Receivables* |
| ASC 321 | FASB ASC Topic 321, *Investments — Equity Securities* |
| ASC 340 | FASB ASC Topic 340, *Other Assets and Deferred Costs* |
| ASC 405 | FASB ASC Topic 405, *Liabilities* |
| ASC 410 | FASB ASC Topic 410, *Asset Retirement and Environmental Obligations* |
| ASC 450 | FASB ASC Topic 450, *Contingencies* |
| ASC 460 | FASB ASC Topic 460, *Guarantees* |
| ASC 470 | FASB ASC Topic 470, *Debt* |
| ASC 480 | FASB ASC Topic 480, *Distinguishing Liabilities from Equity* |
| ASC 505 | FASB ASC Topic 505, *Equity* |
| ASC 606 | FASB ASC Topic 606, *Revenue from Contracts with Customers* |
| ASC 715 | FASB ASC Topic 715, *Compensation — Retirement Benefits* |
| ASC 718 | FASB ASC Topic 718, *Compensation — Stock Compensation* |
| ASC 740 | FASB ASC Topic 740, *Income Taxes* |
| ASC 805 | FASB ASC Topic 805, *Business Combinations* |
| ASC 810 | FASB ASC Topic 810, *Consolidation* |
| ASC 815 | FASB ASC Topic 815, *Derivatives and Hedging* |
| ASC 820 | FASB ASC Topic 820, *Fair Value Measurement* |
| ASC 825 | FASB ASC Topic 825, *Financial Instruments* |
| ASC 830 | FASB ASC Topic 830, *Foreign Currency Matters* |
| ASC 835 | FASB ASC Topic 835, *Interest* |
| ASC 845 | FASB ASC Topic 845, *Nonmonetary Transactions* |
| ASC 848 | FASB ASC Topic 848, *Reference Rate Reform* |
| ASC 850 | FASB ASC Topic 850, *Related Party Disclosures* |
| ASC 855 | FASB ASC Topic 855, *Subsequent Events* |
| ASC 860 | FASB ASC Topic 860, *Transfers and Servicing* |
| ASC 924 | FASB ASC Topic 924, *Entertainment — Casinos* |
| ASU 2009-08 | FASB ASU 2009-08, *Amendment to Section 260-10-S99* |
| ASU 2020-06 | FASB ASU 2020-06, *Debt — Debt with Conversion and Other Options (Subtopic 470-20) and Derivatives and Hedging — Contracts in Entity's Own Equity (Subtopic 815-40): Accounting for Convertible Instruments and Contracts in an Entity's Own Equity* |

| Abbreviation | FASB Accounting Standards Codification |
|---|---|
| ASU 2021-04 | FASB ASU 2021-04, *Earnings Per Share (Topic 260), Debt — Modifications and Extinguishments (Subtopic 470-50), Compensation — Stock Compensation (Topic 718), and Derivatives and Hedging — Contracts in Entity's Own Equity (Subtopic 815-40): Issuer's Accounting for Certain Modifications or Exchanges of Freestanding Equity-Classified Written Call Options (a consensus of the Emerging Issues Task Force)* |
| ASU 2022-04 | FASB ASU 2022-04, *Liabilities — Supplier Finance Programs (Subtopic 405-50): Disclosure of Supplier Finance Program Obligations*. |

| Abbreviation | *Other Guidance* |
|---|---|
| Concepts Statement 6 | FASB Statement of Financial Accounting Concepts No. 6, *Elements of Financial Statements* |
| Rule 4-08(c) | Securities and Exchange Commission Regulation S-X Rule 4-08(c), *General notes to financial statements — Defaults* |
| Rule 144A | Securities Act Rule 144A, *Private resales of securities to institutions* |
| Rule 229.303 | Securities and Exchange Commission Regulation S-K Rule 229.303, *Management's discussion and analysis of financial condition and results of operations* |
| Rule 5-02 | Securities and Exchange Commission Regulation S-X Rule 5-02, *Balance sheets* |

| Abbreviation | *Non-Authoritative Standards* |
|---|---|
| APB 14-1 | FASB Staff Position No. APB 14-1, *Accounting for Convertible Debt Instruments That May Be Settled in Cash upon Conversion (Including Partial Cash Settlement)* |
| ASR 268 | SEC Accounting Series Release No. 268, *Presentation in Financial Statements of "Redeemable Preferred Stocks"* |
| EITF 85-1 | EITF Issue No. 85-1, *Classifying Notes Received for Capital Stock* |
| EITF 90-19 | EITF Issue No. 90-19, *Convertible Bonds with Issuer Option to Settle for Cash upon Conversion* |
| EITF 98-2 | EITF Issue No. 98-2, *Accounting by a Subsidiary or Joint Venture for an Investment in the Stock of Its Parent Company or Joint Venture Partner* |
| EITF 00-19 | EITF Issue No. 00-19, *Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock* |
| EITF 02-2 | EITF Issue No. 02-2, *When Certain Contracts That Meet the Definition of Financial Instruments Should Be Combined for Accounting Purposes* |
| EITF 03-7 | EITF Issue No. 03-7, *Accounting for the Settlement of the Equity-Settled Portion of a Convertible Debt Instrument That Permits or Requires the Conversion Spread to Be Settled in Stock (Instrument C of Issue No. 90-19)* |
| EITF 07-5 | EITF Issue No. 07-5, *Determining Whether an Instrument (or Embedded Feature) Is Indexed to an Entity's Own Stock* |
| EITF 09-1 | EITF Issue No. 09-1, *Accounting for Own-Share Lending Arrangements in Contemplation of Convertible Debt Issuance or Other Financing* |
| EITF D-98 | EITF Topic No. D-98, *Classification and Measurement of Redeemable Securities* |
| FSP FAS 150-3 | FASB Staff Position FAS 150-3, *Effective Date, Disclosures, and Transition for Mandatorily Redeemable Financial Instruments of Certain Nonpublic Entities and Certain Mandatorily Redeemable Noncontrolling Interests under FASB Statement No. 150, Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity* |

| Abbreviation | *Non-Authoritative Standards* |
|---|---|
| FSP FAS 150-5 | FASB Staff Position FAS 150-5, *Issuer's Accounting under FASB Statement No. 150 for Freestanding Warrants and Other Similar Instruments on Shares That Are Redeemable* |
| Statement 115 | FASB Statement of Financial Accounting Standards No. 115, *Accounting for Certain Investments in Debt and Equity Securities* |
| Statement 133 | FASB Statement of Financial Accounting Standards No. 133, *Accounting for Derivative Instruments and Hedging Activities* |
| Statement 140 | FASB Statement of Financial Accounting Standards No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* |
| Statement 150 | FASB Statement of Financial Accounting Standards No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity* |
| Statement 154 | FASB Statement of Financial Accounting Standards No. 154, *Accounting Changes and Error Corrections* |
| Statement 159 | FASB Statement of Financial Accounting Standards No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities* |
| TQA 4110.09 | AICPA Technical Questions and Answers — *Costs Incurred to Acquire Treasury Stock* |
| TQA 4210.01 | AICPA Technical Questions and Answers — *Write-Off of Liquidating Dividends* |
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| Abbreviation | *Miscellaneous* |
|---|---|
| AICPA | American Institute of Certified Public Accountants |
| APB | Accounting Principles Board |
| APIC | Additional Paid-in Capital |
| ARS | Auction Rate Securities |
| ASC | Accounting Standards Codification |
| ASR | Accelerated Share Repurchase |
| ASU | Accounting Standards Update |
| CAD | Canadian Dollar |
| CAESAR | Cash Enhanced Share Repurchase |
| CDO | Collateralized Debt Obligation |
| CNY | Chinese Yuan |
| CPEC | Convertible Preferred Equity Certificate |
| CoCo | Contingently Convertible Debt Instrument |
| DECS | Debt Exchangeable into Common Stock |
| EITF | Emerging Issues Task Force |
| EPS | Earnings Per Share |
| ESOP | Employee Stock Options Plan |
| FAQ | Frequently Asked Question |
| FAS | Financial Accounting Standard |
| FASB | Financial Accounting Standards Board |
| FDIC | Federal Deposit Insurance Corporation |
| FSP | FASB Staff Position |
| FIFO | First In, First Out |
| IASB | International Accounting Standards Board |
| IPO | Initial Public Offering |

| Abbreviation | *Miscellaneous* |
|---|---|
| ISDA | International Swaps and Derivatives Association |
| LIBOR | London Interbank Offering Rate |
| LLC | Limited Liability Corporation |
| LOC | Letter of Credit |
| MD&A | Management's Discussion and Analysis of Financial Condition and Results of Operations (SEC Regulation S-K Rule 229.303) |
| MIPS | Monthly Income Preferred Securities |
| NASDAQ | National Association of Securities Dealers Automated Quotations |
| NCI | Noncontrolling Interest |
| NYSE | New York Stock Exchange |
| OCA | Office of the Chief Accountant of the Securities and Exchange Commission |
| OMR | Open Market Repurchase |
| OP | Operating Partnership |
| PCAOB | Public Company Accounting Oversight Board |
| PEC | Preferred Equity Certificate |
| PIK | Paid-in-Kind |
| PIPE | Private Issuance of Public Equity |
| PRIDES | Preferred Redeemable Increased Dividend Equity Security |
| PV | Present Value |
| QUICS | Quarterly Income Capital Securities |
| QUIPS | Quarterly Income Preferred Securities |
| REIT | Real Estate Investment Trust |
| S&P | Standard & Poor's |
| SAC | Subjective Acceleration Clause |
| SEC | Securities and Exchange Commission |
| SOFR | Secured Overnight Financing Rate |
| SPACs | Special Purpose Acquisition Companies |
| SPE | Special-Purpose Entity |
| TDR | Troubled Debt Restructuring |
| TOPRS | Trust Originated Preferred Securities |
| UPREIT | Umbrella Partnership Real Estate Investment Trust |
| USD | US Dollar |
| US GAAP | United States Generally Accepted Accounting Principles |
| VRDO | Variable Rate Demand Obligations |
| VWAP | Volume Weighted Average Price |

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