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A guide to accounting for debt and equity instruments in financing transactions

May 2025

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1. Foreword

The accounting for debt and equity instruments issued in financing transactions can be quite complicated due in part to the complexity inherent in certain instruments, the sheer volume of transaction documents that may need to be considered in performing the accounting analysis and the myriad of accounting guidance that may be relevant. In many cases, an accounting outcome can be significantly affected by the existence or absence of one sentence in the relevant documents. Consideration needs to be given to not only the appropriate balance sheet classification of instruments such as preferred stock and warrants, which may have both debt and equity characteristics, but also the subsequent measurement. Additionally, instruments such as debt or preferred stock oftentimes have embedded features that may need to be given separate accounting recognition. The accounting analysis is further complicated if multiple instruments are issued as part of the same transaction, as that typically necessitates an allocation of proceeds to the various instruments or features.

This guide is intended to be a resource in understanding and analyzing some of the accounting guidance that may be relevant when analyzing debt and equity instruments issued in financing transactions and should be read in conjunction with the authoritative guidance. Given the complexity of instruments issued in financing transactions and the relevant accounting guidance, management may also want to consider seeking external expertise to assist in the accounting analysis. Appropriate upfront consideration to the accounting ramifications can help to minimize the risk of unanticipated and undesirable accounting consequences. Additionally, while valuation is beyond the scope of this guide, management should be mindful of the potential need to seek external expertise in developing the fair value estimates that may be necessary in appropriately accounting for certain instruments (or embedded features) issued in financing transactions.

For ease of use, definitions for acronyms and titles for ASC topics and subtopics and other literature referred to in this guide are included in Appendix A. In addition, several terms with specific meaning are used throughout this guide. Those terms and the corresponding definition are provided in Appendix B.

1.1 Important information about the scope of the guide

This guide is not intended to be a comprehensive manual, as its content is limited to the accounting complexities associated with certain common instruments issued in financing transactions. The accounting analysis is from the issuer's perspective and differs significantly from an analysis that would be performed from the holder's perspective. This guide does not apply to share-based payments issued in exchange for goods and services within the scope of ASC 718.

This guide assumes that the provisions of ASU 2020-06 are effective. The FASB issued 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*, to reduce complexities associated with the accounting for convertible instruments and the derivatives scope exception for contracts in an entity's own equity. For public business entities that meet the definition of an SEC filer, excluding entities eligible to be smaller reporting companies as defined by the SEC and based on their most recent determination as of August 5, 2020, ASU 2020-06 was effective for fiscal years beginning after December 15, 2021, including interim periods within those fiscal years. For all other entities, the ASU was effective for fiscal years beginning after December 15, 2023, including interim periods within those fiscal years.

1.1.1 Most recent updates to the guide

This guide has been updated to incorporate ASU 2024-04, *Debt—Debt with Conversion and Other Options (Subtopic 470-20): Induced Conversions of Convertible Debt Instruments*. ASU 2024-04 clarifies the requirements for determining whether certain settlements of convertible debt instruments should be accounted for as an induced conversion (refer to Section 3.5.3).

ASU 2024-04 is effective for all entities for annual reporting periods beginning after December 15, 2025, and interim reporting periods within those annual reporting periods. Early adoption is permitted, provided the entity has adopted ASU 2020-06.

See Appendix C for a detailed summary of all significant changes since the last edition.

1.2 Content overview

Chapter 2: Accounting for the issuance of multiple instruments or embedded features

The focus of this chapter is how to identify freestanding instruments from embedded features and how to allocate the proceeds to the various instruments or features. It concludes with a section on registration rights agreements. This chapter should be referenced if multiple instruments are issued contemporaneously to the same counterparty or if certain features within a debt or preferred stock instrument require separate recognition.

Chapter 3: Accounting for debt with conversion and other embedded features

The focus of this chapter is the accounting for embedded features within debt instruments, including conversion, put and call options. This chapter includes an illustration of interest expense recognition (including discount amortization) using the interest method. For guidance related to debt modifications and restructurings (which are beyond the scope of this guide), refer to our publication, A guide to accounting for debt modifications and restructurings (our debt modifications and restructurings guide).

Chapter 4: Accounting for preferred and similar stock

The focus of this chapter is preferred stock and similar instruments issued in the form of a share. The chapter addresses balance sheet classification and subsequent measurement; the accounting for common embedded features; and the accounting for conversions, modifications and redemptions. This chapter also addresses the accounting for delayed issuances of preferred or other stock and dividends on preferred stock. An exhibit at the end of this chapter provides a high-level overview of the accounting for convertible preferred stock when the conversion feature is required to be separately recognized as a derivative in accordance with ASC 815, as well as when the conversion feature is not required to be separately recognized.

Chapter 5: Accounting for warrants and other equity-linked instruments

The focus of this chapter is determining the appropriate accounting treatment for freestanding instruments that are not in the form of shares, but are linked to shares. Examples may include warrants or forward contracts to purchase shares or freestanding options to redeem shares. This chapter also contains guidance on accelerated share repurchases.

1.3 Other RSM technical accounting guidance

Guidance on the accounting for debt modifications and restructurings can be found in our debt modifications and restructurings guide. In addition, guidance on debt classification can be found in our publication, Fundamentals of debt classification. Additional information on various topics is available in our technical accounting guides.

2. Accounting for the issuance of multiple instruments or embedded features

2.1 Overview

It is common for stock offerings and debt issuances to involve multiple financial instruments contemporaneously issued to the same counterparty. This would be the case, for example, if warrants are issued to investors or lenders in conjunction with an equity or debt issuance. When multiple financial instruments are issued together, this generally necessitates allocating the proceeds received to each instrument to establish its initial carrying amount. The allocation will, in many cases, necessitate independent issuance-date estimates of fair value for each of the instruments issued in a bundled transaction. We believe this is typically the case even if specific proceeds were received for each instrument because any arbitrarily assigned prices for specific instruments may not be reflective of fair value. Not only is this allocation critical in establishing the initial carrying amount of each instrument, but it also has ongoing income statement repercussions resulting from factors such as the amortization or accretion of discounts or premiums created on debt, as well as the differing accounting treatment of costs incurred in a financing transaction.

Additionally, it is sometimes necessary to allocate proceeds and give separate recognition to embedded features within debt and equity instruments as elaborated on in Chapter 3 and Chapter 4. A key first step in performing the accounting analysis and allocating proceeds is to identify what instruments are freestanding; this determination impacts what accounting guidance is relevant and the instruments to which proceeds should be allocated. For example, a freestanding put option on an entity's shares would be analyzed in accordance with the chapter on equity-linked instruments and required to be accounted for as a liability under ASC 480-10-25-8, while a put option that is embedded in the underlying shares would be analyzed in the context of the chapter on preferred stock and is not subject to ASC 480-10-25-8. Similarly, when analyzing potential features under ASC 815 to determine if derivative recognition is required, there are additional considerations in ASC 815-15 that are relevant to embedded, but not freestanding, derivatives. To further complicate the analysis, the manner in which proceeds are allocated to each instrument is dependent on the required subsequent measurement for the instrument. Lastly, the determination of whether and to what extent separate recognition must be given to an embedded feature that is not freestanding can be impacted by the amount of proceeds allocated to the freestanding instrument. For example, the amount of proceeds allocated to a debt host contract can impact whether an embedded put or call option requires separate recognition as a derivative (see Section 3.3.2.1). The following steps, which are elaborated on in part in the table that follows and in part in other sections of this guide, are provided as a tool for structuring the accounting analysis when multiple financial instruments or embedded features are involved in a transaction.

Step	Relevant section in this guide
Identify the freestanding financial instruments	Section 2.2
Determine the accounting treatment for each freestanding financial instrument	Chapter 3 for debt, Chapter 4 for preferred stock and Chapter 5 for warrants and other equity-linked instruments
Allocate the proceeds to each freestanding financial instrument	Section 2.3
Determine if any embedded features within each freestanding instrument require separate recognition	Section 3.3 for features that are embedded in a debt instrument Section 4.3 for features that are embedded in preferred and similar stock
Allocate the proceeds to embedded features	Section 2.4 or Section 2.5, as applicable

2.2 Identify the freestanding financial instruments

The determination of what is freestanding versus embedded is sometimes straightforward and, in other circumstances, complex. Generally, if a financial instrument is not freestanding, it is embedded. The ASC Master Glossary defines both terms.

Master Glossary – 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.

Master Glossary – Embedded derivative

Implicit or explicit terms that affect 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.

The following examples illustrate how common instruments or features are typically viewed; however, if facts and circumstances differ from those included in the examples, a different conclusion may be warranted.

Stock purchase warrants	Warrants are generally considered to be freestanding even if issued with another financial instrument, such as debt or stock, because warrants are typically separately exercisable (i.e., the exercise of the warrants would not result in the termination of the debt or stock the warrants may have been issued with). If, on the other hand, the warrants are not detachable from another instrument, such as debt that must be surrendered to exercise the warrants, as noted at ASC 470-20-25-3, the warrants would be considered embedded in the convertible instrument and the following discussion on conversion options applies.
Conversion options in debt or preferred stock	Conversion options are typically viewed as embedded in the convertible debt or preferred stock instruments, given that the conversion option generally cannot be detached and separately exercised (i.e., the exercise of the conversion option would result in the termination of the debt or preferred stock that is converted).
Put and call options related to debt and equity instruments	Put and call options are most commonly considered to be embedded because the options are typically entered into in conjunction with the issuance of the debt or equity instrument, the options cannot be transferred separately from the underlying debt or equity instrument, and the exercise of the option will result in the termination or redemption of the underlying debt or equity instrument.

2.3 Allocate the proceeds to each freestanding financial instrument

The appropriate method to use in allocating proceeds to each freestanding financial instrument depends on whether any of the instruments will be subsequently measured at fair value (through a fair value election or requirement). Instruments such as liability warrants that will be subsequently measured at fair value are generally allocated proceeds equal to their issuance-date fair value. Any remaining proceeds are then allocated to instruments that are not subsequently measured at fair value based on each instrument's proportionate fair value to the total fair value of instruments not subsequently measured at fair value.

Example 2-1: Allocating proceeds to debt and warrants

Debt and warrants are issued as part of the same transaction for total proceeds of $1 million. The allocation of proceeds under two different scenarios follows. For each of these scenarios, assume that the fair value of the debt is $1 million and that the fair value of the warrants is $200,000. Assume also that the debt will not subsequently be measured at fair value (through an election or otherwise).

Scenario 1: Warrants meet the requirements to be classified as equity and therefore will not be subsequently measured at fair value

	Fair value	Allocated proceeds and initial carrying amount	
Debt	$1,000,000	$833,333	(a)
Warrants	200,000	166,667	
Total	$1,200,000	$1,000,000	

(a) Represents the net amount. Assuming the face amount is $1 million, this would be recorded as $1 million of debt with a discount of $166,667.

In this scenario, because ongoing fair value measurement is not required for any instrument, the proceeds are allocated to each financial instrument based on the respective instrument's proportionate fair value (allocated proceeds = instrument fair value ÷ total fair value x total proceeds) in accordance with ASC 470-20-25-2.

Scenario 2: Warrants are classified as a liability and are subsequently measured at fair value

	Fair value	Allocated proceeds and initial carrying amount	
Debt	$1,000,000	$800,000	(a)
Warrants	200,000	200,000	
Total	$1,200,000	$1,000,000	

(a) Represents the net amount. Assuming the face amount is $1 million, this would be recorded as $1 million of debt with a discount of $200,000.

In this scenario, because ongoing fair value measurement is required for the warrants, the proceeds are allocated to the warrants in an amount equal to their fair value. The remaining proceeds would then be allocated to the instruments that are not accounted for at fair value based on their relative fair values. In this example, the debt is the only other freestanding instrument. It should be noted that any discounts (such as the $200,000 in Scenario 2) or premiums on debt (and mandatorily redeemable stock that is accounted for as a liability) that are created through an allocation of the proceeds (or otherwise) are amortized or accreted into interest expense using the interest method described in ASC 835-30 (refer to the illustration at Section 3.6). Similarly, discounts on redeemable preferred stock are accreted as dividends (assuming the preferred stock is not classified as a liability) as elaborated on in Section 4.2.3.3.

In addition to allocating proceeds, we believe it is also appropriate to allocate issuance costs that are not specifically associated with one of the financial instruments to each of the freestanding financial instruments. There is no specific guidance that addresses how such issuance costs should be allocated. Methods employed in practice include allocating costs to each instrument in the same proportion as how the proceeds are allocated to each instrument or allocating the costs to each instrument based on the relative proportion of costs that would be incurred in issuing each instrument separately. Depending on the facts and circumstances, a different approach may be justifiable. For example, in a transaction involving only debt and warrants, if the warrants are issued solely as an incentive to obtain debt financing, it may be appropriate to treat all issuance costs as debt issuance costs. An appropriate allocation of costs is important, as the accounting treatment for the costs differs significantly depending on the accounting treatment for the instrument:

- Costs associated with debt (including mandatorily redeemable stock classified as a liability) are amortized over the life of the debt using the interest method.
- Costs associated with temporary-equity-classified preferred stock are netted against the proceeds and can impact the amount of dividend recognized as the preferred stock is accreted to its redemption amount.
- Costs associated with equity instruments (including warrants that qualify for equity treatment) are netted against the proceeds received in equity.
- Costs associated with warrants that are required to be accounted for as liabilities at fair value are expensed as incurred.

For this reason, it is important to use an approach that is rational in the circumstances and consistently applied.

When using the relative fair value approach to allocate proceeds, there will be no effect on the income statement on the issuance date. However, if the aggregate fair value of instruments that will be subsequently measured at fair value exceeds the total proceeds received, it is possible that there could be a loss (or, in rare cases, a dividend) recorded on the date of the transaction. This is because the amount assigned to the remaining instruments that are not recorded at fair value (the debt in the earlier examples) generally cannot be less than zero. Refer to Remarks by Hillary H. Salo, Professional Accounting Fellow, Office of the Chief Accountant, at the AICPA National Conference on Current SEC and PCAOB Developments – 2014 for a more in-depth discussion of this matter. When fact patterns like this are present, it is particularly important to understand the underlying economics of the transaction, challenge the valuation of the individual financial instruments (given the counterintuitive results), and consider if there are additional rights or obligations requiring separate accounting. We expect this situation to be rare.

The earlier examples should serve to illustrate why it is necessary to identify the freestanding financial instruments and determine their appropriate balance sheet classification and subsequent measurement before allocating the proceeds. It should also be evident from these examples that it may be necessary for management to develop or obtain fair value estimates for certain, or all, of the multiple freestanding financial instruments issued as part of the same transaction to appropriately allocate the proceeds.

2.4 Allocate the proceeds to embedded features

In addition to allocating the proceeds to each freestanding financial instrument when multiple financial instruments are issued together, it is sometimes necessary to allocate a portion of the proceeds attributable to a freestanding financial instrument to certain embedded features that require separate recognition (as discussed in Chapter 3 for debt and Chapter 4 for preferred and similar stock). Common examples of embedded features that may require separate recognition as derivatives include conversion options and puts and calls.

Derivatives requiring separate recognition are reported on the balance sheet as an asset or a liability and initially and subsequently are measured at fair value. Generally, the initial carrying amount is established through an allocation of proceeds, and subsequent changes in fair value are recognized through earnings.

Once the amount of proceeds to be allocated to features requiring separate recognition is known, any remaining proceeds that were received or attributed to the debt or equity instrument as a whole establish the initial carrying amount of the remaining debt or equity instrument.

Example 2-2: Allocating proceeds to embedded features and freestanding instruments

Assume the debt in Scenario 2 of the example presented earlier contains a conversion option with a fair value of $200,000 that requires separate recognition as a derivative. In this situation, $200,000 of the $800,000 allocated to the debt would be allocated to the conversion option derivative liability. The net-of-discount carrying amount of the debt would be the remaining $600,000. The entry to record this transaction would be:

	Debit	Credit
Cash	$1,000,000	
Discount on debt	400,000	
Derivative liability		$200,000
Debt		1,000,000
Warrant liability		200,000

As previously mentioned, discounts (such as the one in this example) or premiums on debt or certain redeemable preferred stock that are created through an allocation of the proceeds (or otherwise) are amortized or accreted into interest expense or dividends using the interest method illustrated in Section 3.6.

With respect to embedded derivatives that require separate recognition, the following additional considerations should be kept in mind:

- When determining the fair value of an embedded derivative that requires separate recognition, the objective is to estimate its fair value separately from the fair value of the nonderivative portions of the instrument in which it is embedded.
- If more than one derivative embedded in an instrument requires separate recognition, those derivatives should be bundled together and treated as one derivative.
- If an embedded non-option derivative, such as a mandatory conversion feature, requires separate recognition, the terms for that non-option derivative should be calibrated to result in a fair value of zero at the issuance date in accordance with ASC 815-15-30-4. Conversely, as noted in ASC 815-15-30-6, the terms should not be adjusted for an option-based derivative, regardless of whether the option is in or out of the money at the issuance date.
- While embedded derivatives that are bifurcated require separate measurement at fair value and are subject to the derivative disclosure requirements, in practice, the recorded balance is typically reported in the same financial statement line item as the host contract if the host contract is an asset or liability. (It would not be appropriate to combine a derivative asset or liability with a host contract that is classified in equity.)
- As an alternative to separately recognizing embedded derivatives that require bifurcation at fair value, an entity may be able to make an election as outlined beginning at ASC 815-15-25-4 to account for the entire instrument at fair value.

2.5 Registration payment arrangements

2.5.1 Definition and scope

It is not uncommon for companies to extend registration rights to their shareholders or potential shareholders in conjunction with an equity offering or the issuance of warrants or convertible debt. ASC 825-20 provides guidance on how to account for those arrangements that meet the definition of a registration payment arrangement, which would be the case if the arrangement requires the issuer:

- Either endeavor to:
  - File a registration statement for the resale of specified financial instruments or the resale of equity shares that are issuable upon exercise or conversion of specified financial instruments, and have that registration statement 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
  - Maintain the effectiveness of the registration statement for a specified period of time (or in perpetuity)
- Transfer consideration to the counterparty if the registration statement is not declared effective or if effectiveness of the registration statement is not maintained
  - The form of the consideration and timing of payment can vary (e.g., the consideration may be in the form of cash, equity instruments or adjustments to the terms of the financial instrument or instruments that are subject to the registration payment arrangement [such as an increased interest rate on a debt instrument])

This guidance applies to a registration payment arrangement regardless of whether it is issued as a separate agreement or included as a provision of a financial instrument or other agreement. Additionally, an arrangement that requires the issuer to obtain or maintain a listing on a stock exchange (instead of, or in addition to, obtaining or maintaining an effective registration statement) is also within the scope of ASC 825-20 if the earlier definition is met.

As outlined at ASC 825-20-15-4, this guidance 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
- Arrangements in which the amount of consideration transferred is determined by reference to either an observable market (other than the market for the issuer's stock) or an observable index
- Arrangements in which the financial instrument or instruments subject to the arrangement are settled when the consideration is transferred (e.g., 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)

Additionally, as noted at ASC 825-20-15-5, this guidance should not be applied by analogy to the accounting for contracts that are not registration payment arrangements as defined earlier.

2.5.2 Recognition and measurement

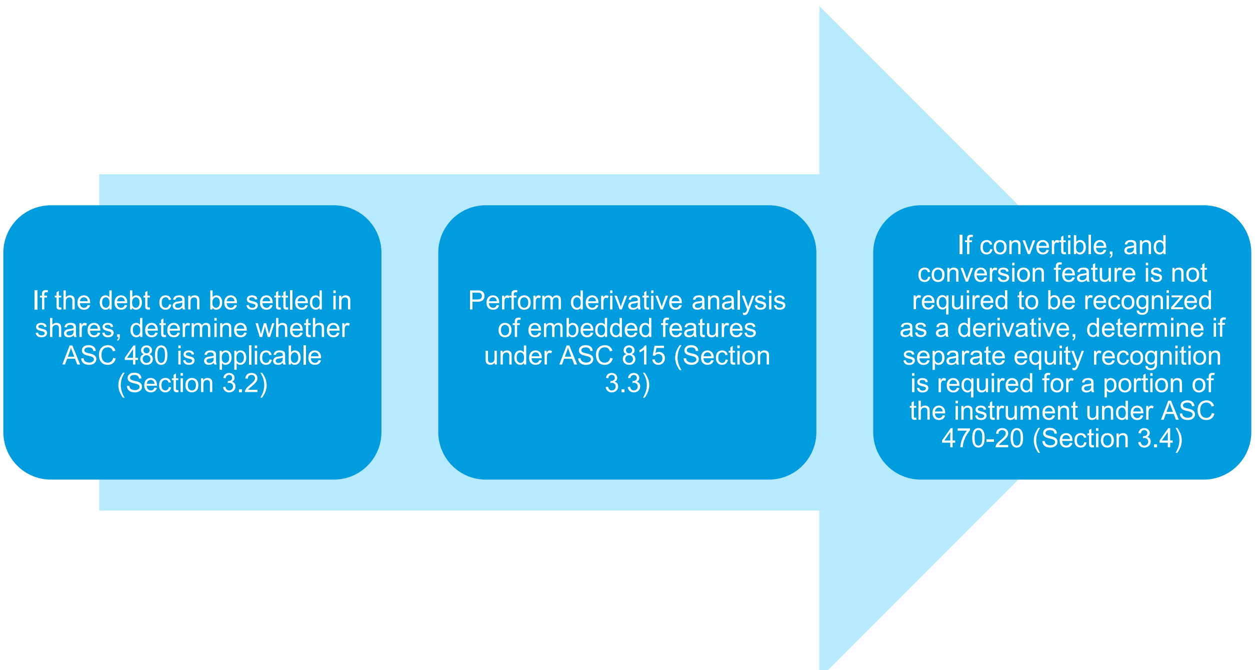
In accordance with ASC 825-20-25, registration payment arrangements within the scope of ASC 825-20 should be recognized as a separate unit of account from the financial instrument or instruments that are subject to the arrangement. Additionally, the financial instruments that are subject to the arrangement should be recognized in accordance with relevant U.S. GAAP without regard to any contingent obligation to transfer consideration under the registration payment arrangement. ASC 450-20 should be followed in determining the appropriate recognition and measurement for the contingent obligation. As a result, if, at the inception of the arrangement, the transfer of consideration is probable and can be reasonably estimated, a liability for this obligation would be established in accordance with ASC 450-20, and any remaining proceeds from the related financing transaction would be allocated to the financial instruments issued in conjunction with the registration payment arrangement in accordance with the provisions of this chapter. ASC 825-20-30-5 indicates that for arrangements requiring payment in shares, if the transfer of consideration is probable and the number of shares to be delivered can be reasonably estimated, the share price at the reporting date should be used in measuring the contingent liability.

If after the inception of the arrangement, the transfer of consideration becomes probable and can be reasonably estimated such that a liability needs to be newly recognized, this liability would be recognized as an expense. Similarly, any adjustments to the carrying amount are also recognized in earnings. Examples are included in ASC 825-20-55 that illustrate the application of this guidance.

3. Accounting for debt with conversion options and other embedded features

3.1 Introduction

The accounting for debt with conversion options and other embedded features, such as put and call options, necessitates giving consideration to ASC 480 to determine if the debt is within its scope, ASC 815 to determine whether any of the features embedded in the debt agreement need to be separately recognized as a derivative and ASC 470-20 for convertible debt issued at a substantial premium for which the conversion feature does not require derivative accounting to determine whether the premium needs to be recognized as a separate component of equity.



Section 3.2 through Section 3.4 summarize the accounting analysis necessary to make these determinations and the resulting ramifications. Section 3.5 addresses derecognition of convertible debt in various scenarios, and Section 3.6 includes an illustration of interest expense recognition, including discount amortization, using the interest method. Guidance related to debt modifications and restructurings can be found in our debt modifications and restructurings guide.

3.2 ASC 480 considerations

While a debt instrument should be classified as a liability regardless of whether ASC 480 applies, if a debt instrument may be settled in shares, consideration should be given to ASC 480-10-25-14, because, if applicable, this could impact the measurement of the instrument and the relevant disclosure requirements. Specifically, a debt instrument that embodies a conditional or unconditional obligation that the issuer must or may settle by issuing a variable number of its equity shares would be subject to ASC 480 if, at inception, the monetary value of the obligation is based solely or predominantly on any one of the following criteria from ASC 480-10-25-14 (referred to for the remainder of this section as the three criteria):

1. A fixed monetary amount known at inception (e.g., a payable settled with the number of issuer's equity shares required to equate to a fixed amount of value)

2. Variations in something other than the fair value of the issuer's equity shares (e.g., a financial instrument indexed to the Standard & Poor's 500 Index and settled with a variable number of the issuer's equity shares)
3. Variations inversely related to changes in the fair value of the issuer's equity shares (e.g., a written put option that could be net share settled)

The following are key terms used in ASC 480-10, along with their definitions from the Master Glossary of the ASC:

Master Glossary – 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.

Master Glossary – Obligation

A conditional or unconditional duty or responsibility to transfer assets or to issue equity shares.

Generally, instruments that are convertible to shares at the holder's option are not subject to ASC 480. However, a debt instrument that must or may be settled in a variable number of the issuer's equity shares (through conversion or otherwise) may be subject to ASC 480 if it meets any of the three criteria. An example of an instrument that may meet the first criterion is a debt instrument that will be settled in a variable number of shares, with that number to be determined based on 80 percent of the conversion date fair value of a share (i.e., a 20 percent discount). In this case, the holder receives the same value regardless of the share price at the time of the conversion. If the face amount of the debt was $1 million and the share price was $6 at the time of conversion, the holder would receive 208,333 shares ($1 million face amount divided by 80 percent of the $6 share price) worth $6 each for an extended value of $1.25 million. If the share price was $7 at the time of conversion, the holder would receive 178,571 shares ($1 million face amount divided by 80 percent of the $7 share price) worth $7 each for the same extended value of $1.25 million.[1]

An instrument that meets criterion one would generally be accounted for as stock-settled debt (which entails accreting the carrying amount up to the $1.25 million settlement amount in the preceding example through the settlement date in accordance with the interest method illustrated at Section 3.6) if the monetary value of the obligation is based solely or predominantly on a fixed settlement amount. Other instruments that fall within the scope of ASC 480 by meeting the second or third criterion may necessitate subsequent measurement at fair value under ASC 480-10-35-5 unless another subtopic of U.S. GAAP specifies a different measurement attribute.

The analysis of whether a debt instrument is within the scope of ASC 480 becomes more complex when the monetary value is in part, but not solely, based on one of the three criteria. Subjectivity comes into play in determining if the monetary value is based predominantly on one of these criteria, as "predominantly" is not defined in ASC 480. We are aware of divergent views in practice as to whether predominant should be interpreted as "more likely than not" or a higher threshold, such as 90 percent, as suggested by the use of the words "in small part" in ASC 480-10-55-22. Other examples in ASC 480-10-55 may also be useful in making this determination. In the context of the example in the preceding paragraph, if the number of shares to be issued is determined based on an average share fair value over a stated period of time (e.g., 30 days before settlement) rather than the fair value of the shares on the

[1] As noted in the footnote to the section that follows, some bridge notes are settled in a variable number of shares upon the occurrence of a qualified financing event, with the number of shares determined based on the price at which shares are issued in the financing event. These instruments are generally not viewed as subject to ASC 480-10-25-14 unless an obligation exists at the issuance date to conduct a qualified financing event and settlement in a manner that meets the first criterion is deemed to be predominant at the issuance date.

conversion date, based on the example at ASC 480-10-55-22, a conclusion would be reached that while the monetary value is in small part based on variations in the fair value of the shares that can occur during the 30 day period, the monetary value is predominantly fixed such that the first criterion would be met.

In circumstances involving multiple potential settlement outcomes, the analysis becomes even more complex, as it is necessary to assess which outcome is predominant as of the issuance date. In the preceding example, the debt will settle in shares at a discount to the conversion date fair value (a situation that may meet the first of the three criteria). If the debt in that example was also convertible at the holder's option into a fixed number of shares or could be settled in cash upon its maturity (two alternatives that would not meet any of the three criteria), the reporting entity would need to determine if an outcome that meets one of the criteria is predominant. In making this determination, consideration should be given to all pertinent information, such as the current stock price and volatility, the strike price of the instrument, and any other relevant factors to determine if, for example, it would be more advantageous for the holder to elect to convert to the fixed number of shares. If settlement in a manner that meets one of the three criteria is determined to be predominant, the instrument is accounted for in accordance with ASC 480. If not, the feature that could result in the issuance of a variable number of shares is evaluated to determine if it should be separately recognized as a derivative as discussed in the next section.

3.3 Derivative analysis of embedded features

3.3.1 Overview

It is common for debt instruments to have embedded features that may require separate recognition as derivatives—including conversion options, early redemption features (such as put and call options), additional payments if a contingent event such as a change in control occurs and interest that is indexed to something other than interest rates. While the focus of this section is on the features we have most commonly observed in practice, there may be other features within a debt instrument that necessitate similar consideration. The focus should be on features that can alter the amount or timing of cash flows or the value of other exchanges (e.g., conversion shares).

RSM COMMENTARY: Distinguishing between conversion and redemption options

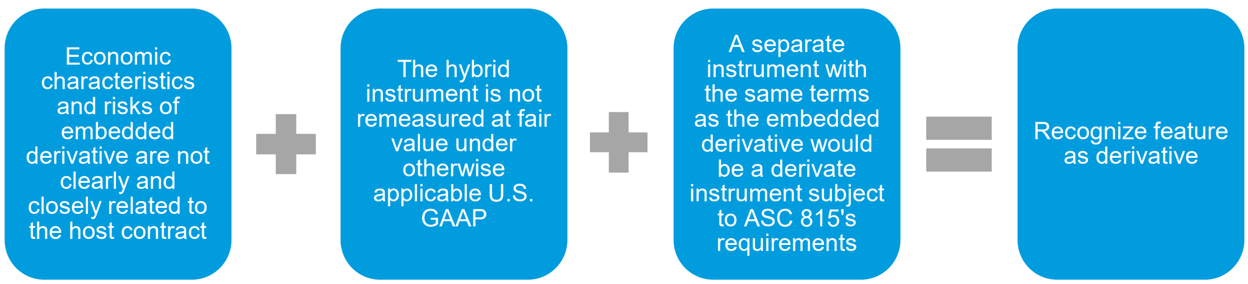
Standard conversion options allow for conversion of the debt into a fixed or substantially fixed number of shares. Standard redemption features, such as put and call options, give the holder the right to put the debt to the issuer (or the issuer the right to call the debt from the holder) at a stated amount to be paid in cash or shares. Some instruments provide for conversion into a variable number of shares, with the number of shares determined at the time of conversion based on the fair value of the shares at the conversion date. Such a feature is designed to ensure that the holder receives a predetermined amount of value paid in whatever number of shares it takes to arrive at that value.[2] In other words, the value that the holder is expected to receive upon conversion is not expected to vary based on changes in the value of the underlying shares. Assuming that this feature does not result in classification as stock-settled debt as discussed at Section 3.2, we believe it would be appropriate to analyze this feature as

[2] We have observed several variations of debt instruments in practice (typically bridge financing notes) that contractually convert into the class of shares issued in the next qualified financing event (as defined in the agreement) at the price at which shares are issued in the financing event, or a percentage of that price (e.g., 80% of the qualified financing price). Generally, such features are evaluated as a redemption option rather than a conversion option, assuming that the qualified financing event is defined in a manner that one would expect the shares to be issued at a price reflective of fair value, such that the feature is designed to give the debt holders a fixed amount of value paid in a variable number of shares. (That may not be the case if the financing event is defined to be substantially based on the exercise or conversion of preexisting warrants or convertible instruments at preestablished contractual strike prices.) In some cases, there may be multiple conversion features or optionality in the conversion price (i.e., the debt will convert at the lower of a predefined price or a predefined percentage of the qualified financing price), in which case, the instrument may contain both a conversion option and a redemption option.

a redemption option rather than a conversion option in the analysis that follows to determine when certain embedded features must be separately recognized as derivatives.

The determination of which, if any, embedded features must be separately recognized as derivatives is complex. Specifically, ASC 815-15-25-1 requires derivative recognition for embedded features if all of the following three criteria 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 U.S. GAAP.
3. A separate instrument with the same terms as the embedded derivative would be a derivative instrument subject to the requirements of ASC 815 (i.e., it meets the definition of a derivative and does not qualify for one of the scope exceptions outlined at ASC 815-10-15-13).



3.3.2 Application of the embedded derivatives guidance to common features in debt instruments

Criteria 1 and 3 are discussed in more depth in the sections that follow. Regarding Criterion 2, if the debt instrument qualifies, and the reporting entity elects to account for it at fair value or the instrument is required to be accounted for at fair value on an ongoing basis, no embedded derivatives would require separate recognition and the embedded derivative analysis is not relevant.

3.3.2.1 Criterion 1

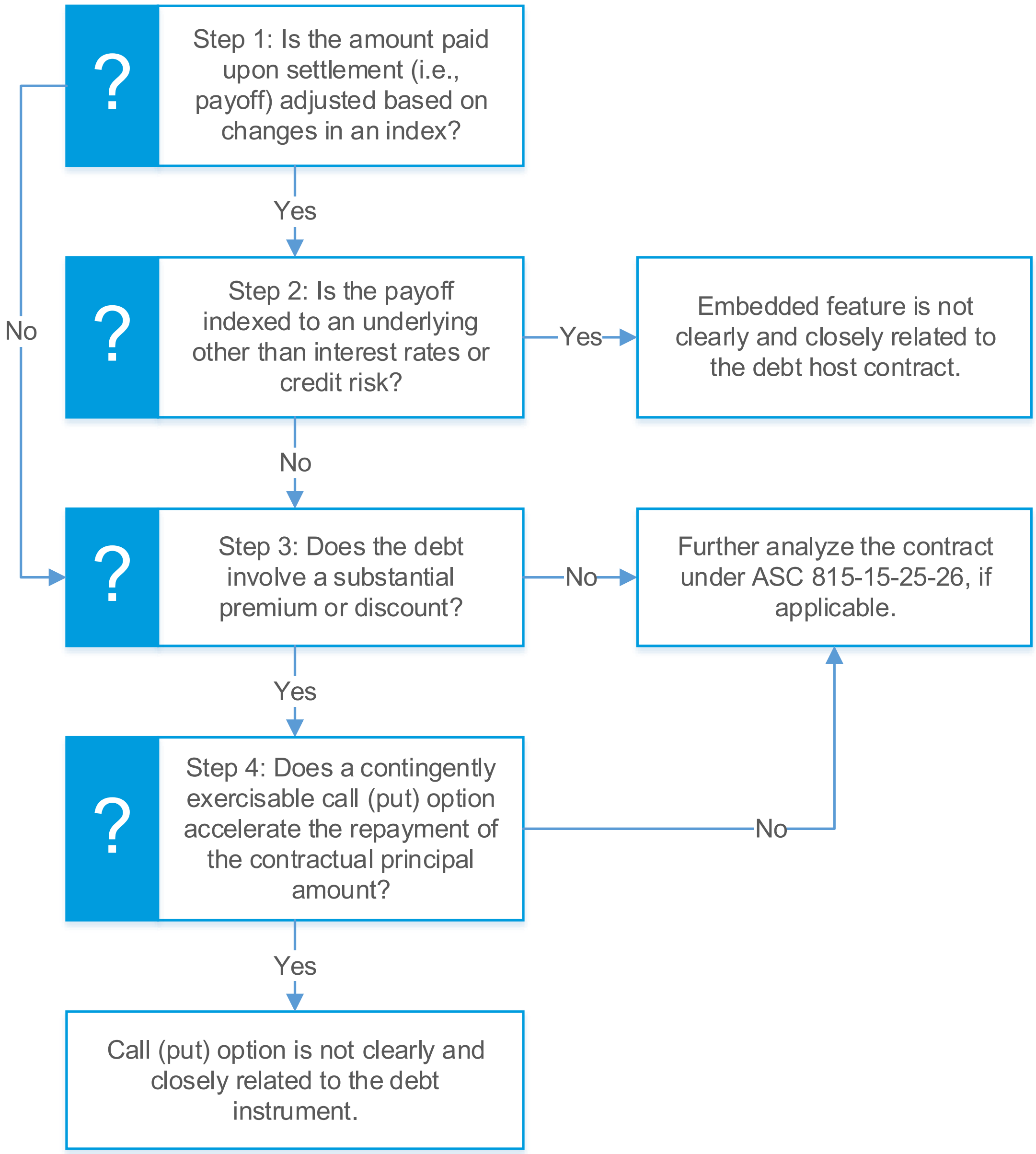
The first criterion to consider in the embedded derivative analysis is whether the economic characteristics and risks of the embedded derivative are clearly and closely related to the economic characteristics and risks of the host contract. Instruments issued in financing transactions are analyzed to determine whether the host contract is more debt-like or equity-like. This analysis is based on all stated and implied substantive terms and features, with each term and feature evaluated and weighted to determine if a specific instrument is more debt-like or equity-like. Instruments issued in the legal form of debt, as well as certain preferred or other stock that have strong debt-like characteristics, are generally considered to have a debt host contract (refer to Section 4.3.2.1 for the determination of the nature of the host contract for preferred stock and similar instruments issued in the form of a share). The primary economic characteristics and risks associated with a debt host are interest rates, inflation and credit risk. As pointed out at ASC 815-15-25-51, equity conversion options are not clearly and closely related to a debt host contract because their underlying value is dependent upon the value of an equity interest. As it relates to redemption features within debt instruments that can accelerate repayment (whether in cash or shares), such as put and call options, additional analysis is necessary to determine if a particular feature is clearly and closely related to the debt host contract. Specific guidance relevant to this determination is primarily found in ASC 815-15-25-26 and ASC 815-15-25-42.

The guidance in ASC 815-15-25-26 does not apply if there is an underlying related to the put or call option other than interest rates or an interest rate index. If, for example, a put or call option can only be exercised upon the occurrence of a contingent event, which is another underlying, this guidance is not relevant.

The guidance on put and call options at ASC 815-15-25-42 outlines a four-step decision sequence that should be followed in determining whether options that can accelerate the settlement of debt instruments are clearly and closely related to the debt host contract. This decision sequence results in a conclusion that put and call options are not clearly and closely related under any of the following circumstances:

- Rather than being the repayment of principal at par, the payoff amount is indexed to something other than interest rates or credit risk.
- The debt involves a substantial premium or discount and the option is contingently exercisable.
- One of the two conditions outlined later in this section from ASC 815-15-25-26 are met, if applicable.

The four-step decision sequence in ASC 815-15-25-42 follows on the next page.



An example of the type of put or call option that we have observed most frequently in practice that is not clearly and closely related to the debt host contract is a feature that will result in payment of the debt at a significant premium upon the occurrence of a contingent event, such as a change in control. When considering Steps 1 and 2 of the decision sequence, we believe repayments that are based on either a fixed premium to par or a premium that changes due to the passage of time would not be considered indexed to something other than interest rates or credit risk. In evaluating the significance of a premium or discount in Step 3, in practice, premiums or discounts of 10% or more are generally viewed as substantial; however, consideration should be given to the specific facts and circumstances. Additionally, we believe that when determining if the debt involves a substantial premium or discount, consideration should be given to not only the relationship of the par amount to the issuance proceeds attributable to the debt, but also to the relationship of the payoff amount to the issuance proceeds attributable to the debt. As such, even when debt is issued at par, but a portion of the proceeds is allocated to other freestanding instruments (such as warrants) in accordance with Chapter 2, the debt could be deemed to involve a substantial discount. Generally, it would not be appropriate to consider discounts created by separately recognizing a conversion option associated with the debt, given that typically the holder would not benefit from the conversion option if the instrument is redeemed. However, it may be necessary to consider premiums or discounts created from bifurcating other embedded derivatives from the debt that could result in payments that are incremental to the redemption feature and can be triggered prior to or on the redemption date. Additionally, while fees paid to the creditor can create a discount that would be considered in this analysis, discounts related to issuance costs paid to third parties would be ignored in this analysis.

The guidance in ASC 815-15-25-26 is relevant to the analysis of noncontingent puts and calls and other features in a debt instrument that can alter the interest payments if the only underlying in the potential derivative is an interest rate or interest rate index. (As mentioned earlier, keep in mind that if exercise of the option is contingent on the occurrence of a certain event, such as a change in control, this would constitute a non-interest rate underlying and, as such, ASC 815-15-25-26 would not be relevant to the analysis for that option.) When applicable, a conclusion would be reached under ASC 815-15-25-26 that an embedded feature is clearly and closely related to a debt host contract unless one of the following conditions exists:

- There is a possible situation in which the creditor could be forced by the terms of the debt instrument to accept settlement in such a way that it would not recover substantially all of its initial recorded investment. (In practice, “substantially all” has generally been interpreted to mean at least 90%.) For example, a debt is issued at a premium greater than 10% and gives the debtor the option of prepaying at par.
- There is a possible future interest rate scenario under which the embedded derivative would at least double the creditor’s initial rate of return on the debt instrument and result in a rate of return that would be at least twice the then-current market rate of return for a debt instrument with the same terms involving a debtor with similar credit quality at the inception of the debt. This condition does not apply if the right to accelerate the payment of the debt can only be exercised by the debtor.

In determining whether either of the two conditions exists, keep in mind that the analysis should be performed after allocating the proceeds to freestanding financial instruments that may have been issued together in the same transaction, such as warrants and debt.

Examples are provided at ASC 815-15-55-13 and ASC 815-15-55-25 to illustrate whether embedded put and call options are clearly and closely related to debt host contracts.

3.3.2.2 Criterion 3

The third criterion in the embedded derivative analysis necessitates determining if a separate instrument with the same terms as the embedded derivative would be a derivative instrument subject to the requirements of ASC 815. Addressing this criterion involves determining if the embedded feature meets the definition of a derivative as outlined beginning at ASC 815-10-15-83, and if so, whether it qualifies for one of the scope exceptions outlined at ASC 815-10-15-13.

RSM COMMENTARY: Understanding the terminology

By definition, a derivative instrument has all of the following characteristics:

- One or more underlyings
- One or more notional amounts or payment provisions
- 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 can be settled net by any of the following means:

- Its terms implicitly or explicitly require or permit net settlement.
- It can readily be settled net by a means outside the contract.
- It provides for delivery of an asset that puts the recipient in a position not substantially different from net settlement.

While an in-depth discussion of derivatives is beyond the scope of this guide, the following chart provides an indication of whether each characteristic would likely be met for standard conversion and redemption options in debt instruments or debt host contracts.

Characteristic	Conversion option	Redemption option
Underlying	Yes, fair value of the shares into which it can be converted	Yes, the fair value of the debt host, which is a function of interest rates and credit risk. Additionally, if exercise of the option is contingent, the occurrence of the contingent event would also constitute an underlying.
Notional amount or payment provision	Yes, number of shares into which it can be converted	Yes, face or payoff amount
No or smaller initial net investment	Yes, the fair value (i.e., initial net investment) of the conversion option at inception is generally less than the fair value of the underlying shares.	Yes, the fair value (i.e., initial net investment) of the redemption option at inception is generally less than the fair value of the underlying debt.
Net settlement	Yes, if the conversion shares are readily convertible to cash or contractually the conversion option can be settled net	Yes, due to ASC 815-10-15-107[3]
Scope exception that may be relevant	ASC 815-10-15-74(a), if the conversion option is indexed to the issuer's stock and classified in stockholders' equity as defined in ASC 815-40 and discussed in Section 5.2.2.1 and Section 5.2.2.2	Put and call options in debt host contracts generally do not qualify for a scope exception.

As demonstrated in this chart, redemption features such as put and call options embedded in debt host contracts typically meet the definition of a derivative and are generally required to be recognized as such if the first and third criteria discussed in Section 3.3.2.1 and Section 3.3.2.2 are also met. Conversion options typically meet the definition of a derivative if net settlement exists, either contractually or because the shares that would be delivered (conversion shares) if the option is exercised are readily convertible to cash. Contractual net settlement could result from a provision for the holder to receive the as-converted value in cash. For example, this may exist in the form of a noncontingent put or redemption option that allows the holder to receive the greater of face or the as-converted value in cash.

[3] We believe net settlement would also exist under ASC 815-10-15-107 for conversion features in debt instruments that are in substance redemption options (i.e., the value of the feature is not expected to vary with changes in the fair value of the underlying shares).

If contractual net settlement does not exist for a conversion option, consideration should be given to whether the conversion shares are readily convertible to cash. This typically depends on whether the shares are publicly traded and if so, the daily transaction volume.

RSM COMMENTARY: Are the shares readily convertible to cash?

The determination of whether the shares are readily convertible to cash needs to be considered on an ongoing basis throughout a contract's life. Delisting, an initial public offering (IPO) or significant changes in the level of trading activity are examples of factors that could influence the conclusion, as consideration needs to be given to whether the smallest increment of shares that would be delivered in accordance with each individual contract is small relative to the daily transaction volume. Assume, for example, that a debt instrument can be converted at a conversion price that would result in the issuance of 100,000 shares of publicly traded common stock. The average daily trading volume associated with the common stock is 50,000 shares. If the debt instrument could only be converted in total, the 100,000 shares into which it would be converted is large relative to the daily transaction volume, and the common shares would not be considered to be readily convertible to cash. Many instruments permit conversion in whole or in part (i.e., in whatever increment the holder elects), in which case, generally, the common shares would be considered to be readily convertible to cash if they are actively traded. Refer to the guidance beginning at ASC 815-10-15-130 and Example 7 beginning at ASC 815-10-55-99 for additional information.

Given that a conversion option is not clearly and closely related to a debt host contract, if a conclusion is reached that a conversion option is a derivative, consideration would next be given to ASC 815-40 to determine whether it qualifies for an exception to the derivative requirements by being both indexed to the issuer's stock and classified in stockholders' equity. If it does qualify for the exception, reference should be made to Section 3.3.4. If the conversion option is a derivative that does not qualify for this exception, reference should be made to Section 3.3.3. Refer to the guidance at Section 5.2.2.1 and Section 5.2.2.2 in making this determination.

In applying the guidance at Section 5.2.2.2, it is important to first determine whether the instrument is a convertible debt instrument for 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, at the issuer's discretion, the equivalent amount of cash. The guidance in ASC 815-40-25-7 through 25-30 and ASC 815-40-55-2 through 55-6 that requires giving consideration to circumstances that can require net cash settlement is not applicable to conversion options that are embedded in this type of convertible debt. For this purpose, the number of shares is considered fixed even if the conversion rate is subject to standard antidilution adjustments.

Careful attention should be given to circumstances under which the conversion rate may be adjusted, however, as it is not uncommon for convertible instruments to provide for adjustments that extend beyond standard antidilution events, in which case the requirements in ASC 815-40-25-7 through 25-30 and ASC 815-40-55-2 through 55-6 would be applicable. Standard antidilution events are defined to consist of equity restructuring events, such as a stock dividend; stock split; spinoff; rights offering; or recapitalization through a large, nonrecurring cash dividend. Adjustments that would be made in the event the issuer issues shares at a price lower than the conversion price are not standard antidilution adjustments.

3.3.2.3 Other potential embedded derivatives within debt host contracts

The following are other potential embedded derivatives within debt host contracts:

- *Default rate of interest.* ASC 815-15-25-46 makes it clear that derivative treatment is not appropriate for interest rates that are reset in the event of default, including violation of a credit-risk related covenant, a change in the debtor's published credit rating or change in creditworthiness (indicated by a change in its spread over U.S. Treasury bonds, for example). Careful consideration should be given to the default provisions within the agreement, as it is not uncommon for the default rate of interest to be triggered in circumstances that are unrelated or not directly related to the creditworthiness of the debtor.

- *Interest based on shares.* Interest payments that are based on share prices or dividends paid on shares (whether shares of the debtor or other entities) may require bifurcation if they are a derivative within the scope of ASC 815, given that these features have characteristics and risks that are associated with an equity host contract rather than a debt host contract.

- *Payments based on sales or other performance measures.* ASC 815-10-15-59 includes a scope exception to derivative recognition that applies to embedded features if the underlying on which settlement is based is specified volumes of sales or service revenues of one of the parties to the contract. While this scope exception does not apply to payments based on changes in sales or revenues due to changes in market prices, it is evident from the example at ASC 815-15-55-10 that in addition to volume of sales or service revenues, the scope exception applies to payments based on a portion of net earnings or operating cash flows. Generally, if contingent payments such as these do not require derivative recognition, they are accounted for in accordance with the guidance in ASC 470-10-25, if relevant, and if not, ASC 450.

3.3.3 Accounting treatment if derivative recognition is required

If an embedded feature, such as a conversion or redemption option, requires separate recognition as a derivative asset or liability under ASC 815, it is initially and subsequently measured and carried at fair value, with changes in fair value reflected in earnings in accordance with ASC 815-15-30 and ASC 815-10-35. (Refer to Section 2.4 for a discussion related to the initial recognition and fair value determinations.) The allocation of proceeds to separately recognized derivatives will generally result in the debt carrying amount being less than its face amount, creating a discount that should be amortized using the interest method as elaborated on at Section 3.6.

3.3.4 Accounting treatment if derivative recognition is not required

An embedded feature that does not require derivative recognition is not given separate recognition unless required under ASC 470-20. This subtopic is discussed at Section 3.4 and applies to conversion options that are not required to be accounted for as derivatives.

In the event a redemption option is exercised, extinguishment accounting should be applied. Refer to Section 3.5 for further guidance on the accounting upon conversion or extinguishment.

3.3.5 Ongoing need for reassessment of derivative conclusions

As pointed out at ASC 815-40-35-8, there is an ongoing need to reassess certain conclusions that were reached related to potential embedded derivatives. For example, reassessment would be necessary if the terms of an instrument are modified. Absent modification of any terms, the primary circumstances necessitating reassessment for debt instruments or debt host contracts relate to conversion options and conclusions reached on whether they meet the definition of a derivative, and if so, whether they qualify for the scope exception in ASC 815-10-15-74(a) by being indexed to the entity's own stock (addressed at Section 5.2.2.1) and meeting the requirements to be classified in equity (addressed at Section 5.2.2.2). Specifically, if derivative treatment hinged on the conclusion reached on whether the conversion shares are readily convertible to cash (as discussed at Section 3.3.2.2), as pointed out at ASC 815-10-55-84, this conclusion should be reassessed on an ongoing basis, given that this conclusion could change for various reasons, including an IPO, sustained changes in daily trading value, and listing or delisting of the shares on a national stock exchange. Increased trading activity could result in a conclusion that a conversion option that was initially not a derivative now is, and vice versa. In reassessing whether or not conversion options that are deemed to be derivatives qualify for the previously mentioned scope exception, ongoing consideration needs to be given to the requirements for equity classification as summarized at Section 5.2.2.2, unless the instrument is a conventional convertible debt instrument as defined earlier. If, for example, the conclusion changes related to whether an entity can demonstrate it has sufficient authorized shares to settle the conversion option, reclassification may be necessary. Additionally, there may be circumstances that cause the conclusion to change related to whether a feature is considered indexed to the entity's stock, as summarized at Section 5.2.2.1. This may be the case, for example, if the conversion terms are subject to adjustment for a limited period of time, because after the terms are no longer subject to adjustment, the conversion feature may be indexed to the entity's stock. It is generally not appropriate to reassess conclusions reached related to the first criterion discussed at Section 3.3.2.1 unless the instrument is subsequently modified.

3.3.5.1 Conversion option subsequently requires derivative recognition

If, upon reassessment, a conversion option that was not previously required to be recognized as a derivative requires derivative recognition, the fair value of that conversion option would be recognized as a liability at its fair value on that date. It would continue to be subsequently measured at fair value, with changes in fair value recognized through earnings. ASC 815-40-35-9 indicates that, in these circumstances, the derivative should be separated from the host contract (i.e., the debt carrying amount should be debited in creating the derivative liability), and we believe the discount this creates should be amortized using the interest method over the remaining life of the debt instrument.

3.3.5.2 Conversion option no longer requires derivative recognition

For a conversion option that previously was recognized as a derivative but upon reassessment no longer should be, ASC 815-15-35-4 indicates that the carrying amount of the conversion option (fair value on the reclassification date) should be reclassified from a liability to shareholders' equity without subsequent adjustment to fair value. The debt discount that was created when the conversion option was originally recognized as a derivative should continue to be amortized. In the event the holder elects to exercise the conversion option, any remaining unamortized discount should be recognized as interest expense upon conversion in accordance with ASC 815-15-40-1. If the instrument is extinguished before its stated maturity date rather than converted, the reacquisition price needs to be allocated to both the equity and debt components of the instrument to determine the gain or loss on extinguishment. Namely, a portion of the reacquisition price equal to the fair value of the conversion option at the date of the extinguishment is allocated to equity, with the remainder allocated to the extinguishment of the debt in accordance with ASC 815-15-40-4.

3.4 ASC 470-20 considerations when the debt instrument is convertible

If a conversion option embedded in a convertible instrument does not require separate recognition as a derivative, the guidance in ASC 470-20 should be considered. If convertible debt is issued at a substantial premium, it is generally appropriate to recognize the premium in its entirety as additional paid-in capital, as discussed at Section 3.4.1. Section 3.5 addresses the accounting for a convertible debt instrument when no separate recognition is warranted for the conversion option, as well as the guidance for conversion under various scenarios.

3.4.1 Convertible debt instruments issued at a substantial premium

ASC 470-20-25-13 indicates that if a convertible debt instrument is issued at a substantial premium, there is a presumption that the premium represents additional paid-in capital. We believe this should be considered only after determining that derivative recognition is not necessary for the conversion option. The intent of ASC 470-20-25-13 is somewhat of a catchall in that if, after considering the other guidance, you are left with a convertible instrument that is issued at an initial carrying amount that is significantly greater than its face, that premium should be recognized in its entirety as additional paid-in capital. A circumstance we have observed in practice relates to modifications of convertible instruments that result in extinguishment accounting under ASC 470-50, whereby the modified debt instruments are required to be measured at fair value. As a result of the conversion feature being in the money at the fair value measurement date, the instruments had a fair value that was significantly in excess of the face amount.

Example 3-1: Convertible debt issued at a substantial premium

A convertible debt instrument with a face amount of $10 million is recorded at its fair value on June 15, 20X1, as a result of a debt extinguishment. The fair value of the debt is determined in accordance with ASC 820 and estimated to be $15 million—a premium of $5 million or 50%. This premium is primarily attributable to the fact that the conversion feature is significantly in the money at the valuation date, given that the value of the shares into which the instrument can be converted was $13 million at that time. Given that the premium is substantial and attributable in part to the conversion feature being in the money, we believe it would be appropriate to record the full $5 million premium as additional paid-in capital.

"Substantial premium" is not defined; however, in practice, some have referred to ASC 470-50-40-10, which uses a threshold of a 10% change in the present value of cash flows to determine whether a modified instrument is substantially different. Applying this guidance by analogy, a premium of 10% or more (measured after allocation of proceeds to other instruments if warranted) would be considered to be substantial. We have observed instances in which without the recognition of the premium as additional paid-in capital, the accretion of the premium would more than offset the contractual interest expense, resulting in negative interest expense recognition on the debt instrument. Circumstances such as this may warrant recognition of the premium as additional paid-in capital regardless of the percentage size of the premium.

The SEC staff guidance in ASC 480-10-S99-3A also should be considered to determine whether a substantial premium recognized in equity in accordance with ASC 470-20 should be classified as temporary equity. This would be the case if, as of the balance sheet date, the issuer can be required to settle the convertible instrument for cash or other assets (i.e., the instrument is currently redeemable or convertible for cash or other assets). The portion of the equity-classified component that is presented in temporary equity (if any) is measured as the excess of the amount of cash or other assets that would be required to be paid to the holder upon redemption or conversion over the current carrying amount of the liability-classified component of the convertible debt instrument. For example, if the 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 has a carrying amount of $950, $50 of the equity-classified component should be presented as temporary equity.

3.4.2 Interest forfeiture

If the terms of a convertible debt instrument provide that any accrued but unpaid interest at the date of conversion is forfeited, that interest should be accrued or imputed to the date of conversion in accordance with ASC 470-20-35-11.

3.5 Derecognition

The guidance in this section addresses derecognition of a convertible debt instrument in the following situations:

- Conversion pursuant to the debt instrument's contractual terms when the conversion option was not separately accounted for as a derivative (Section 3.5.1)
- Conversion, modification or extinguishment of the debt instrument for which a conversion option was recognized as a derivative (Section 3.5.2)
- Conversion pursuant to an induced conversion (Section 3.5.3)
- Conversion due to the issuer's exercise of a call option (Section 3.5.4)
- Conversion not pursuant to contractual terms. (Section 3.5.5)

- Modifications or extinguishments of a convertible debt instrument (Section 3.5.6)

3.5.1 Conversion pursuant to the contractual terms when conversion option was not separately accounted for as a derivative

If the determination was made that no separate recognition was necessary for the conversion feature, when the convertible debt is converted to shares pursuant to the original conversion terms, the carrying amount of the debt inclusive of any accrued interest that is contractually converted as well as unamortized discounts, premiums or issuance costs is removed through a credit to the respective capital accounts for the shares, with no gain or loss recognized. If, in addition to shares, cash or other assets were transferred as part of this contractual conversion, the carrying amount of the converted debt would first be reduced by the amount of cash or other assets transferred in accordance with ASC 470-20-40-4 before reclassifying the remaining carrying amount of the debt to the capital accounts. If interest that is not paid upon conversion (see the discussion regarding interest forfeiture in Section 3.4.2) is not deductible for income tax purposes, any related tax benefit that may have been recognized previously should be charged to additional paid-in capital.

We believe that when conversion is pursuant to a share-settled redemption feature rather than a standard conversion option (see related discussion in Section 3.3.1), the conversion should be accounted for as a debt extinguishment as discussed in Section 3.5.5.

3.5.2 Conversion, modification or extinguishment of the debt instrument for which a conversion option was recognized as a derivative

3.5.2.1 Conversion

In circumstances where the conversion feature was required to be bifurcated and accounted for as a derivative liability at fair value, there is no equity conversion feature remaining in the debt instrument for accounting purposes. Therefore, while there may be a legal conversion of the debt, for accounting purposes both the debt host contract and the bifurcated conversion feature are subject to extinguishment accounting because these liabilities are being satisfied in exchange for shares. As such, in general, a gain or loss upon extinguishment equal to the difference between the recorded value of the liabilities and the fair value of the shares issued to extinguish them should be recorded.

Accounting for the conversion of convertible debt when the conversion feature was separately recognized as a derivative liability requires the following three steps:

1. Update the valuation of the conversion feature and any other bifurcated derivatives to the legal conversion date through earnings as necessary. (Note that if conversion occurred on the expiration date of the conversion feature, the fair value would likely be the intrinsic value on that date. Otherwise, an option pricing model that gives consideration to the remaining exercise period would generally be used to estimate the fair value. We have observed diversity in practice in that some entities adjust the conversion feature to intrinsic value rather than fair value at the conversion date. The impact to the income statement in total should be the same as the impact of adjusting the carrying value of the feature to intrinsic value rather than fair value, given that the gain or loss on extinguishment will change accordingly.)
2. Adjust the carrying value of the host debt instrument through interest expense if necessary to bring the amortization or accretion of any premiums, discounts or unamortized issuance costs up to date as of conversion.
3. Recognize the difference between the fair value of the shares that are issued in satisfaction of the debt and the updated net carrying amount of the debt (with consideration given to any remaining unamortized premiums, discounts and issuance costs) and conversion feature as an extinguishment gain or loss.

The following example illustrates the entries under the two alternatives discussed in Step 1.

Example 3-2: Accounting for the conversion of debt for which the conversion option was recognized as a derivative

Assume that debt with a face amount of $10,000 and a maturity date in 20X5 was converted in full on December 31, 20X4. The fair value of the conversion feature, estimated using an option pricing model, decreased by $100 since the most recent valuation date to $500 as of the conversion date. The intrinsic value of the conversion feature as of the conversion date was $400, determined as the excess of the value of the common shares at that date over the conversion price. A discount on the debt was created through the recognition of the conversion feature as a derivative at the issuance date. Assume that on the conversion date, the net carrying amount of the debt after the accretion of the issuance-date discount to the conversion date was $9,500.

	Adjust conversion feature to fair value		Adjust conversion feature to intrinsic value	
	Debit	**Credit**	**Debit**	**Credit**
Adjust carrying amount of derivative to conversion date value				
Derivative liability	$100		$200	
Other income		$100		$200
Record common stock at fair value and remove debt and related derivative				
Debt	$9,500		$9,500	
Derivative liability	500		400	
Loss on extinguishment	400		500	
Common stock (par and additional paid-in capital)		$10,400		$10,400
Net impact to income statement	$300		$300	

3.5.2.2 Modification or extinguishment

For a discussion of modification and extinguishment considerations related to convertible debt instruments in general, refer to Section 3.5.6 of this guide, as well as our debt modifications and restructurings guide. As is noted in ASC 470-50-40-11, the guidance in ASC 470-50-40-10 specific to conversion options does not pertain to convertible instruments for which the conversion option is separately accounted for as a derivative. As such, there is no guidance that specifically addresses the accounting for the modification of such an instrument. Given that the conversion option is separated from the debt, we believe the cash flows test in ASC 470-50-40-10 should be applied to the debt instrument, ignoring the conversion feature, particularly in those circumstances in which the conversion option requires separate recognition as a derivative both before and after the modification. Any changes in the fair value of the conversion option that are associated with a modification will be recognized in earnings as the carrying amount of the conversion option is adjusted to its fair value post modification. The extinguishment of a convertible debt instrument for which the conversion option is separately accounted for as a derivative is addressed in the example in Section 3.5.2.1.

3.5.3 Induced conversion

3.5.3.1 Accounting for an induced conversion after adoption of ASU 2024-04

Issuers may, for various reasons, decide to induce conversion of a convertible debt instrument by offering certain incentives to make conversion more attractive. An induced conversion, as defined and discussed in ASC 470-20-40-13 through 40-17, involves a situation in which the conversion privileges in a convertible debt instrument are changed, or additional consideration is paid, to debt holders for the purpose of inducing prompt conversion of the debt instrument. For example, the changed terms may involve the reduction of the original conversion price so that additional shares of stock are issued, the issuance of warrants or other securities not provided for in the original conversion terms, or the payment of cash or other consideration to those debt holders who convert during a limited period of time. To be an induced conversion, the conversion must satisfy all of the following conditions in ASC 470-20-40-13:

1. The conversion occurs pursuant to changed conversion privileges that are exercisable only for a limited period of time.
2. The conversion includes the issuance of all of the consideration (in form and amount) issuable pursuant to conversion privileges provided in the terms of the existing debt instrument, regardless of the party that initiates the offer or whether the offer relates to all debt holders.
3. The existing debt instrument, regardless of whether it is currently convertible, contained a substantive conversion feature at both the time of issuance and the date the inducement offer is accepted by the convertible debt holder.

In determining whether the conversion includes the issuance of all of the consideration issuable under the existing debt terms (the preceding item 2), an entity should compare the amount of cash or other assets and number of shares issuable under the conversion privileges provided in the terms of the existing instrument with the amount of cash or other assets and number of shares issuable under the inducement offer. When comparing the consideration issuable before and after the inducement offer, an entity should consider the guidance in ASC 470-20-40-13A.

ASC 470-20-40-13A

In applying the guidance in paragraph 470-20-40-13(b), an entity shall compare the amount of cash (or other assets) and number of shares issuable under the conversion privileges provided in the terms of the existing instrument with the amount of cash (or other assets) and number of shares issuable under the inducement offer. An entity shall consider the following:

a. For purposes of comparing the amount of cash (or other assets) and number of shares issuable, if the settlement terms under either the existing conversion privileges or the inducement offer are based on a future share price or average of future share prices (such as a volume-weighted average price), then an entity shall use the fair value of the shares as of the date the inducement offer is accepted. For example, the incorporation, elimination, or modification of a volume-weighted average price formula that is based on future share prices does not affect the determination of the amount of cash or number of shares issuable for the induced conversion assessment because the fair value of the shares as of the date the inducement offer is accepted would be used instead of the future volume-weighted average price. A future share price refers to a share price measured after the inducement offer is accepted.
b. Changes that result in the amount of cash (or other assets) and number of shares being indexed to something other than the future price of the issuer's shares (for example, the fair value of a commodity) shall be considered a change in the form of settlement.
c. If within the one-year period preceding the date the inducement offer is accepted by the convertible debt holder the existing debt has been exchanged or modified (without being deemed to be substantially different in accordance with the guidance in Subtopic 470-50), then the conversion privileges provided in the debt terms that existed one year before the date the offer is accepted by the convertible debt holder shall be used in place of the conversion privileges provided in the terms of the existing debt instrument.

When all the conditions specified in ASC 470-20-40-13 for an induced conversion are met, the issuer should recognize an expense equal to the fair value of all securities and other consideration transferred in the transaction in excess of the fair value of securities and other consideration issuable pursuant to the conversion privileges provided under the terms of the existing instrument. The fair value of the securities and any other consideration should be measured as of the date the inducement offer is accepted (normally the date the debt holder converts or enters into a binding agreement to convert.) If, on the other hand, the conditions in ASC 470-20-40-13 for an induced conversion are not met, the issuer should apply extinguishment accounting (refer to Section 3.5.5).

The following examples illustrate this accounting. For simplicity, the face amount of each security is assumed to be equal to its carrying amount in the financial statements (i.e., no original issue premium or discount exists). Example 3-3 illustrates application of the guidance on measuring the expense when a convertible debt instrument is converted pursuant to an inducement offer.

Example 3-3: Induced conversions of convertible securities – Case A: Reduced conversion price, increase in bond fair value (ASC 470-20-55-3 through 55-5)

On January 1, 19X4, Entity A issues a $1,000 face amount 10 percent convertible bond maturing December 31, 20X3. The carrying amount of the bond in the financial statements of Entity A is $1,000, and it is convertible into common shares of Entity A at a conversion price of $25 per share. On January 1, 19X6, the convertible bond has a fair value of $1,700. To induce convertible bondholders to convert their bonds promptly, Entity A reduces the conversion price to $20 for bondholders that convert before February 29, 19X6 (within 60 days).

Assuming the market price of Entity A's common stock on the date the inducement offer was accepted is $40 per share, the fair value of the incremental consideration that will be paid by Entity A is calculated as follows for each $1,000 bond that is converted before February 29, 19X6.

Value of securities issued [a]	$2,000
Value of securities issued pursuant to existing conversion privileges [b]	1,600
Fair value of incremental consideration	$400

(a) Value of securities issued to debt holders is computed as follows:

Face amount	$1,000	
÷ New conversion price	÷ $20	per share
Number of common shares issued upon conversion	50	shares
× Price per common share	× $40	per share
Value of securities issued	$2,000	

(b) Value of securities issuable pursuant to existing conversion privileges is computed as follows:

Face amount	$1,000	
÷ Existing conversion price	÷ $25	per share
Number of common shares issuable pursuant to existing conversion privileges	40	shares
× Price per common share	× $40	per share
Value of securities issuable pursuant to existing conversion privileges	$1,600	

Entity A concludes that it meets all of the criteria in paragraph 470-20-40-13. Therefore, upon conversion, Entity A records debt conversion expense equal to the fair value of the incremental consideration paid as follows.

	Debit	Credit
Convertible debt	$1,000	
Debt conversion expense	400	
Common stock		$1,400

Example 3-4, Example 3-5 and Example 3-6 illustrate application of the guidance for determining whether an inducement offer includes the issuance of all of the consideration issuable pursuant to conversion privileges provided in the terms of the existing debt instrument.

Example 3-4: Induced conversions of convertible securities – Case C: Offer to settle convertible debt instrument in cash and warrants (ASC 470-20-55-9A through 55-9D)

On January 1, 2X24, Entity A issues a $1,000 face amount 10 percent convertible bond maturing December 31, 2X33. The bond has a conversion price of $25 per share. The terms of the existing instrument require that, upon conversion, the issuer settle the principal in cash and the conversion premium in any combination of cash and shares. Under the existing conversion privileges, the total amount of cash (or the total value of the cash and shares) required to be issued upon conversion equals the product of 40 shares per $1,000 bond and a volume-weighted average price of Entity A's common stock. The volume-weighted average price is calculated over a period of 40 days beginning the day after the holder notifies the issuer that it will convert the debt instrument. On May 15, 2X27, to induce convertible bondholders to convert their bonds promptly, Entity A offers the following consideration in exchange for each $1,000 bond that is converted within 60 days (for purposes of this Example, assume the offer meets the other criteria in paragraph 470-20-40-13 and that the offer is accepted by bondholders on June 1, 2X27):

a. A cash payment equal to 40 shares multiplied by the volume-weighted average price of Entity A's common stock calculated over a period of 15 days (beginning the day after the holder accepts the inducement offer)

b. Five warrants (offered as a sweetener). Each warrant enables the holder to acquire a share of Entity A's common stock at a fixed exercise price of $40. The warrants are exercisable upon issuance and expire five years after issuance.

Assume that the fair value of Entity A's common stock on the date the inducement offer was accepted (June 1, 2X27) is $40 per share. To evaluate whether the inducement offer meets the criterion in paragraph 470-20-40-13(b), Entity A would compare the form and amount of consideration offered with the form and amount of consideration that would be issued upon conversion pursuant to the terms of the existing instrument. The conversion privileges in the existing instrument require Entity A to settle the principal in cash and permit Entity A to settle the conversion premium in any combination of cash and shares.

In this Case, the inducement offer includes the form (entirely cash) and amount ($1,600) of consideration required to settle both the principal ($1,000) and the conversion premium ($600) pursuant to the conversion privileges provided in the terms of the existing debt instrument. The amount of $1,600 is the product of 40 shares and the fair value of Entity A's shares at the offer acceptance date ($40).

The offer of warrants to induce conversion does not affect the assessment of whether the inducement offer includes the form and amount of consideration issuable under the existing conversion privileges because the existing conversion privileges did not provide for the issuance of warrants (however, the offer of warrants as a sweetener affects the measurement of the debt conversion expense recognized in accordance with paragraph 470-20-40-16). Similarly, the fact that the inducement offer changes the number of days over which the volume-weighted average price of Entity A's shares is measured does not affect whether the inducement offer includes the amount of consideration issuable under the existing conversion privileges because Entity A would use the fair value of its common stock as of the offer acceptance date to calculate the amount of cash payable under both the conversion privileges in the existing instrument and the inducement offer in accordance with paragraph 470-20-40-13A(a). Therefore, the inducement offer satisfies the criterion in paragraph 470-20-40-13(b).

Consideration Issuable Pursuant to Existing Conversion Privileges

Principal		
Cash	$1,000	
Conversion premium		
Any combination of cash and shares with a total value of $600. If $600 of the conversion premium is settled in cash, then the conversion premium would be settled as follows:		
Cash and	$600	
Shares [(a)]	0	shares

Consideration Issuable Pursuant to Inducement Offer

Cash and	$1,600	
Warrants	5	warrants

(a) Number of shares issuable pursuant to existing conversion privileges is computed as follows:

Value of 40 shares (40 shares × $40 per share as of the offer acceptance date)	$1,600	
− Face amount	−$1,000	
Value of conversion premium	$600	

Value of conversion premium	$600	
Amount of conversion premium settled in cash	−$600	
Value of conversion premium to be settled in shares	$0	

Example 3-5: Induced conversions of convertible securities – Case D: Offer to settle convertible debt instrument in cash and shares (ASC 470-20-55-9E through 55-9G)

Assume the same facts as in Case C, except that Entity A offers the following consideration (instead of the consideration listed in paragraph 470-20-55-9A):

a. A cash payment of $1,400

b. Ten shares of Entity A's common stock.

To evaluate whether the inducement offer meets the criterion in paragraph 470-20-40-13(b), Entity A would compare the form and amount of consideration offered with the form and amount of consideration that would be issued upon conversion pursuant to the terms of the existing instrument. The conversion privileges in the terms of the existing instrument require Entity A to settle the principal in cash and permit Entity A to settle the conversion premium in any combination of cash and shares.

In this Case, the inducement offer includes the form (cash) and amount ($1,000) of consideration required to settle the principal pursuant to the conversion privileges provided in the terms of the existing debt instrument. Under the existing conversion privileges, the remaining settlement value of $600 can be settled in any combination of cash and shares. If $400 ($1,400 total cash payment − $1,000 principal) of the conversion premium is settled in cash, then the inducement offer must provide for at least 5 shares ($200 remaining conversion premium ÷ $40 share price) of Entity A's common stock to provide the same form (cash and shares) and at least the same amount of cash and shares that would have been provided under the conversion privileges of the existing instrument. Because the inducement offer illustrated in Case D includes 10 shares, it would satisfy the criterion in paragraph 470-20-40-13(b). The fact that the inducement offer eliminates the volume-weighted average price formula contained in the existing conversion privileges and instead offers a specified amount of cash and shares does not affect whether the inducement offer includes the amount of consideration issuable under the existing conversion privileges because Entity A would use the fair value of its common stock as of the offer acceptance date to calculate the amount of cash payable and shares issuable under the conversion privileges in the existing instrument in accordance with paragraph 470-20-40-13A(a).

Consideration Issuable Pursuant to Existing Conversion Privileges

Principal		
Cash	$1,000	
Conversion premium		
Any combination of cash and shares with a total value of $600. If $400 of the conversion premium is settled in cash, then the conversion premium would be settled as follows:		
Cash and	$400	
Shares [(a)]	5	shares

Consideration Issuable Pursuant to Inducement Offer

Cash and	$1,400	
Shares	10	shares

(a) Number of shares issuable pursuant to existing conversion privileges is computed as follows:

Value of 40 shares (40 shares × $40 per share as of the offer acceptance date)	$1,600	
− Face amount	−$1,000	
Value of conversion premium	$600	

Value of conversion premium	$600	
Amount of conversion premium settled in cash	− $400	
Value of conversion premium to be settled in shares	$200	

Value of conversion premium to be settled in shares	$200	
÷ Price per share (as of the offer acceptance date)	÷ 40	
Number of shares issued to satisfy conversion premium	5	shares

Example 3-6: Induced conversions of convertible securities – Case E: Offer to settle convertible debt instrument in shares and warrants (ASC 470-20-55-9H through 55-9J)

Assume the same facts as in Case C, except that Entity A offers the following consideration (instead of the consideration listed in paragraph 470-20-55-9A):

a. Forty shares of Entity A's common stock

b. Five warrants (offered as a sweetener). Each warrant enables the holder to acquire a share of Entity A's common stock at a fixed exercise price of $40. The warrants are exercisable upon issuance and expire five years after issuance.

To evaluate whether the inducement offer meets the criterion in paragraph 470-20-40-13(b), Entity A would compare the form and amount of consideration offered with the form and amount of consideration that would be issued upon conversion pursuant to the terms of the existing instrument. The conversion privileges in the terms of the existing instrument require Entity A to settle the principal in cash and permit Entity A to settle the conversion premium in any combination of cash and shares.

In contrast to Case C and Case D, the inducement offer does not include the issuance of all the consideration (in form and amount) issuable pursuant to the conversion privileges included in the terms of the existing instrument. The terms of the existing instrument require settlement of the principal amount in cash, but Entity A did not offer cash consideration in the inducement offer. Therefore, Entity A would conclude that the criterion in paragraph 470-20-40-13(b) is not satisfied.

3.5.3.2 Accounting for an induced conversion prior to adoption of ASU 2024-04

Issuers may for various reasons decide to induce conversion of a convertible debt instrument by offering certain incentives to make conversion more attractive. An induced conversion, as defined and discussed in ASC 470-20-40-13 through 40-17, involves a situation in which the conversion privileges in a convertible debt instrument are changed, or additional consideration is paid, to debt holders for the purpose of inducing prompt conversion of the debt to equity securities. To be an induced conversion, the conversion must both:

- Occur pursuant to changed conversion privileges that are exercisable only for a limited period of time
- Include the issuance of all of the equity securities issuable pursuant to conversion privileges included in the terms of the debt at issuance, regardless of the party that initiates the offer or whether the offer relates to all debt holders

The changed terms may involve the reduction of the original conversion price so that additional shares of stock are issued, the issuance of warrants or other securities not provided for in the original conversion terms, or the payment of cash or other consideration to those debt holders who convert during the specified time period.

When both conditions specified in the preceding paragraph are met, the issuer should recognize an expense equal to the fair value of all securities and other consideration transferred in the transaction in excess of the fair value of securities issuable pursuant to the original conversion terms. The fair value of the securities and any other consideration should be measured as of the date the inducement offer is accepted. (This is normally the date the debt holder converts or enters into a binding agreement to convert.)

The following example from ASC 470-20-55-3 through 55-5 illustrates this accounting. For simplicity, the face amount of each security is assumed to be equal to its carrying amount in the financial statements (that is, no original issue premium or discount exists).

Example 3-7: Induced conversions of convertible securities – Case A: Reduced conversion price for conversion before determination date – bond fair value increased (ASC 470-20-55-3 through 55-5)

On January 1, 19X4, Entity A issues a $1,000 face amount 10 percent convertible bond maturing December 31, 20X3. The carrying amount of the bond in the financial statements of Entity A is $1,000, and it is convertible into common shares of Entity A at a conversion price of $25 per share. On January 1, 19X6, the convertible bond has a fair value of $1,700. To induce convertible bondholders to convert their bonds promptly, Entity A reduces the conversion price to $20 for bondholders that convert before February 29, 19X6 (within 60 days).

Assuming the market price of Entity A's common stock on the date of conversion is $40 per share, the fair value of the incremental consideration paid by Entity A upon conversion is calculated as follows for each $1,000 bond that is converted before February 29, 19X6.

Value of securities issued [(a)]	$2,000
Value of securities issuable pursuant to original conversion privileges [(b)]	1,600
Fair value of incremental consideration	$400

(a) Value of securities issued to debt holders is computed as follows:

Face amount	$1,000	
÷ New conversion price	÷ $20	per share
Number of common shares issued upon conversion	50	shares
× Price per common share	× $40	per share
Value of securities issued	$2,000	

(b) Value of securities issuable pursuant to original conversion privileges is computed as follows:

Face amount	$1,000	
÷ Original conversion price	÷ $25	per share
Number of common shares issuable pursuant to original conversion privileges	40	shares
× Price per common share	× $40	per share
Value of securities issuable pursuant to original conversion privileges	$1,600	

Therefore, Entity A records debt conversion expense equal to the fair value of the incremental consideration paid as follows.

	Debit	Credit
Convertible debt	$1,000	
Debt conversion expense	400	
Common stock		$1,400

3.5.4 Conversion due to the issuer's exercise of a call option

If an instrument becomes convertible due to the issuer's exercise of a call option and the conversion option is considered to be nonsubstantive as of the instrument's issuance date, the conversion would be accounted for as a debt extinguishment. If the conversion feature is deemed to be substantive as of its issuance date, the conversion is accounted for as a conversion; that is, there is no gain or loss recognized related to the equity securities issued to settle the instrument. By definition, a substantive conversion feature is at least reasonably possible of being exercised in the future. Instruments with extremely high conversion prices at the issuance date or that only become convertible if the issuer exercises a call option are generally considered to have conversion features that are not substantive. ASC 470-20-40-9 provides additional guidance to be used in making this determination.

3.5.5 Conversion not pursuant to contractual terms

ASC 470-50-15 does not apply to conversions that occur in accordance with the contractual terms or to induced conversions; however, it does apply to extinguishments caused by issuing stock that does not represent the exercise of a substantive conversion right contained in the terms of the debt at issuance. For example, if debt is converted into the issuer's shares pursuant to either a share-settled redemption feature or terms not contractually provided for in the note, the conversion is accounted for as a debt extinguishment under ASC 470-50. This assumes the conversion is not an induced conversion (refer to Section 3.5.3) or a troubled debt restructuring. Under extinguishment accounting, the difference between the fair value of the shares that are issued in satisfaction of the debt and the net carrying amount of the debt (with consideration given to any remaining unamortized premiums, discounts and issuance costs) is recognized as an extinguishment gain or loss. However, to the extent the borrower and lender are related entities, consideration should be given to whether the extinguishment of a loan is effectively a capital transaction between the parties. For additional guidance on the accounting for an extinguishment, refer to our debt modifications and restructurings guide.

3.5.6 Modifications or extinguishments

ASC 470-50 includes guidance specific to convertible debt in the context of modifications and extinguishments. As pointed out in ASC 470-50-15, this guidance does not apply to conversions that occur in accordance with the contractual terms or to induced conversions; however, it does apply to modifications of convertible debt and to extinguishments effected by issuing stock that does not represent the exercise of a conversion right contained in the terms of the debt at issuance.

- ASC 470-50-40-5 indicates that if debt issued with warrants is permitted to be tendered towards the exercise price of the warrants, any such tendering would be accounted for in the same manner as a conversion rather than an extinguishment.
- ASC 470-50-40-10 through 40-12 include guidance on determining how modifications to an embedded conversion option, or the addition or elimination of a conversion option, should be considered in determining if a modified debt instrument is substantially different.
- ASC 470-50-40-14 through 40-15 address how a change in the fair value of a conversion option should be accounted for if a modification occurs.

The guidance in Section 3.5.2.2 addresses modifications and extinguishments when the conversion feature was given separate recognition as a derivative. For additional guidance, refer to our debt modifications and restructurings guide.

3.6 Amortizing discounts on debt or redeemable preferred stock

ASC 835-30 requires the use of the interest method, which is defined as "the method used to arrive at a periodic interest cost (including amortization) that will represent a level effective rate on the sum of the face amount of the debt and (plus or minus) the unamortized premium or discount and expense at the beginning of each period." The use of a straight-line or other simplified approach for amortizing discounts can significantly distort the results, particularly when, as a result of allocating proceeds to other instruments, the initial carrying amount of the debt or redeemable stock is significantly less than the face amount. Here is an example illustrating this in the context of a non-amortizing debt instrument with a face amount of $5 million. The initial net carrying amount of the debt is $2 million, given that proceeds of $3 million were allocated to warrants, creating a discount on the debt. As is illustrated through this example on the next two pages, the use of the straight-line method rather than the interest method results in an overstatement of interest expense of $454,898 in the first year that reverses in the second year. The computation would be similar for redeemable stock; however, dividends (rather than interest expense) would be recognized if the redeemable stock is accounted for as equity or temporary equity.

					Interest method	
	A	B (Note 1)	C = A – B	D (Note 2)	E = F – D	F (Note 3)
Date	Principal	Unamortized discount	Net carrying amount	Contractual interest (10%)	Amortization	Total interest
1/1/2014	$5,000,000	($3,000,000)	$2,000,000			
1/31/2014	5,000,000	(2,936,193)	2,063,807	$41,096	$63,807	$104,903
2/28/2014	5,000,000	(2,873,516)	2,126,484	38,356	62,677	101,033
3/31/2014	5,000,000	(2,800,727)	2,199,273	42,466	72,789	115,255
4/30/2014	5,000,000	(2,726,468)	2,273,532	41,096	74,259	115,355
5/31/2014	5,000,000	(2,645,709)	2,354,291	42,466	80,759	123,225
6/30/2014	5,000,000	(2,563,319)	2,436,681	41,096	82,390	123,486
7/31/2014	5,000,000	(2,473,717)	2,526,283	42,466	89,602	132,068
8/31/2014	5,000,000	(2,379,259)	2,620,741	42,466	94,458	136,924
9/30/2014	5,000,000	(2,282,893)	2,717,107	41,096	96,366	137,462
10/31/2014	5,000,000	(2,178,092)	2,821,908	42,466	104,801	147,267
11/30/2014	5,000,000	(2,071,175)	2,928,825	41,096	106,917	148,013
12/31/2014	5,000,000	(1,954,899)	3,045,101	42,466	116,276	158,742
Subtotal						1,543,733
1/31/2015	5,000,000	(1,832,321)	3,167,679	42,466	122,578	165,044
2/28/2015	5,000,000	(1,715,604)	3,284,396	38,356	116,717	155,073
3/31/2015	5,000,000	(1,580,056)	3,419,944	42,466	135,548	178,014
4/30/2015	5,000,000	(1,441,771)	3,558,229	41,096	138,285	179,381
5/31/2015	5,000,000	(1,291,381)	3,708,619	42,466	150,390	192,856
6/30/2015	5,000,000	(1,137,954)	3,862,046	41,096	153,427	194,523
7/31/2015	5,000,000	(971,098)	4,028,902	42,466	166,856	209,322
8/31/2015	5,000,000	(795,198)	4,204,802	42,466	175,900	218,366
9/30/2015	5,000,000	(615,746)	4,384,254	41,096	179,452	220,548
10/31/2015	5,000,000	(420,586)	4,579,414	42,466	195,160	237,626
11/30/2015	5,000,000	(221,485)	4,778,515	41,096	199,101	240,197
12/31/2015	-	-	-	42,466	221,485	263,951
Subtotal						2,454,901
Total				$998,634	$3,000,000	$3,998,634

Note 1: Unamortized discount is computed by reducing the previous month's unamortized discount balance by the current month's amortization.

Note 2: Contractual interest is computed by multiplying the outstanding principal balance at the beginning of the month by 10%, dividing that result by 365 days and multiplying that result by the number of days in the month for which interest is payable.

Note 3: Total interest is computed by multiplying the net carrying amount at the beginning of the month by the effective interest rate (63.816%), dividing that result by 365 days and multiplying that result by the number of days in the month. (The effective interest rate was determined by solving for the rate that equates the present value of the future cash outflows to the initial net carrying amount of $2 million.) In addition, total interest for December 2015 includes an additional $4,956 for balancing purposes due to rounding.

		Straight-line method			Interest method	
		A (Note 1)	B (Note 2)	A + B		
Date	Principal	Contractual interest (10%)	Amortization	Total interest	Total interest	Difference
1/1/2014	$5,000,000					
1/31/2014	5,000,000	$41,096	$127,397	$168,493		
2/28/2014	5,000,000	38,356	115,068	153,424		
3/31/2014	5,000,000	42,466	127,397	169,863		
4/30/2014	5,000,000	41,096	123,288	164,384		
5/31/2014	5,000,000	42,466	127,397	169,863		
6/30/2014	5,000,000	41,096	123,288	164,384		
7/31/2014	5,000,000	42,466	127,397	169,863		
8/31/2014	5,000,000	42,466	127,397	169,863		
9/30/2014	5,000,000	41,096	123,288	164,384		
10/31/2014	5,000,000	42,466	127,397	169,863		
11/30/2014	5,000,000	41,096	123,288	164,384		
12/31/2014	5,000,000	42,466	127,397	169,863		
Subtotal				1,998,631	$1,543,733	$454,898
1/31/2015	5,000,000	42,466	127,397	169,863		
2/28/2015	5,000,000	38,356	115,068	153,424		
3/31/2015	5,000,000	42,466	127,397	169,863		
4/30/2015	5,000,000	41,096	123,288	164,384		
5/31/2015	5,000,000	42,466	127,397	169,863		
6/30/2015	5,000,000	41,096	123,288	164,384		
7/31/2015	5,000,000	42,466	127,397	169,863		
8/31/2015	5,000,000	42,466	127,397	169,863		
9/30/2015	5,000,000	41,096	123,288	164,384		
10/31/2015	5,000,000	42,466	127,397	169,863		
11/30/2015	5,000,000	41,096	123,289	164,385		
12/31/2015	-	42,466	127,398	169,864		
Subtotal				2,000,003	2,454,901	(454,898)
Total		$998,634	$3,000,000	$3,998,634	$3,998,634	$ -

Note 1: Contractual interest is computed by multiplying the outstanding principal balance at the beginning of the month by 10%, dividing that result by 365 days and multiplying that result by the number of days in the month for which interest is payable.

Note 2: Amortization is computed by dividing the total discount of $3 million by the number of days in the term of the debt (730) and multiplying that result by the number of days in the month.

4. Accounting for preferred and similar stock

4.1 Introduction

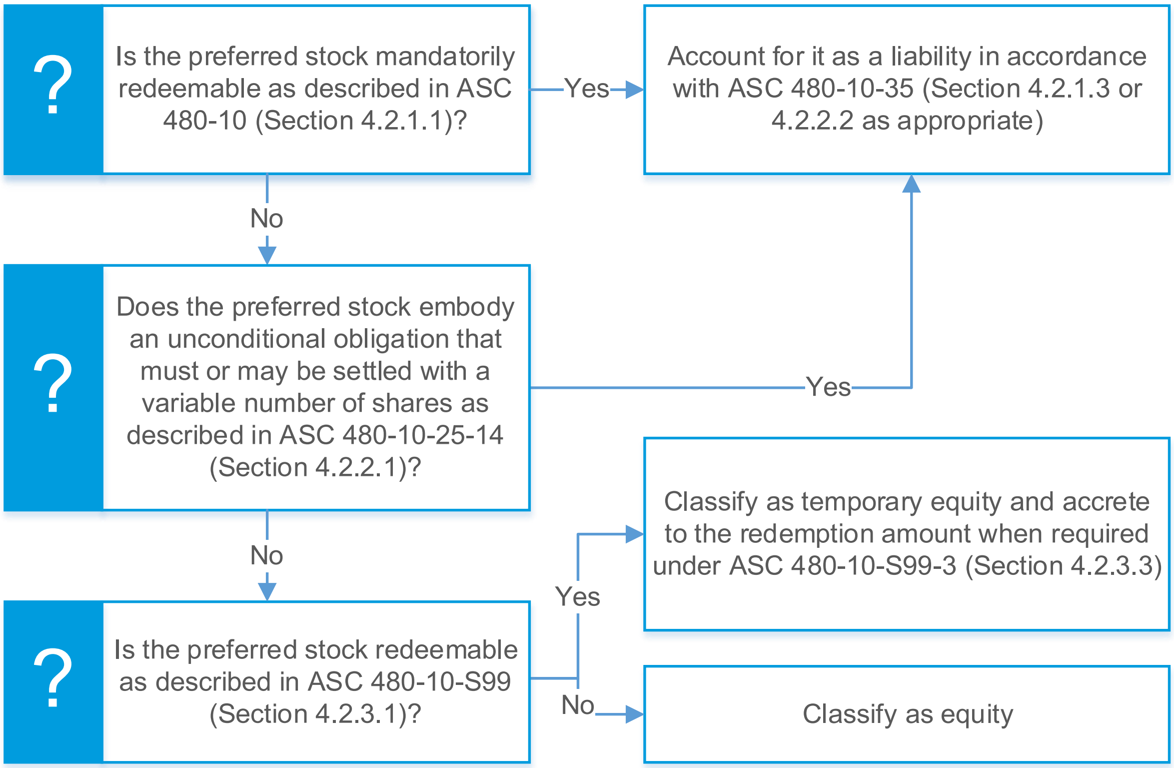
Accounting for preferred and similar stock can be complex given the need to determine the appropriate balance sheet classification and resultant subsequent measurement under ASC 480, as well as whether any feature embedded in the preferred stock instrument needs to be separately recognized as a derivative under ASC 815.

These steps are discussed in Section 4.2 to Section 4.3, respectively. This chapter also addresses the accounting for down round features, conversions, modifications and redemptions in Section 4.4; delayed issuances of preferred or other stock in Section 4.5; and dividends on preferred stock in Section 4.6. Lastly, the exhibit at the end of this chapter contains a high-level overview of the accounting for convertible preferred stock when the conversion feature is required to be separately recognized as a derivative in accordance with ASC 815 and when the conversion feature is not required to be separately recognized.

While the focus of this chapter is preferred stock, for the most part, the discussion applies to any stock issued by an entity that has features that are not found in typical common stock, including stated dividends, conversion options and provisions for redemption, regardless of the label.

4.2 Balance sheet classification and subsequent measurement

The first step in accounting for preferred stock is to determine its proper balance sheet classification by considering the guidance within ASC 480. Depending on its characteristics, preferred stock may need to be classified as debt, equity or temporary equity (also referred to as mezzanine capital). ASC 480-10 requires liability treatment for certain mandatorily redeemable stock as well as certain preferred or other instruments in the form of a share that embody an unconditional obligation that the issuer must or may settle in a variable number of its equity shares. SEC staff guidance is also included within ASC 480-10-S99 to address when temporary equity presentation is required. This thought process is summarized in the following flowchart and discussed in more depth in referenced sections that follow.



4.2.1 Mandatorily redeemable stock

4.2.1.1 Determining if a stock is mandatorily redeemable

ASC 480-10-25-4 requires liability treatment for certain mandatorily redeemable financial instruments.

> **Master Glossary – 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.

It is important to note that if an entity issues preferred shares that are redeemable at either party's option or upon the occurrence of a contingent event that is not certain to occur, the shares are not within the scope of ASC 480 because there is no unconditional obligation. In other words, redemption is not mandatory, as it is subject to a party electing to exercise the redemption option or a contingent event occurring.

In determining if an instrument is mandatorily redeemable, consider:

- As is pointed out at ASC 480-10-25-4, if redemption is required to occur only upon the liquidation or termination of the reporting entity, the instrument would not be considered mandatorily redeemable in that entity's standalone financial statements. However, it would be considered mandatorily redeemable in the consolidated financial statements if redemption is required to occur before the liquidation or termination of the reporting entity.
- If redemption is to occur upon the death or termination of the holder, the instrument would be considered mandatorily redeemable in accordance with ASC 480-10-55-4.
- As is pointed out at ASC 480-10-25-6, term extension options, provisions that defer redemption until a specified liquidity level is reached, or similar provisions that may delay or accelerate the timing of a

mandatory redemption do not affect the classification of a mandatorily redeemable financial instrument as a liability.

- In accordance with ASC 480-10-55-11, redeemable instruments that are convertible into common shares are generally not considered to be mandatorily redeemable during the period of time they are convertible because redemption is conditional upon the holder not electing to convert. As noted in the next bullet point, if the conversion option is nonsubstantive (e.g., the conversion price is extremely high in relation to the current share price), it would be disregarded.
- As is pointed out at ASC 480-10-55-12, nonsubstantive or minimal features are disregarded.
- There can be a continuous need for reassessment as instruments that are conditionally redeemable upon an event not certain to occur become mandatorily redeemable if the event occurs, the condition is resolved or the event becomes certain to occur in accordance with ASC 480-10-25-5.

The following examples adapted from ASC 480-10-55-10 through 55-12 serve to illustrate these concepts.

Example 4-1: Reclassification of stock that becomes mandatorily redeemable (adapted from ASC 480-10-55-10 through 55-12)

Conditionally redeemable shares become mandatorily redeemable

An entity issues equity shares on January 20, 20X4, that must be redeemed (i.e., 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, 20X8, there is a change in control, requiring the shares to be redeemed on June 30, 20X9. On December 31, 20X8, the entity treats the shares as mandatorily redeemable and reclassifies the shares as liabilities, measured initially at fair value. Additionally, the entity reduces equity by the amount of that initial measurement, recognizing no gain or loss.

Convertible, redeemable shares

An entity issues preferred shares with a stated redemption date 30 years hence that are convertible at the option of the holders into a fixed number of common shares during the first ten years. Those instruments are not mandatorily redeemable for the first ten years because the redemption is conditional (i.e., contingent upon the holder's not exercising its option to convert the preferred shares into common shares). If the conversion option was not substantive at issuance (e.g., the conversion price is extremely high in relation to the current share price), it would be disregarded and the preferred shares would be considered mandatorily redeemable and classified as liabilities with no subsequent reassessment of the nonsubstantive feature.

4.2.1.2 Application to private companies

ASC 480 provides a scope exception that excludes mandatorily redeemable stock issued by nonpublic entities that are not SEC registrants from the liability classification, measurement and disclosure guidance in ASC 480 unless the stock is mandatorily redeemable on fixed dates for amounts that are either fixed or are determined by reference to an external index. An example of a mandatorily redeemable instrument that would not be subject to the scope exception is an instrument that is required to be redeemed on a stated date for the original issue price plus a stated rate of dividends or a variable rate of dividends based on changes in an interest rate index. Examples of instruments that would qualify for the scope exception include those instruments that are required to be redeemed at the greater of the original issuance price or fair (or book) value at the time of redemption, given that the redemption amount is not fixed or determined by reference to an external index.

For purposes of the scope exception, an SEC registrant is defined as an entity (or an entity that is controlled by an entity) that has or will issue debt or equity securities that are traded in a public market (domestic or foreign stock exchange or an over-the-counter market), is required to file financial statements with the SEC, or provides financial statements for the purpose of issuing any class of securities in a public market.

4.2.1.3 Initial and subsequent measurement

If the preferred stock is required to be accounted for as a mandatorily redeemable instrument, it is measured initially at fair value (generally, the proceeds for which it was issued, or its allocated share of proceeds if it was issued with other freestanding financial instruments). For each subsequent reporting period, ASC 480-10-35-3 provides that the instrument is measured in one of the following ways:

- If both the amount to be paid and the settlement date are fixed, the instrument is subsequently measured at the present value of the amount to be paid at settlement, accruing interest cost using the interest rate implicit at inception.
- If either the amount to be paid or the settlement date varies based on specified conditions, the instrument is subsequently measured at the amount of cash that would be paid under the condition 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.

ASC 480-10-30-2 addresses the accounting for a conditionally redeemable instrument that becomes mandatorily redeemable and indicates that the instrument's fair value at that time would be reclassified from equity to a liability, with no gain or loss recognized. (Paid in capital would be adjusted to the extent the fair value of the liability differs from the carrying amount of the preferred instrument.) The instrument is subsequently measured in accordance with the preceding paragraph.

4.2.2 Obligations to issue a variable number of shares

4.2.2.1 Determining if the stock embodies an obligation to issue a variable number of shares

A financial instrument such as preferred stock that is in the form of an outstanding share requires liability treatment under ASC 480-10-25-14 if it embodies an unconditional 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 criteria (referred to for the remainder of this section as the three criteria):

1. A fixed monetary amount known at inception (e.g., a payable settled with the number of issuer's equity shares required to equate to a fixed amount of value)
2. Variations in something other than the fair value of the issuer's equity shares (e.g., a financial instrument indexed to the Standard & Poor's 500 index and settled with a variable number of the issuer's equity shares)
3. Variations inversely related to changes in the fair value of the issuer's equity shares (e.g., a written put option that could be net share settled)

> The following are key terms used in ASC 480-10, along with their definitions from the Master Glossary of the ASC:
>
> **Master Glossary – 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.
>
> **Master Glossary - Obligation**
>
> A conditional or unconditional duty or responsibility to transfer assets or to issue equity shares.

While it is not uncommon for preferred stock instruments to have conversion or other features that could result in the issuance of a variable number of shares, the obligation that may result in settlement in a variable number of shares needs to be unconditional and the monetary value of the obligation needs to be based solely or predominantly on one of the three criteria listed earlier. The preferred stock we have observed in practice rarely meets these requirements. However, on occasion, we have observed instruments that are required to be settled for a fixed monetary amount payable in a variable number of shares.

Example 4-2: Preferred stock requires conversion into shares worth a stated value

An entity issues preferred stock for $1,000 that unconditionally requires conversion into common shares worth $1,100 on the stated conversion date. In this situation, the number of common shares that are required to be issued varies based on the fair value of those shares at the conversion date. Regardless of changes in the fair value of the common shares, the holder will receive $1,100 of value.

Example 4-3: Preferred stock must be redeemed for cash or settled in shares (adapted from ASC 480-10-55-28)

An entity issues 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 or to settle by issuing sufficient shares of its common stock to be worth $25 per share. This obligation does not represent an unconditional obligation to transfer assets, and, therefore, is not a mandatorily redeemable financial instrument. However, it is still a liability under ASC 480 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.

The analysis becomes more complex when the monetary value ($1,100 in the first and $25 in in the second of the examples above) is not solely based on one of the three criteria, but rather is in part based on one of these criteria. Subjectivity comes into play in determining if the monetary value is based predominantly on one of these criteria because “predominantly” is not defined in ASC 480. Certain examples in ASC 480-10-55 touch on this, including ASC 480-10-55-22. In the context of the two preceding examples, if the number of common shares to be issued is determined based on an average share value over a stated period of time (e.g., 30 days before settlement), rather than the fair value of the shares at settlement, based on the example at ASC 480-10-55-22, a conclusion would be reached that while the monetary value is in small part based on variations in the fair value of the shares that can occur during the 30-day period, the monetary value is predominantly fixed. We are aware of divergent views in practice as to whether predominant should be interpreted as “more likely than not” or a higher threshold (e.g., 90%) as suggested by the use of the words “in small part” in ASC 480-10-55-22. If the instrument does embody an unconditional obligation that the issuer must or may settle in a variable number of its shares, and at issuance the monetary value is based solely or predominantly on one of the three criteria, the instrument should be accounted for as a liability. If not, the feature that could result in the issuance of a variable number of shares is evaluated to determine if it should be separately recognized as a derivative, as discussed in Section 4.3.

4.2.2.2 Initial and subsequent measurement

ASC 480-10-30 indicates the initial measurement of instruments within the scope of the guidance should be fair value, which is generally the issuance price. As indicated at ASC 480-10-35-5, financial instruments recognized as a liability based on the guidance applicable to obligations to issue a variable number of shares are generally subsequently measured at fair value, with changes in fair value recognized in earnings unless ASC 480 or another topic provides otherwise. In the examples in Section 4.2.2.1, the instruments that will be settled for a fixed monetary value are generally accounted for as stock-settled debt and accreted or amortized (as applicable) to the fixed settlement amount through interest expense in accordance with the interest method (illustrated in Section 3.6).

4.2.3 Temporary equity presentation of redeemable stock

4.2.3.1 Determining if the stock is redeemable

The guidance in ASC 480-10-S99, which was issued by the SEC staff, provides that redeemable stock that is not required to be accounted for as a liability should be reported in temporary equity rather than permanent equity and accreted to its redemption amount as elaborated on herein. While this guidance technically only applies to SEC registrants, we believe it is preferable for private companies to follow it as well.

Redeemable stock for the purpose of this guidance is defined in ASC 480-10-S99-3A to include any type of equity security that has any of the following characteristics:

- It is redeemable at a fixed or determinable price on a fixed or determinable date or dates.
- It is redeemable at the option of the holder.
- It has any condition for redemption that is not solely within the control of the issuer, without regard to probability.

Careful consideration should be given to all circumstances that could permit or require the issuer to redeem the stock. To illustrate, even an equity instrument that can be redeemed at the option of the issuer (i.e., is callable) could require temporary equity classification because, for example, the holders of the class (or similar classes) of shares control the board of directors or have majority voting rights such that they are effectively making the decision as to whether the call option is exercised.

Ordinary liquidation provisions that provide for the redemption and liquidation of all of an entity's equity instruments through the distribution of net assets upon the final liquidation or termination of the entity do not result in classification as redeemable stock. However, further consideration needs to be given to provisions that may require redemption upon the occurrence of deemed liquidation events that do not result in the liquidation or termination of the issuing entity. Deemed liquidation events may include events such as a change in control, delisting of the issuer's securities from an exchange or the violation of a debt covenant. If the issuer would or could be required to redeem one or more particular classes of equity for cash or other assets upon the occurrence of a deemed liquidation event, those instruments would be considered to be redeemable stock unless all of the holders of equally and more subordinated equity instruments of the issuer would always be entitled to also receive the same form of consideration (e.g., cash or shares) upon the occurrence of the event.

ASC 480-10-S99-3A(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).

The following table addresses common deemed liquidation events and whether such events would be considered to be within the issuer's control.

Event	Example provision	Within the issuer's control?
Change in control	Any transaction, or series of related transactions, in which shares of the company are transferred such that more than 50% of the company's voting power is transferred	No, if a purchaser could acquire a majority of the voting power without the issuer's approval
A consolidation, merger or reorganization	Any consolidation or merger of the company with or into any other company or other entity, or any other corporate reorganization, other than any such consolidation, merger or reorganization in which the share of capital stock of the company immediately prior to such consolidation, merger or reorganization continue to represent a majority of the voting power of the surviving entity	It depends upon whether the board of directors is required to approve such event and whether the holder controls the issuer (e.g., through voting shares or board representation)
A sale, transfer or disposition of all or substantially all of the assets	A sale, lease, exclusive license or other disposition of all or substantially of all of the assets of the company in one or more transactions	Yes, provided the holder cannot trigger or otherwise require the sale of the assets through board representation, or through other rights
Involuntary delisting of the issuer's securities from an exchange	The company's shares are no longer traded on a major stock exchange, including the NYSE or NASDAQ	No, the issuer does not solely control whether its securities continue to be listed on an exchange
Violation of a debt covenant	In the event that the company violates any material debt covenant under its existing loan agreements	It depends upon the nature of the debt covenant and whether the issuer solely controls the circumstances triggering the violation

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. Accordingly, all of the individual facts and circumstances surrounding events that could trigger redemption should be evaluated. For convertible instruments, this includes considering whether the issuer can control share settlement of the conversion option, with consideration given to the guidance in ASC 815-40-25, because otherwise, redemption of the instrument would be presumed. The possibility that any triggering event that is not solely within the control of the issuer could occur (without regard to probability) requires the instrument to be considered redeemable stock.

Spotlight on change:

After adoption of ASU 2020-06, an entity is no longer required to consider the following conditions in ASC 815-40-25 when determining whether share settlement is within its control:

- Settlement is permitted in unregistered shares. As amended by ASU 2020-06, a requirement to settle in registered shares would not preclude equity classification unless the contract explicitly states that an entity must settle the instrument or feature in cash if registered shares are unavailable.
- There are no counterparty rights that rank higher than shareholder rights. Even if the instrument or feature provides the counterparty with rights that rank higher than those of the holder of the underlying shares, equity classification would not be precluded.
- There is no collateral required. Equity classification would not be precluded if the contract includes a requirement to post collateral.

While ASU 2020-06 eliminated these three conditions and cash settlement is no longer presumed in such circumstances under ASC 815-40-25, corresponding changes have not been made to the SEC guidance in ASC 480-10-S99 on temporary equity classification. Specifically, there is some uncertainty around how the changes to ASC 815-40 impact the application of the SEC guidance in ASC 480-10-S99-3A in determining whether instruments that meet the requirements in ASC 815-40 for equity treatment should be classified as temporary or permanent equity in light of the scope of this SEC guidance and the requirement in ASC 480-10-S99-3A(6) to consider the guidance in ASC 815-40-25 when determining whether an issuer can control share settlement. Based on informal discussions with the SEC staff, the references in ASC 480-10-S99-3A are to the legacy guidance in ASC 815-40-25 (i.e., guidance in place prior to ASU 2020-06). Entities are encouraged to carefully consider these nuances and monitor future developments.

Examples in which temporary equity classification is appropriate

The following examples from ASC 480-10-S99-3A are useful in understanding when instruments are considered to be redeemable such that temporary equity classification is appropriate. These examples are followed by others in ASC 480-10-S99-3A demonstrating when permanent equity classification is appropriate.

Example 4-4: Temporary equity classification is appropriate (ASC 480-10-S99-3A)

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.

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.

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.

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.

Examples in which permanent equity classification is appropriate

The following examples from ASC 480-10-S99-3A are useful in understanding under what circumstances permanent equity classification is appropriate.

Example 4-5: Permanent equity classification is appropriate (ASC 480-10-S99-3A)

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.

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.

4.2.3.2 Presentation of redeemable stock

Redeemable stock (as defined earlier) should be reported between long-term debt and stockholders' equity, without a subtotal that might imply it is a part of stockholders' equity.

4.2.3.3 Initial and subsequent measurement of redeemable stock

Paragraph 12 of ASC 480-10-S99-3A indicates that the initial carrying amount of redeemable stock should be its fair value at the date of issuance (generally the proceeds for which it was issued or its allocated share of proceeds if issued with other freestanding financial instruments). The proceeds would be reduced by any separately recognized bifurcated derivatives to arrive at the initial carrying amount for the redeemable instrument. As it relates to subsequent measurement, which is addressed in paragraphs 13 through 17 of ASC 480-10-S99-3A, if the instrument is currently redeemable, it should be carried on the balance sheet at an amount not less than the maximum redemption price based on conditions that exist at the balance sheet date. If the instrument is not currently redeemable (e.g., because a contingency has not been met), but it is probable that the instrument will become redeemable (e.g., when the redemption depends solely on the passage of time), either of the following accounting methods may be used:

- Accrete changes in the redemption value over the period from the date of issuance (or, if later, from the date that it becomes probable that the instrument will become redeemable) to the earliest redemption date of the instrument using an appropriate methodology, which is usually the interest method (see illustration of this method at Section 3.6). Changes in the redemption value are considered to be changes in accounting estimates and accounted for as such.
- Recognize changes in the redemption value (e.g., fair value) immediately as they occur and adjust the carrying value 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.

If an equity instrument is not currently redeemable (e.g., because a contingency has not been met) and redemption is not probable, subsequent adjustment is not necessary until redemption is probable. In that case, disclosure should be made of why redemption is not probable. There should be consistent application of the accounting method selected, along with appropriate disclosure of the selected policy in the footnotes to the financial statements. Moreover, disclosure of the redemption value of the equity instrument as if it were currently redeemable is required for SEC registrants that elect to accrete changes in redemption value over the period from the date of issuance to the earliest redemption date.

As is indicated in paragraph 20 of ASC 480-10-S99-3A, increases and decreases to the carrying amount of the redeemable stock as a consequence of these subsequent measurement provisions are accounted for in the same manner as dividends (i.e., generally charged to retained earnings; in the absence of retained earnings, to paid in capital; and in the absence of both, to accumulated deficit). These increases and decreases also impact the earnings pre share (EPS) computation by reducing or increasing income available to common shareholders. As noted in paragraph 16(e) of ASC 480-10-S99-3A, decreases to the carrying amount would not be recognized to the extent that the decreases would reduce the carrying amount presented in temporary equity below the initial carrying amount. In other words, reductions to the carrying amount should not exceed previously recognized increases.

Application to Special-purpose Acquisition Companies (SPACs)

In their IPOs, SPACs often issue shares that include provisions for redemption that result in the class of shares being presented in temporary equity. Specifically, the shares are redeemable if the SPAC does not complete a business combination by a specified date or the holder elects to be redeemed if the SPAC does complete a business combination. Typically, there also is a provision within the SPAC's charter requiring net tangible assets be maintained above a certain minimum level (e.g., $5 million). Some entities had concluded that the provision to maintain a minimum level of net tangible assets effectively limits the redemption of the redeemable shares, and as such classified that minimum amount in permanent equity. However, the SEC staff has objected to this position indicating that, since each individual share is redeemable, there is no support pursuant to ASC 480-10-S99 to exclude this amount from temporary equity.

If the redemption provisions lapse upon completion of the business combination, shares that remain outstanding may then qualify for permanent equity classification (i.e., if no other features of the shares or circumstances require temporary equity classification under the guidance in ASC 480-10-S99).

4.3 Derivative analysis of embedded features

4.3.1 Overview

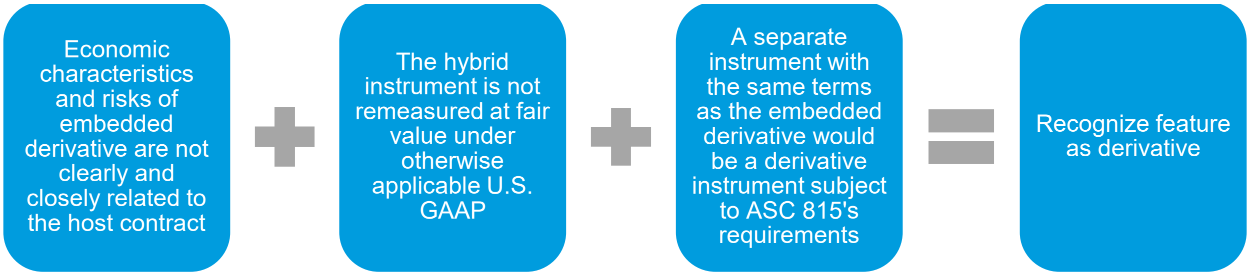
It is common for preferred stock to have embedded features that may require separate recognition as derivatives. The most common features within preferred stock that are observed in practice and sometimes require derivative recognition are conversion and redemption options. Hence, the focus of this section is on these features. However, there may be other features within a preferred stock instrument that necessitate similar consideration. The focus should be on features that can alter the amount or timing of cash flows or value of other exchanges (e.g., conversion shares).

RSM COMMENTARY: Distinguishing between conversion and redemption options

Standard conversion options allow for conversion of the preferred stock instrument into a fixed or substantially fixed number of shares of another class or series. Standard redemption options give the holder the right to put the shares to the issuer (or the issuer the right to call the shares from the holder) at a stated amount, to be paid typically in cash (or, in some cases, shares). Some instruments provide for conversion into a variable number of shares, the number to be determined at the time of conversion based on the fair value of the conversion shares at the conversion date to ensure that the holder receives a predetermined amount of value paid in whatever number of conversion shares it takes to arrive at that value. Assuming that this feature does not result in classification as stock-settled debt under ASC 480-10-25-14, as discussed at Section 4.2.2, we believe it would generally be appropriate to analyze this feature as a redemption option rather than a conversion option.

The determination of which embedded features must be separately recognized as derivatives is complex and is addressed in ASC 815. Specifically, ASC 815-15-25-1 requires derivative recognition for embedded features if all of the following three criteria 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 generally accepted accounting principles.
3. A separate instrument with the same terms as the embedded derivative would be a derivative instrument subject to the requirements of ASC 815. (In other words, it meets the definition of a derivative and does not qualify for one of the scope exceptions outlined at ASC 815-10-15-13.)



4.3.2 Criterion 1 of embedded derivative analysis

The first criterion of the embedded derivative analysis necessitates consideration of whether the economic characteristics and risks of the embedded derivative are clearly and closely related to the economic characteristics and risks of the host contract. When analyzing embedded features within preferred stock under this criterion, an evaluation needs to be performed to determine if the preferred stock is more akin to debt or equity. This determination is not based on the balance sheet classification of the instrument, but rather a subjective evaluation and weighting of all relevant terms and features of the instrument. That being said, it would be rare for an instrument that is required to be classified as a liability to be considered more akin to equity. The significance of this determination is that if the instrument is overall deemed to be more debt-like, equity features such as a conversion option would meet the first criterion. Conversely, if the instrument is overall deemed to be more equity-like, debt-like features such as a redemption option would meet the first criterion. It should also be noted that the conclusion on whether the preferred stock is more equity-like or debt-like can also impact the analysis of the third criterion, which is elaborated on later.

4.3.2.1 Determining the nature of the host contract

The analysis of the nature of the preferred stock host contract should be based on all stated and implied substantive terms and features, with each term and feature evaluated to determine if it is more debt-like or equity-like and weighted on the basis of relevant facts and circumstances in existence at the date of issuance. The template that follows is provided as a tool in evaluating and weighting features commonly associated with preferred stock to arrive at a conclusion on the nature of the host contract as more debt-like or equity-like.

Factors to consider	Insights on weighting certain factors	Analysis
Redemption rights (generally debt-like characteristic)		
Is redemption mandatory or contingent?	A mandatory redemption right would be given more weight. The weight placed on a contingent redemption right would be commensurate with the likelihood of redemption being triggered.	
Who holds the redemption right?	A redemption right held by an investor would be given more weight than if held by the issuer.	
Is the redemption right in the money or out of the money?	An in-the-money right would be given more weight.	

Factors to consider	Insights on weighting certain factors	Analysis
Is a conversion option also provided, and if so, how favorable is this option in comparison to the redemption right?	Less weight would be placed on a redemption right if the conversion option was more favorable.	
Are there legal restrictions or solvency factors that would prohibit the issuer from redeeming the instrument?	Such restrictions and factors would reduce the weight placed on the redemption right.	
Are there issuer-specific considerations that make redemption unlikely (e.g., is the issuer thinly capitalized or unprofitable)?	Such considerations would reduce the weight placed on the redemption right.	
Conversion rights (generally equity-like characteristic unless settlement will be in a variable number of shares designed to result in a fixed amount of value)		
Who holds the conversion right?	A conversion right held by an investor would be given more weight than if held by the issuer.	
Is conversion mandatory?	More weight would be placed on a mandatory conversion right.	
Is the conversion right contingent?	Less weight would be placed on a contingent conversion right, commensurate with the likelihood of it not being triggered.	
Is the conversion right in the money or out of the money?	An in-the-money conversion right would be given more weight.	
If the instrument is also redeemable, what is more likely to occur first, conversion or redemption?	Less weight would be placed on the conversion right if redemption was more likely to occur first.	
Rights upon liquidation		
Is there a stated liquidation preference?	If so, the liquidation right is a debt-like characteristic.	

Factors to consider	Insights on weighting certain factors	Analysis
Does the holder participate in the residual value of the entity?	If so, the liquidation right is an equity-like characteristic.	
Voting rights (equity-like characteristic weighted commensurately with the level of influence the rights provide)		
Does the holder have voting rights and if so, are they entitled to vote on all or limited matters?		
How much influence can the holder's class of stock exercise based on its voting rights?		
Dividend rights		
Are the dividends mandatory or discretionary?	Mandatory dividends are a debt-like characteristic, while discretionary dividends are an equity-like characteristic.	
Are the dividends stated or participating?	Stated dividends are a debt-like characteristic, while participating dividends are an equity-like characteristic.	
Are the dividends cumulative or noncumulative?	Cumulative dividends are a debt-like characteristic, while noncumulative dividends are an equity-like characteristic	
Protective covenants (debt-like characteristic weighted commensurately with the level of protection the covenants provide)		
Are there collateral requirements akin to collateralized debt?		
If the instrument contains a redemption option held by the investor (holder), is the issuer's performance upon redemption guaranteed by the parent of the issuer or otherwise?		
Does the instrument provide the holder with certain rights akin to creditor rights (e.g., the ability to force bankruptcy or a preference in liquidation)?		

Factors to consider	Insights on weighting certain factors	Analysis
Conclusion (In light of the factors to consider and the most likely outcome of the instrument, conclude as to the nature of the preferred stock host contract as more debt-like or equity-like and the weight placed on the various features in reaching that conclusion.)		

4.3.2.2 Determining if the economic characteristics and risks are clearly and closely related

Once a conclusion is reached on the nature of the preferred stock host contract, the determination can be made as to whether or not each embedded feature has economic characteristics and risks that are clearly and closely related to the economic characteristics and risks of the host contract to address the first criterion. The following table helps to illustrate this in the context of conversion and redemption options which are the most common features within preferred stock that may require derivative treatment. If the preferred stock host contract is deemed to be more debt-like in nature, the embedded derivatives should be evaluated as outlined in Chapter 3 beginning at Section 3.3.2.

	Conversion option	Redemption option
Debt-like host	Not clearly and closely related	May be clearly and closely related (See Section 3.3.2.1)
Equity-like host	Clearly and closely related	Not clearly and closely related

4.3.3 Criterion 2 of embedded derivative analysis

The second criterion of the embedded derivative analysis (i.e., the hybrid instrument is not remeasured at fair value under otherwise applicable U.S. GAAP) is generally met for preferred stock unless the instrument is required to be accounted for as a liability and is subsequently measured at fair value. If the instrument is required to be accounted for as a liability but not subsequently measured at fair value, the embedded derivatives should be evaluated as outlined in Chapter 3 beginning at Section 3.3.2.

4.3.4 Criterion 3 of embedded derivative analysis

4.3.4.1 Determining if the feature is a derivative

Addressing the third criterion of the embedded derivative analysis (i.e., a separate instrument with the same terms as the embedded derivative would be a derivative instrument subject to the requirements of ASC 815) involves determining if the embedded feature meets the definition of a derivative as outlined beginning at ASC 815-10-15-83, and if so, whether it qualifies for one of the scope exceptions outlined at ASC 815-10-15-13.

RSM COMMENTARY: Understanding the terminology

By definition, a derivative instrument has all of the following characteristics:

- One or more underlyings
- One or more notional amounts or payment provisions
- 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 can be settled net by any of the following means:

- Its terms implicitly or explicitly require or permit net settlement.
- It can readily be settled net by a means outside the contract.
- It provides for delivery of an asset that puts the recipient in a position not substantially different from net settlement.

While an in-depth discussion of derivatives is beyond the scope of this guide, the following table provides an indication of whether each characteristic would likely be met for standard conversion and redemption options in preferred stock instruments, and if so, the scope exception outlined at ASC 815-10-15-13 for which it may qualify. For further guidance on derivatives, refer to our publication, A guide to accounting for derivatives and hedge accounting.

Characteristic	Conversion option	Redemption option
Underlying	Yes, fair value of the shares into which it can be converted	Yes, fair value of the preferred stock
Notional amount or payment provision	Yes, number of shares into which it can be converted	Yes, redemption price
No or smaller initial net investment	Yes, the fair value of the conversion option at inception is generally less than the fair value of the underlying shares	Yes, the fair value of the redemption option at inception is generally less than the fair value of the underlying stock
Net settlement	Yes, if the conversion shares are readily convertible to cash or contractually the conversion option can be settled net	Yes, if the host contract is debt-like due to ASC 815-10-15-107 Yes, if the host contract is equity-like and the redeemable shares are readily convertible to cash or contractually the redemption option can be settled net
Scope exception that may be relevant	ASC 815-10-15-74(a), if the conversion option is indexed to the issuer's stock and classified in stockholders' equity as defined in ASC 815-40 and discussed at Section 5.2.2.1 and Section 5.2.2.2	ASC 815-10-15-74(a), if the host contract is equity-like and the redemption option is indexed to the issuer's stock and classified in stockholders' equity as defined in ASC 815-40 and discussed at Section 5.2.2.1 and Section 5.2.2.2 If the host contract is debt-like, redemption options would generally not qualify for an exception, but may be clearly and closely related to the host contract in the first criterion

As demonstrated in this table, conversion options typically meet the definition of a derivative if net settlement exists, either contractually or because the shares that would be delivered (conversion shares) if the option is exercised are readily convertible to cash. Contractual net settlement could result from a provision for the holder to receive the as-converted value in cash. For example, this may exist in the form of a put or redemption option that allows the holder to receive the fair value of the instrument or the as-converted value in cash.

Example 4-6: Contractual net settlement

Convertible preferred stock issued for $1,000 is redeemable in five years at the holder's option at a redemption price that is equal to the greater of the $1,000 original issuance price or the as-converted value. Because the holder has the ability to get the as-converted value in cash, we believe this effectively creates net settlement for the conversion option. The ability for redemption at the original issuance price would generally be evaluated separately as a redemption option.

If contractual net settlement does not exist for a conversion option, consideration should be given to whether the conversion shares are readily convertible to cash. This typically depends on whether the shares are publicly traded and if so, the daily transaction volume.

RSM COMMENTARY: Are the shares readily convertible to cash?

The determination of whether the shares are readily convertible to cash needs to be considered on an ongoing basis throughout a contract's life. Delisting, an IPO or significant changes in the level of trading activity are examples of factors that could influence the conclusion, as consideration needs to be given to whether the smallest increment of shares that would be delivered in accordance with each individual contract is small relative to the daily transaction volume. Assume, for example, that a preferred share can be converted at a conversion price that would result in the issuance of 100,000 shares of publicly traded common stock. The average daily trading volume associated with the common stock is 50,000 shares. If each share of preferred stock could only be converted in total, the 100,000 shares into which it would be exchanged is large relative to the daily transaction volume, and the common shares would not be considered to be readily convertible to cash. Many instruments permit conversion in whole or in part (i.e., in whatever increment the holder elects), in which case, generally, the common shares would be considered to be readily convertible to cash if they are actively traded. Refer to the guidance beginning at ASC 815-10-15-130 and Example 7 beginning at ASC 815-10-55-99 for additional information.

If a conclusion is reached that the conversion feature is a derivative and the preferred stock is debt-like, consideration would next be given to ASC 815-40 to determine if it qualifies for an exception to the derivative requirements by being indexed to the issuer's stock and classified in stockholders' equity. Refer to the guidance in Section 5.2.2.1 and Section 5.2.2.2. If the preferred stock is equity-like, a conversion feature would be considered clearly and closely related such that Criterion 1 of the embedded derivative analysis is not met and derivative treatment is not required. Section 4.3.5 summarizes the accounting treatment if derivative recognition is required.

As the table demonstrates, redemption options in debt-like preferred stock host contracts typically meet the definition of a derivative, given that ASC 815-10-15-107 states that the net settlement component of a derivative exists for put and call options in debt instruments. As such, the analysis generally hinges on the first criterion in the embedded derivative analysis (i.e., the determination of whether the economic characteristics and risks associated with the redemption option are clearly and closely related to the economic characteristics and risks of the host contract). For this analysis, refer to the discussion in Section 3.3.2.1. As is evident from ASC 815-10-15-109, this net settlement guidance does not apply to redemption options in equity-like host contracts. As such, these features in an equity-like host contract would not meet the definition of a derivative unless contractual net settlement exists or the shares subject to the redemption option are readily convertible to cash as discussed earlier. If a redemption option in an equity-like host does meet the definition of a derivative, consideration would next be given to whether it qualifies for an exception to derivative recognition by being indexed to the issuer's stock and classified in stockholders' equity. Refer to Section 5.2.2.1 and Section 5.2.2.2 for this analysis.

In the event it is determined that the conversion option does not require separate recognition as a derivative, the instrument is accounted for in the same manner as a nonconvertible security.

4.3.5 Accounting treatment if derivative recognition is required

If an embedded feature such as a conversion or redemption option requires separate recognition as a derivative asset or liability under ASC 815, it is initially and subsequently measured and carried at fair value, with changes in fair value reflected in earnings in accordance with ASC 815-15-30 and ASC 815-10-35. For additional information related to the initial recognition and fair value determinations, refer to Section 2.4 or Section 2.5 of this guide, as applicable. The allocation of proceeds to separately recognized derivatives will generally result in the initial preferred stock carrying amount being less than its stated preference upon liquidation or redemption, in effect creating a discount that may need to be amortized as elaborated on in Section 4.2.3.3.

4.3.6 Ongoing need for reassessment of derivative conclusions

As pointed out at ASC 815-40-35-8, there is an ongoing need to reassess certain conclusions that were reached related to potential embedded derivatives. For example, reassessment would be necessary if the terms of an instrument are modified. Additionally, if derivative treatment for a conversion or redemption option hinged on the conclusion of whether the shares that would be converted or redeemed are readily convertible to cash as discussed at Section 4.3.4.1, this conclusion should be reassessed on an ongoing basis because, as pointed out at ASC 815-10-55-84, the conclusion could change for various reasons including an IPO, sustained changes in daily trading value, and listing or delisting of the shares on a national stock exchange. Increased trading activity could result in a conclusion that a conversion or redemption option that was initially not a derivative now is and vice versa. (Note that if a conversion option is embedded in an equity-like host contract, it would typically not meet Criterion 1 discussed in Section 4.3.2, in which case, derivative treatment would not hinge on whether the conversion shares are readily convertible to cash.) In reassessing whether or not conversion and redemption options that are deemed to be derivatives qualify for the scope exception mentioned earlier, ongoing consideration needs to be given to the requirements for equity classification as summarized at Section 5.2.2.2. If, for example, the conclusion changes related to whether an entity can demonstrate it has sufficient authorized shares to settle the conversion option, reclassification may be necessary. Additionally, there may be circumstances that cause the conclusion to change related to whether a feature is considered indexed to the entity's stock (addressed at Section 5.2.2.1). This may be the case, for example, if the conversion terms are subject to adjustment for a limited period of time, as after the terms are no longer subject to adjustment, the conversion feature may be indexed to the entity's stock. It is generally not appropriate to reassess conclusions reached related to Criterion 1 discussed at Section 4.3.2 unless the instrument is subsequently modified.

4.3.6.1 Embedded feature subsequently requires derivative recognition

If upon reassessment an embedded feature that was not previously required to be recognized as a derivative requires derivative recognition, the fair value of that feature would be reclassified to an asset or liability (as appropriate) at its fair value on that date. It would continue to be subsequently measured at fair value with changes in fair value recognized through earnings. ASC 815-40-35-9 indicates that "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."

4.3.6.2 Bifurcated feature no longer requires derivative recognition

If a bifurcated feature that had been recognized as a derivative no longer should be upon reassessment, the carrying amount of the feature (fair value on the reclassification date) should generally be reclassified to shareholders' equity without subsequent adjustment to fair value. This presumes the preferred stock is classified as equity. If, instead, the instrument is mandatorily redeemable preferred stock classified as a liability under ASC 480-10-25-4, reference should be made to the guidance in Section 3.3.5.2.

4.4 Subsequent accounting considerations for preferred and similar stock

4.4.1 Accounting upon triggering a down round feature

Master Glossary – 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.

ASC 260-10-25-1 and ASC 260-10-30-1 provide guidance relevant to convertible preferred stock (if the conversion feature has not been bifurcated), with down round features. This guidance applies only to entities that are required to or voluntarily present EPS. Each time a down round feature is triggered (i.e., the strike price is reduced) for one of these instruments, the effect (value created) is accounted for by an entity that presents EPS as a dividend through a reduction to retained earnings and an increase to the instrument's carrying amount. This amount also reduces income available to common shareholders in basic EPS.

The amount to be recognized as a dividend each time a down round feature is triggered is the difference between the following two amounts, determined in accordance with ASC 820 immediately after the down round feature is triggered:

1. The fair value of the financial instrument (ignoring the down round feature) with the strike price that was in effect before the strike price reduction
2. The fair value of the financial instrument (ignoring the down round feature) with the reduced strike price resulting from the down round being triggered

Section Subsequent measurement considerations for freestanding equity-classified financial instruments with down round features provides an example of this accounting in the context of an adjustment to the strike price of warrants. It should be noted that, while the down round feature is ignored when determining the fair value of the instrument for the purpose of this computation, all features of an instrument (including a down round feature) should be considered when it is necessary to determine the fair value of an instrument for other purposes (such as to establish its initial carrying amount). Additionally, this accounting does not apply to liability-classified convertible instruments.

4.4.2 Conversion of preferred stock in accordance with its contractual terms

When convertible preferred stock or other shares are converted to a different class of equity securities (such as common stock) pursuant to the original conversion terms, the net carrying amount of the converted stock (adjusted as necessary for accretion through the conversion date) is generally debited, with that amount credited as appropriate to the par value and additional paid-in capital accounts for the shares into which the instrument was converted in accordance with ASC 470-20-40-4.

There is no specific guidance to address the contractual conversion of preferred or other stock in circumstances where the conversion feature was required to be bifurcated and accounted for as a derivative liability at fair value. While there may be a legal conversion of the instrument, we believe this should be viewed as an extinguishment. Given that the convertible instrument is equity classified or temporary-equity classified rather than liability classified, the extinguishment is accounted for under ASC 260-10-S99-2 rather than ASC 470-50. A method of accounting that we believe would be appropriate is illustrated through the entries that follow. Assume that the fair value of the conversion option immediately prior to conversion is $5,000 and the recorded balance is $4,000. The carrying amount of the preferred stock is $50,000 and the value of the common stock issued upon conversion is $53,000 on the conversion date.

Adjust the carrying amount of the derivative to its pre-conversion fair value

	Debit	Credit
Other expense	$1,000	
Conversion option derivative liability		$1,000

Record the conversion of the preferred stock

	Debit	Credit
Conversion option liability	$5,000	
Preferred stock	50,000	
Common stock (par) and additional paid-in capital		$53,000
Equity (return from preferred holder)		2,000

As these entries illustrate, the conversion feature and other bifurcated derivatives (if any) associated with the converted amounts would be adjusted to the conversion-date fair value through earnings. The carrying amount of both the preferred shares that were converted and the associated bifurcated derivatives would then be written off and common or other stock into which the instrument converted (conversion shares) credited for the conversion date fair value of the conversion shares. Any difference between the carrying amount of the converted preferred stock (and related derivatives) and fair value of the conversion shares is accounted for similar to a dividend to or return from preferred stockholders and subtracted from or added to net income to arrive at income available to common stockholders in the calculation of EPS.

4.4.3 Induced conversions of preferred stock

If convertible preferred stock is converted into other securities pursuant to an inducement offer as described in Section 3.5.3, the excess of the fair value of the securities and other consideration transferred in the transaction over the fair value of securities issuable pursuant to the original conversion terms, if any, should be accounted for similar to a dividend on preferred stock, as elaborated on in ASC 260-10-S99-2. (Refer to the illustration in Section 3.5.3; however, rather than debiting expense, retained earnings is debited for the preferred stock dividend, which will reduce income available to common stockholders in the calculation of EPS.) Refer also to the discussion that follows.

4.4.4 Modification, extinguishment and redemption of preferred stock instruments (including conversion of instruments for which the conversion feature was bifurcated as a derivative)

4.4.4.1 Overview and accounting for redemptions

SEC staff guidance codified at ASC 260-10-S99-2 addresses the redemption and induced conversions of equity-classified preferred stock (including those instruments classified as temporary equity), as well as modifications and exchanges of these instruments that are accounted for as extinguishments. While this is SEC staff guidance, we believe it would generally be appropriate for non-SEC reporting entities to also consider it, given the lack of other guidance. The guidance contained within ASC 260-10-S99 requires that redemptions of preferred stock should be accounted for in a similar manner to the treatment of dividends, with the difference between the fair value of the consideration transferred to the preferred stockholders and the net carrying amount of the preferred stock subtracted from (or added to) net income to arrive at income available to common stockholders in the EPS calculation.

While the guidance in the previous paragraph does not specifically address the accounting in circumstances in which the instrument being redeemed has embedded features that were bifurcated and are accounted for as derivatives, we believe a reasonable approach would be to continue to adjust the derivatives to fair value through earnings to the redemption date and include the then-current fair value of the bifurcated derivatives in the carrying value of the preferred stock in the calculation described in that paragraph. As indicated in Section 4.4.2, similar accounting should generally be applied in circumstances involving the conversion of preferred stock where the conversion feature had been bifurcated and is accounted for as a derivative.

4.4.4.2 Determining if a modification or exchange is an extinguishment

The accounting prescribed in ASC 260-10-S99-2 also applies to modifications and exchanges of equity or temporary-equity classified preferred stock instruments that are accounted for as extinguishments. While guidance exists in ASC 470-50 to address the accounting for debt modifications, including preferred stock that is accounted for as a liability, there is no comparable guidance to address the accounting for modifications to preferred stock instruments that are accounted for as equity or temporary equity, which necessitates the subjective determination of whether a modification or exchange represents an extinguishment. This issue was discussed by SEC staff member T. Kirk Crews in a speech he gave at the 2014 Forty-Second AICPA National Conference on Current SEC and PCAOB Developments. His view was that the legal form and whether or not new preferred stock is issued should not be viewed as determinative factors, but rather one data point that should be considered in the overall analysis. Based on the observations outlined in the speech, the following acceptable approaches have been employed in practice:

- **Qualitative approach (most common):** Consider the significance of any contractual terms added, removed or changed, as well as the business purpose for the changes and how the changes may influence the economic decisions of the investor. “If these changes are judged to be significant, the amendments or exchange would be treated as an extinguishment; otherwise, the changes are considered a modification to the preferred stock.”
- **Fair value approach:** If the amendments result in a 10% or greater change in the fair value of the preferred stock, it is “considered substantially different and the amendment or exchange would be accounted for as an extinguishment. If the change is less than 10% the preferred stock was simply modified.”
- **Cash flow approach:** This approach is similar to the fair value approach, except that contractual cash flows are evaluated, rather than the fair value, similar to the approach outlined in ASC 470-50 for debt modifications.

We would generally expect the cash flow approach to be applied only when the preferred stock has well-defined periodic cash flows.

4.4.4.3 Accounting for extinguishments and modifications

If the conclusion is reached that an extinguishment occurred, the transaction is accounted for under ASC 260-10-S99-2, as described at Section 4.4.4.1. On the other hand, modifications are generally accounted for by analogy to the guidance in ASC 718-20-35, which is applicable to modifications of stock-based compensation instruments classified as equity. This would result in the excess of the fair value of the preferred stock as modified over the fair value of the preferred stock immediately prior to modification, if any, to generally be reflected as a deemed dividend to the preferred holders, which would impact income available to common shareholders for purposes of calculating EPS. In certain circumstances, it may be appropriate to reflect the debit as an expense (e.g., compensation for agreeing to restructure). Given the lack of guidance and multiple approaches applied in practice in evaluating modifications and concluding if an extinguishment occurred, we recommend that reporting entities have a rational basis for the approach followed as well as consistently apply that approach where warranted by similar facts and circumstances. In addition, the approach followed by the entity should be disclosed.

4.5 Delayed issuance of preferred or other stock

4.5.1 Overview

Entities occasionally enter into arrangements to issue shares to investors at subsequent dates. These arrangements are typically entered into contemporaneously with a current issuance or sale of shares. While the discussion that follows is focused on issuances of preferred stock, where such an arrangement most commonly exists in practice, the same concepts generally apply to issuances of common stock. The delayed issuance of preferred stock may be mandatory or optional. Such arrangements are often contingent upon the company completing milestones, such as a specified phase in a clinical trial, and are most often encountered in the pharmaceutical, biotech and technology sectors. These arrangements may also be referred to as tranche preferred share issuances. The following is an example of one such arrangement incorporated into a stock purchase agreement.

Example 4-7: Delayed issuance of preferred stock

Upon the achievement of the Milestone (as defined), the Company shall sell, and the Purchaser shall purchase, 200,000 shares of Series B-2 Preferred Stock of the Company, at a price of $15.00 per share.

In this example, the Company is obligated to sell, and the investor is obligated to purchase, shares at a fixed price at a later date. Other arrangements may obligate only one party to the transaction, which would be the case in this example if the Company could decide whether or not to request the delayed issuance. In other circumstances commonly observed, entities extend rights to participate in future offerings such that if the entity subsequently conducts an equity offering, pre-existing investors will have the right to participate in the future offering on the same terms as new investors. This latter arrangement generally does not require upfront accounting recognition, given that the entity is not obligated to conduct a subsequent offering, nor is the investor obligated to participate if a subsequent offering occurs. However, it should be noted that in those circumstances where one or both parties is contractually obligated (contingently or otherwise) to sell or purchase shares at a future date at a pre-established price, separate accounting treatment for this right or obligation may be necessary. In determining the appropriate accounting for such an arrangement, it is necessary to first determine whether the arrangement would be considered a freestanding or embedded financial instrument.

4.5.2 Determining if the future tranche right is freestanding or embedded

As defined in ASC 480, a freestanding financial instrument is a financial instrument that is either:

- Entered into separate and apart from any of the entity's other financial instruments or equity transactions
- Entered into in conjunction with some other transaction and is legally detachable and separately exercisable

Given that delayed issuances of preferred stock are typically entered into in conjunction with an initial preferred stock issuance, it will generally be necessary to consider whether the arrangement is considered to be legally detachable and separately exercisable. In the context of a future right or obligation to issue preferred shares in a later tranche entered into in conjunction with an initial preferred stock issuance, if either the initial preferred shares or the future right (or obligation) to issue preferred shares (referred to hereafter as the future tranche right) can be legally detached (e.g., sold or transferred) and separately exercised, then the instrument would be considered freestanding. In other words, if the holder is not contractually restricted from having the ability to sell the initial preferred shares while retaining the future tranche right, or vice versa, the instruments would likely be considered freestanding. Consideration must also be given to whether the initial preferred shares would remain outstanding upon exercise of the future tranche right, which is typically the case. If the initial preferred shares can only be sold or transferred along with the future tranche right, the instruments would typically not be viewed as freestanding. A careful assessment of all contractual restrictions or provisions related to the transfer of these instruments is necessary.

4.5.3 Accounting analysis for freestanding future tranche rights

If the future tranche right is considered to be freestanding, it should be evaluated in accordance with Chapter 5 to determine its classification as an asset, liability or equity. This entails giving consideration to ASC 480 and ASC 815-40. Under ASC 480, a financial instrument (other than a share) would be classified as a liability if it embodies an obligation, either conditional or unconditional, to repurchase the issuer's equity shares. Accordingly, if the arrangement conditionally or unconditionally obligates the entity (as opposed to giving the entity the option) to issue preferred or other shares that contain a redemption feature (that is not within the entity's control), that would necessitate liability classification of the future tranche right or obligation and the instrument would be measured in accordance with ASC 480-10-30 and ASC 480-10-35.

If the determination is made that the future tranche right is not a liability under ASC 480, the freestanding instrument must next be analyzed under ASC 815 to determine its balance sheet classification and to determine whether the instrument is a derivative in its entirety. As noted at ASC 815-40-15-5, the classification guidance in ASC 815-40 should be considered for all freestanding financial instruments that are potentially settled in an entity's own stock that are not accounted for under ASC 480, regardless of whether the instruments meet the definition of a derivative. ASC 815-40 contains the requirements for an instrument to be indexed to a company's own stock and classified in stockholders' equity, which are also discussed in Chapter 5. As is further noted in Chapter 5, the classification under ASC 815 should be reassessed at each balance sheet date.

If the future tranche right is required to be accounted for as an asset or liability and continuously adjusted to fair value through earnings, in allocating the initial proceeds from the preferred stock issuance, proceeds would first be allocated to the future tranche right based on its fair value and the remaining proceeds would be allocated to the initial preferred shares.

If the future tranche right does not require ongoing fair value measurement as an asset or liability, the allocation of the proceeds to the two components (the initial preferred shares issued and the future tranche right) would be done proportionately based upon their relative fair values.

4.5.4 Accounting analysis for embedded future tranche rights

If the future tranche right is determined to be an embedded, rather than freestanding, financial instrument, the provisions of ASC 815-15 should be considered to determine whether the right or obligation to issue the preferred shares component should be bifurcated and accounted for as a derivative. As discussed in Section 4.3.1, ASC 815-15-25-1 requires derivative recognition for embedded features if all of the following three criteria 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 U.S. GAAP.
3. A separate instrument with the same terms as the embedded derivative would be a derivative instrument subject to the requirements of ASC 815.

In considering the first criterion, typically bifurcation is not required, as the economic characteristics and risks of a right or obligation to purchase shares are generally clearly and closely related to a host contract in the form of the same shares. As it relates to the third criterion and whether net settlement exists, in most cases the agreements do not provide for net settlement and the future tranche rights typically do not relate to publicly traded stock or stock that otherwise could be readily converted to cash. Additionally, even if net settlement and the other required characteristics of a derivative exist, the scope exception under ASC 815-10-15-74(a) may apply to an instrument that is indexed to an entity's own stock and classified in stockholders' equity.

If the future tranche right is required to be bifurcated and accounted for as a derivative pursuant to ASC 815-15, it would be continuously adjusted to fair value through earnings. In allocating the initial proceeds from the preferred stock issuance, proceeds would first be allocated to the future tranche right based on its fair value and the remaining proceeds would be allocated to the initial preferred shares.

If separate recognition of the tranche right was not required, all of the proceeds would be allocated to the initial preferred stock issuance.

4.6 Preferred stock dividends

4.6.1 Overview

Dividends on equity securities are generally recognized when declared, as that is the time the entity becomes obligated to pay them. As the name implies, preferred stockholders typically are entitled to dividends before dividends can be paid to more subordinate classes of preferred or common stock. Preferred dividends are sometimes cumulative, whereby specific dividend rights are outlined in a company's certificate of designation (Certificate) as a fixed annual amount (expressed either in dollars or a fixed annual percentage of the preferred stock's original issuance price), that the holder is entitled to if and when declared. The Certificate generally indicates circumstances under which the holder would be entitled to receive any cumulative unpaid dividends even if not declared. For example, unpaid preferred dividends may become payable upon the declaration of a dividend to a more subordinate class of shareholders, redemption of the preferred stock, its conversion into common stock, a sale or change in control of the entity (both often referred to collectively as deemed liquidation events), or the liquidation of the entity. There is limited authoritative guidance to address the accounting for cumulative dividends and the accounting for dividends when there is a deficit in retained earnings. As such, these matters, as well as the accounting for dividends on increasing rate preferred stock, are addressed in the sections that follow.

4.6.1.1 Cumulative dividends on nonredeemable preferred stock classified as equity

For equity-classified preferred stock that does not have provisions for redemption that are outside the control of the issuer (referred to as nonredeemable preferred stock), cumulative dividends that the entity is legally obligated to pay should be accrued as they are earned. An example of this would be when the terms of the preferred stock instrument require that the entity pay dividends as they are earned, regardless of whether they are declared. Reference should also be made to Section 4.6.1.5 for perpetual instruments that are required to pay dividends at rates that increase in subsequent years.

Dividends that have not yet been declared by the board of directors and for which there is no legal obligation to pay unless declared should not be recognized until declared by the board of directors. This is consistent with nonauthoritative guidance in AICPA Technical Questions and Answers Section 4210.04, which states, in part:

> Inquiry — A corporation has cumulative preferred stock. It has not paid any dividends on this stock in the last three years. Should the corporation accrue the preferred dividends in arrears?
>
> Reply — Generally, preferred stock contains a cumulative provision whereby dividends omitted in previous years must be paid prior to the payment of dividends on other outstanding shares [i.e., a "dividend stopper" provision]. Since dividends do not become a corporate liability until declared, no accrual is needed.

It is important to note that while recognition may not be required, consideration should be given to the disclosure requirements of ASC 505-10-50 for arrearages in cumulative preferred dividends, and to ASC 260 for the ramifications of cumulative dividends to EPS.

In some cases, the legal obligation to pay dividends is contingent, in which case it would be appropriate to recognize the dividends when the contingency occurs. For example, a cumulative preferred stock instrument may require payment of all accumulated and unpaid dividends if the entity declares a dividend on its common shares, or if the holder exercises an option to convert its preferred shares to common stock. If the entity declares a dividend on its common shares, the entity should accrue a liability for the cumulative unpaid dividends on the preferred stock instrument even if it has not formally declared payment of such dividends. Similarly, for those dividends that become payable upon conversion, a liability should be recognized at conversion (if not paid).

Some entities have a policy of recognizing cumulative dividends as they are earned (regardless of declaration) if the preferred holder has the ability or an unconditional right to trigger payment. Examples include the preceding scenario whereby the holder has a noncontingent conversion option, and, if exercised, cumulative dividends are required to be paid in cash. A company following such a policy would recognize the liability for the dividends as they accrue rather than waiting until the conversion option was triggered. The accounting policy that is elected for the recognition of dividends when the preferred holder has the ability or an unconditional right to trigger payment should be consistently applied.

With the exception of redeemable preferred stock (discussed next) and increasing rate preferred stock discussed in Section 4.6.1.5, we believe the recognition of unpaid dividends should be through a liability and not through an increase to the carrying amount of the preferred stock.

4.6.1.2 Dividends on redeemable preferred stock that meets the requirements to be classified in temporary equity

As more fully discussed in Section 4.2.3, the SEC staff's guidance on redeemable securities in ASC 480-10-S99-3A addresses the accounting for preferred stock instruments that contain redemption features that are not within the entity's control. Such instruments are required to be classified in temporary equity, and subsequently measured at, or accreted up to, the redemption amount, including any dividends that would be paid at redemption. We believe it is preferable (though not required) that private companies follow this guidance. We also believe a private company that does not follow the subsequent measurement provisions outlined in Section 4.2.3.3 for its redeemable stock should account for cumulative dividends consistent with the guidance in Section 4.6.1.1. In other words, it would not be appropriate for a private company to recognize accrued dividends through an adjustment to the carrying amount of its redeemable preferred stock unless it is also adjusting the carrying amount of the preferred stock to its redemption value in accordance with the guidance in Section 4.2.3.3.

4.6.1.3 Dividends on mandatorily redeemable preferred stock classified as a liability

As more fully discussed in Section 4.2.1, ASC 480-10-25-4 requires liability treatment for certain mandatorily redeemable financial instruments. Cumulative dividends on mandatorily redeemable stock instruments classified as liabilities that will become payable upon settlement of the instrument (whether or not declared) are reflected in the subsequent measurement of the financial instrument as interest expense.

4.6.1.4 Recognition of dividends when there is a deficit in retained earnings

Generally, dividends are recognized through a debit to retained earnings. Questions often arise regarding the equity component that should be debited for dividends on equity-classified shares when the entity has an accumulated deficit. We believe consideration needs to be given to the entity's governing documents and any state laws of the jurisdiction in which it is incorporated that specifically address the equity accounts from which distributions to stockholders can be made. For example, as noted in AICPA Technical Questions and Answers Section 4210.01, state law may require that liquidating or other dividends in excess of prior year earnings be charged to accounts such as "capital repayment," "capital returned" or "liquidating dividends," which appear on the balance sheet as offsets to paid-in capital.

If not addressed by the entity's governing documents or relevant state laws, dividends in excess of retained earnings are generally accounted for as:

- A reduction to APIC until APIC has been reduced to zero, after which the accumulated deficit would be increased because APIC should not be reduced below zero; SEC registrants are required to follow this approach for redeemable stock within the scope of the guidance in ASC 480-10-S99
- An increase to the accumulated deficit

The accounting policy followed should be consistently applied and appropriately disclosed.

4.6.1.5 Accounting for dividends on increasing rate preferred stock

Certain preferred stock instruments are required to pay dividends at a stated rate that increases in subsequent years and may eventually level off at a higher perpetual rate. Generally, it is not appropriate to recognize the dividends according to the stated rates. There is SEC staff guidance included in ASC 505-10-S99-7 that addresses the accounting for nonredeemable instruments with dividend features of this nature, and it results in recognition of imputed dividends in the early years of these instruments through a decrease to retained earnings and an increase to the carrying amount of the preferred stock, in a manner that produces a constant rate of effective dividends. (Note that the accounting for redeemable instruments is addressed in ASC 480-10-S99-3A and summarized in Section 4.2.3.3 of this guide.) These instruments are typically issued at a discount to compensate the holder for the lower amount of dividends in the early years. This discount equates to prepaid dividends that should be amortized to retained earnings using a discount rate that equals the market rate for comparable preferred stock without consideration of dividends. While this guidance is for SEC reporting entities, it is consistent with the requirement to use the interest method for redeemable preferred stock instruments and for debt instruments.

Example 4-8: Accounting for increasing rate preferred stock

A company issues nonredeemable preferred stock with a $100 par value on January 1, 20X7. The stock, by its terms, will pay no dividends during the first three years. The stock will pay cumulative dividends at an annual rate of $7 per share beginning in 20Y0. At the time of issuance, 7% was considered a market rate for this issuer and this type of instrument. The stock was issued at a discount to par value, given the lack of dividends for the first three years. The imputed dividend amount and carrying amount of the stock over the three-year period preceding the commencement of dividends is a present value computation whereby the number of periods (three), the discount rate (7%) and the future value ($100) are known. The beginning- and end-of-year carrying amounts for a share of this preferred stock as adjusted for dividends of 7% applied to the beginning of year balance are shown below.

Year	Beginning of year	Imputed dividend	End of year
20X7	$81.63	$5.71	$87.34
20X8	$87.34	$6.12	$93.46
20X9	$93.46	$6.54	$100.00

In 20Y0 and subsequent years, payment of the stated dividend of $7 per share will result in the same effective 7% rate as the preceding three years when no dividend was paid.

4.7 High-level overview of the accounting for convertible preferred stock

The table that follows provides a high-level overview of the accounting for convertible preferred stock when the conversion feature is required to be separately recognized as a derivative in accordance with ASC 815 and the conversion feature is not required to be separately recognized. Sections of this guide are referenced and should be considered along with the authoritative guidance to supplement this overview. This table only applies to equity-classified preferred stock instruments (either permanent or temporary). Refer to Chapter 3 for preferred stock instruments that are classified as liabilities.

<table>
<tr><th></th><th>Derivative (Section 4.3)</th><th>No separate recognition</th></tr>
<tr><td>Balance sheet classification and initial measurement of the conversion option</td><td>The conversion option is accounted for as a liability at fair value (Section 4.3.5).</td><td>N/A (The conversion option is not separately recognized.)</td></tr>
<tr><td rowspan="2">Subsequent measurement considerations</td><td>The conversion option is subsequently measured at fair value with changes in fair value recognized in earnings (Section 4.3.5). The discount may need to be amortized as elaborated on at Section 4.2.3.3.</td><td>N/A</td></tr>
<tr><td colspan="2">Reassess whether the derivative conclusions remain appropriate (Section 4.3.6).</td></tr>
<tr><td>Ongoing reminders (in part)</td><td>Recognize additional derivative amounts as appropriate if dividends accrue and are convertible.</td><td>The triggering of a down-round provision is recognized in accordance with Section 4.4.1.</td></tr>
<tr><td>Accounting upon conversion</td><td>Account for as an extinguishment as outlined at Section 4.4.2.</td><td>Account for as a conversion as outlined at Section 4.4.2 or Section 4.4.3 (if induced conversion).</td></tr>
<tr><td>Accounting upon modification</td><td colspan="2">Refer to Section 4.4.4.2 in making the determination as to whether modification or extinguishment accounting is appropriate, and account for accordingly with consideration given to Section 4.4.4.3.
Reassess conclusions reached on the accounting for any conversion features and other potential derivatives in light of the modifications.</td></tr>
<tr><td>Accounting upon extinguishment</td><td colspan="2">Account for in accordance with Section 4.4.4.3.</td></tr>
</table>

5. Accounting for warrants and other equity-linked instruments

5.1 Overview

It is not uncommon for debt issuances and equity offerings to include warrants or other freestanding instruments to purchase or issue common or preferred stock, hereafter referred to as equity-linked instruments. Warrants are the most common type of instrument and generally give an investor or lender (as the holder) the option to purchase a stated number of the issuer's shares at a stated exercise price and constitute a written call option to the issuer. In some cases, companies issue written put options on their shares, which give the holder the right to sell certain securities back to the company. In addition to options for which exercise is at the election of one of the parties to the transaction, companies sometimes enter into forward contracts or commitments that require them to issue or sell a certain number of shares and require the other entity (e.g., investor or counterparty) to purchase those shares at a predefined price and settlement date (or period). There are many variations of equity option and forward contracts, some of which are freestanding instruments and some of which are embedded in either debt or preferred or other stock. The accounting analysis related to these instruments is complex and dependent upon whether the instrument or feature in question is considered to be freestanding or embedded. When applying the guidance in this chapter, it is important to note:

- Reference should be made to Section 2.2 for guidance in determining if an instrument or feature is freestanding or embedded.
  - ASC 480 (and therefore Section 5.2.1 of this guide) does not apply to embedded features.
  - The starting point for analyzing embedded, equity-linked features is the guidance in Section 3.3, (for features embedded in a debt agreement) and Section 4.3 (for features embedded in preferred and similar stock), given that the applicability of Section 5.2.2 to embedded features is limited to those features that are determined to be a derivative that is not clearly and closely related to the host contract, as is elaborated on in these sections.
- This chapter is not applicable to share-based compensation arrangements that are within the scope of ASC 718.

This chapter addresses the balance sheet classification and ongoing measurement of equity-linked instruments in Section 5.2. Section 5.3 provides guidance specific to accelerated share repurchase programs.

5.2 Determining the balance sheet classification and ongoing measurement

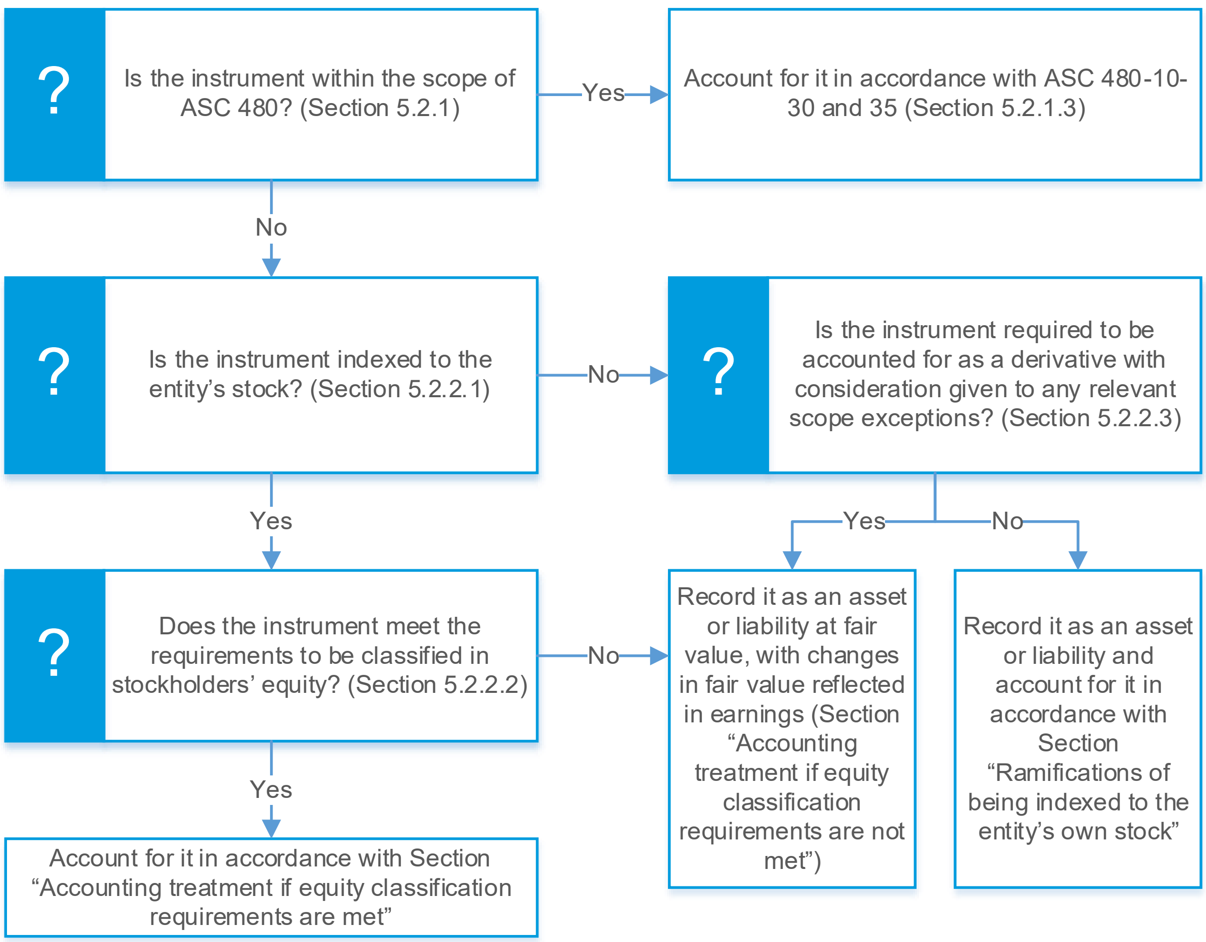
ASC 480 and ASC 815 are the relevant guidance to consider in determining if an equity-linked instrument should be classified as an asset or liability or should be classified as equity. The balance sheet classification impacts the ongoing measurement, as generally instruments that are classified as equity are not subsequently remeasured, while those that are classified as assets or liabilities often require ongoing fair value measurement.

RSM COMMENTARY: It is not uncommon for entities to be unpleasantly surprised by the fact that certain instruments, such as warrants and other obligations to issue shares, can require separate recognition as liabilities and ongoing fair value measurement. Examples of common instruments include:

- Warrants, or warrants to purchase shares, that can be put back to the company for cash or other assets, including those that can only be put upon the occurrence of an event that is not within the company's control (Section 5.2.1.1)
- Other obligations to issue puttable shares (Section 5.2.1.1)

- Warrants (or other obligations to issue shares) that provide for adjustments to the terms (e.g., exercise price, number of shares) that cause the instrument to not be indexed to the entity's own stock (Section 5.2.2.1)
- Warrants or other equity-linked instruments that require net cash settlement or permit the holder to elect net cash settlement, including upon the occurrence of an event that is not within the company's control (Section 5.2.2.2)
- Warrants or other obligations to issue an unlimited number of shares, or a number of shares that exceeds the number of shares that the company has authorized and available for issuance (Section Entity has sufficient authorized and unissued shares and Section Contract contains an explicit share limit)

The following flowchart summarizes a logical approach to follow when performing the accounting analysis for the issuance of equity-linked instruments. The various steps of the process include references to the discussion that follows.



To appropriately apply the guidance in ASC 480 and ASC 815, it is important to review the contract and understand how it will or may be settled. As elaborated on at Section 5.2.1, certain provisions of ASC 480 apply to contracts that could be settled in cash and other assets, and other provisions apply to contracts that may be settled in a variable number of shares. Additionally, the form of settlement impacts the balance sheet classification under ASC 815-40, as elaborated on at Section 5.2.2.2.

The following are key terms used in ASC 815-40, along with their definitions from the Master Glossary of the ASC:

Master Glossary – 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.

Master Glossary – 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.

Master Glossary – 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.

The table below applies these definitions in the context of the settlement of a few common equity-linked instruments.

Physical settlement	Net cash settlement	Net share settlement
Warrant exercise: The warrant holder has the option to purchase 100 shares of the company at a $5 per share exercise price for a stated period of time. Assume that the warrant is exercised when the shares have a fair market value of $9. (Since the warrant is an option, the holder would not exercise the warrant unless the fair value of the shares at the time of exercise exceeds the exercise price.)		
The warrant holder pays $500 ($5 x 100 shares) in exchange for 100 shares.	No shares exchange hands. The company makes a cash payment for the gain of $400 to the warrant holder, determined as the amount by which the $9 fair value of a share to be purchased exceeds the $5 exercise price, multiplied by the 100 shares to be purchased.	No cash exchanges hands. The company delivers 44 shares to the warrant holder, determined by dividing the $400 gain in the preceding scenario by the $9 fair value of a share.
Warrant redemption: The warrant holder has the option to purchase 100 shares of the company at a $5 per share exercise price or put the warrant back to the company for a $2 per warrant redemption price. Assume that the shares are worth only $1 at the expiration date, such that the warrants are out of the money and the holder elects to put the warrant back to the company.		
The company pays $200 ($2 x 100 warrants) in exchange for the warrants.	The company makes a cash payment for the gain of $200 to the warrant holder, determined as the amount by which the $2 per warrant redemption price multiplied by the 100 warrants to be purchased exceeds the value (zero) of the warrants.	No cash exchanges hands. The company delivers 200 shares to the warrant holder, determined by dividing the $200 gain in the preceding scenario by the $1 fair value of a share.
Settlement of forward contract, fair value of the shares exceeds purchase price: The company is obligated to sell, and the investor is obligated to purchase, 100 shares at a $5 per share price at a future date. Assume that the shares have a fair market value of $9 when the contract is settled.		
The investor pays $500 ($5 x 100 shares) in exchange for	No shares exchange hands. The company makes a cash payment to the investor for the investor's gain	No cash exchanges hands. The company delivers 44 shares of its stock to the

Physical settlement	Net cash settlement	Net share settlement
100 shares worth $900 ($9 x 100 shares).	of $400, attributable to the ability to purchase shares worth $900 for $500.	investor, determined by dividing the $400 gain by the $9 fair value of the shares.
Settlement of forward contract, purchase price exceeds the fair value of the shares: The company is obligated to sell, and the investor is obligated to purchase, 100 shares at a $10 per share price at a future date. Assume that the shares have a fair market value of $6 when the contract is settled.		
The investor pays $1,000 ($10 x 100 shares) in exchange for 100 shares worth $600 ($6 x 100 shares).	No shares exchange hands. The investor makes a cash payment to the company for the company's gain of $400, attributable to the ability to sell shares worth $600 for $1,000.	No cash exchanges hands. The investor delivers 67 shares of the company's stock to the company, determined by dividing the $400 gain by the $6 fair value of the shares.

It is not uncommon for an instrument to provide for multiple forms of settlement. A warrant may, for example, require physical settlement in general, but give the holder the option for net share settlement or net cash settlement under certain circumstances, such as a change in control. As will be evident from the discussion that follows, the potential forms of settlement and the party that is in control of the forms of settlement are relevant to the analysis.

5.2.1 ASC 480 considerations

The starting point in the analysis is generally to determine if the instrument is within the scope of ASC 480, which applies to freestanding financial instruments with characteristics of both liabilities and equity. In other words, ASC 480 does not apply to embedded features. As such, if an equity-linked feature such as a put option is determined to be embedded in a debt or preferred (or similar) stock instrument, refer to Chapter 3 or Chapter 4 of this guide, as appropriate, for the application of ASC 480 to the debt or stock instrument as a whole. In the context of equity-linked instruments that are not issued in the form of debt or a share, and are freestanding rather than embedded, ASC 480 requires liability classification (or, in some cases, asset classification) for financial instruments that embody an obligation to repurchase equity shares (or are indexed to such an obligation) by transferring cash or other assets (discussed in Section 5.2.1.1) and for certain obligations to issue a variable number of shares (discussed in Section 5.2.1.2).

5.2.1.1 Obligations to repurchase the issuer's shares

ASC 480-10-25-8 requires that a financial instrument other than an outstanding share should be classified as a liability (or asset in certain circumstances[4]) if, at inception, it embodies an obligation to repurchase the issuer's equity shares or is indexed to such an obligation and requires or may require the issuer to settle the obligation by transferring assets. An obligation as defined in ASC 480-10-20 includes a conditional or unconditional duty or responsibility. As such, as is pointed out at ASC 480-10-25-9, any obligations that permit the holder to require the issuer to transfer cash or other assets (rather than shares) result in liabilities, even if the obligation is conditional. Conversely, options that permit (rather than require) the issuer to repurchase the shares are not subject to ASC 480. If there are conditional circumstances under which repurchase would be required, and those circumstances are not solely within the control of the issuer, it would constitute an obligation of the issuer.

[4] As elaborated on in ASC 480-10-25-12, instruments such as forward purchase contracts and combined options can both embody obligations and contain characteristics of assets. When that is the case, the instrument's classification as an asset or liability depends on its fair value on a given reporting date.

The following are examples of instruments that are typically subject to this paragraph of ASC 480, assuming that the contract is to be physically or net cash settled. (Refer to Section 5.2.1.2 of this guide for guidance regarding freestanding contracts that are to be net share settled.)

- Written put options
- Forward purchase contracts
- Warrants that are puttable
- Warrants to purchase shares that are puttable

As it relates to the last two bullet points, it is evident from the implementation guidance in ASC 480-10-55 that when determining whether a freestanding financial instrument, such as a warrant or forward contract, is subject to this guidance, consideration needs to extend beyond the contractual provisions of the freestanding instrument to the underlying shares to determine whether a potential obligation to repurchase the underlying shares exists. For example, a company may issue a warrant that, if exercised, obligates it to issue shares that are puttable. The warrant would be a liability under ASC 480-10-25-8, even if the warrant itself has no contractual provisions that would subject it to this guidance. The examples that follow serve to illustrate this as well as the overall application of this guidance.

Examples of obligations to repurchase equity shares

ASC 480-10-55-31

Puttable Warrant that May Require Cash Settlement

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.

In this example, the holder has an unconditional right to put the warrant back to the issuer in exchange for cash. Keep in mind that the warrant would be classified as a liability even if the holder's ability to put the warrant back was conditional. To illustrate, certain warrants permit the holder to put the warrant back to the issuer upon the occurrence of a contingent event, such as a change in control. As noted at ASC 815-40-55-2, the occurrence of a change in control is not within the issuer's control. As such, this would constitute a conditional obligation of the issuer, and the warrant generally would be classified as a liability. In practice, the guidance of ASC 815-40-55-3 through 55-4 and ASC 480-10-S99-3A(3)(f) is referred to by analogy; as a limited exception that rarely comes into play, this redemption feature would not trigger liability treatment for the warrant if all of the holders of equally and more subordinated equity instruments would always be entitled to receive the same form of consideration upon the occurrence of the event that gives rise to the redemption. (In other words, all subordinate shareholder classes would also be entitled to redeem for cash upon the occurrence of a change in control.) As the following examples from ASC 480-10-55-32 and 55-33 demonstrate, the outcome is the same (i.e., liability classification for the warrant) if the shares that can be purchased through the warrant are puttable, rather than the warrant being puttable.

ASC 480-10-55-32

Warrant for Shares that Are Puttable that May Require Cash Settlement

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.

While in the preceding example, the underlying shares are immediately puttable for a fixed amount, ASC 480 requires liability treatment for freestanding warrants and other freestanding instruments that require the issuance of shares that are either puttable or mandatorily redeemable, regardless of whether the shares are immediately redeemable or are redeemable at a later date and regardless of whether the redemption price is fixed because those instruments embody obligations to transfer assets. Accordingly, ASC 480-10-25-8 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. This is consistent with guidance provided in FSP FAS 150-5 on paragraph 11 of Statement 150, which subsequently was codified in ASC 480-10-25-8.

ASC 480-10-55-33

Freestanding Warrants and Other Similar Instruments on Shares that Are Redeemable

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 following example from ASC 480-10-55-18 through 55-20 illustrates how an instrument that contains both a written put option and purchased call option can be an asset or a liability at a given point in time.

ASC 480-10-55-18 through 55-20

Combination of Written Put Option and Purchased Call Option Issued as a Freestanding Instrument

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.
>
> 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.
>
> 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.

Simple agreement for future equity

A Simple Agreement for Future Equity or SAFE is an agreement under which an entity receives an upfront payment in exchange for providing holders with a right to future equity when a specific event (i.e., a triggering event)—such as a future funding round, acquisition or initial public offering—occurs. SAFEs commonly have the following features:

- The instruments do not accrue interest and do not have a maturity date.
- Upon a triggering event (e.g., the next round of equity financing) the holder receives a variable number of shares based on the transaction price (or a discount to the transaction price) or based on a valuation cap.
- Upon a liquidity event, which often includes a change in control, the holder may have an option to convert to shares or to receive a cash out payment.
- Holders of these instruments typically have rights subordinate to those of debt holders and equal to those of preferred stockholders.

A SAFE is typically not in the form of a legal share nor in the legal form of debt. When this is the case, the instrument must be evaluated as a contract on an entity's own equity. An entity should first consider whether the instrument is within the scope of ASC 480. ASC 480 requires liability classification:

- Under ASC 480-10-25-8, for financial instruments that embody an obligation to repurchase equity shares (or are indexed to such an obligation) by transferring cash or other assets
- Under ASC 480-10-25-14, for certain obligations to issue a variable number of shares (discussed in Section 5.2.1.2).

If a SAFE provides the holder the option to elect cash settlement upon a change in control (an event not within the entity's control), similar to the example in ASC 480-10-55-31, the SAFE instrument may require classification as a liability under ASC 480-10-25-8.

If a SAFE is not within the scope of ASC 480, consideration would next be given to ASC 815 for guidance on whether the instrument is a derivative within the scope of ASC 815-10 (refer to Section 5.2.2.3) and ASC 815-40 to determine if the equity-linked instrument or feature is indexed to the entity's own stock and classified in equity (refer to Section 5.2.2.1).

5.2.1.2 Obligations to issue a variable number of shares

ASC 480-10-25-14 requires liability treatment (or asset in some circumstances) for a freestanding financial instrument that embodies a conditional or unconditional 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 three criteria:

1. A fixed monetary amount known at inception (e.g., a payable settled with a variable number of the issuer's equity shares)
2. Variations in something other than the fair value of the issuer's equity shares (e.g., a financial instrument indexed to the Standard & Poor's S&P 500 index and settled with a variable number of the issuer's shares)
3. Variations inversely related to changes in the fair value of the issuer's equity shares (e.g., a written put option that could be net share settled)

> The following are key terms used in ASC 480-10, along with their definitions from the Master Glossary of the ASC:
>
> **Master Glossary – 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.
>
> **Master Glossary – Obligation**
>
> A conditional or unconditional duty or responsibility to transfer assets or to issue equity shares.

As is pointed out at ASC 480-10-55-26, forward purchase contracts and written put options that must or may be net share settled are examples of instruments that are liabilities due to the third criterion because as the issuer's share price decreases, the obligation to the issuer increases. (Note that those contracts that will be physically settled or net cash settled should be analyzed at Section 5.2.1.1.)

The analysis of whether a freestanding financial instrument is within the scope of ASC 480-10-25-14 becomes more complex when the monetary value is in part, but not solely, based on one of the three criteria and when the instrument in question has multiple components, some of which may be settled in a variable number of shares. Subjectivity comes into play in determining if the monetary value of the component obligation or obligations that meet the criteria of ASC 480-10-25-14 are predominant over all other component obligations, such that liability classification is required due to this guidance in ASC 480. This is in contrast to ASC 480-10-25-8 discussed at Section 5.2.1.1 whereby if any component obligates the issuer to repurchase shares (or is indexed to such an obligation) and may require a transfer of cash or other assets, no consideration is given to predominance and the instrument is classified as a liability (or an asset in some circumstances) in its entirety. The analysis is further complicated by the fact that "predominantly" is not defined in ASC 480. We are aware of divergent views in practice as to whether predominant should be interpreted as more likely than not or a higher threshold, such as 90%, as suggested by the use of the words "in small part" in ASC 480-10-55-22. As such, it is important for management to have a well-documented and thought-out interpretation of predominant that is consistently applied.

The following examples from ASC 480-10-55-42 through 55-52 may be useful in performing this analysis.

Example 5-1: Certain financial instruments involving multiple components that may be settled in a variable number of shares (ASC 480-10-55-42 through 55-52)

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.

RSM COMMENTARY: If payment of the put price was required to be in cash, or would be in cash or shares at the holder's discretion, the warrant would be a liability due to ASC 480-10-25-8 as elaborated on at Section 5.2.1.1.

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.

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

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.

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.

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.

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.

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

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.

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

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).

RSM COMMENTARY: If payment of the put price was required to be in cash or could be in cash at the holder's discretion, the warrant would be a liability due to ASC 480-10-25-8 as elaborated on at Section 5.2.1.1.

5.2.1.3 Initial and subsequent measurement of instruments subject to ASC 480

ASC 480-10-30 and ASC 480-10-35 address the initial and subsequent, respectively, measurement of freestanding financial instrument contracts that are subject to the scope of ASC 480. With the exception of physically settled forward contracts discussed later in this section, freestanding equity-linked instruments that are subject to ASC 480 are initially measured at fair value. When determining the subsequent measurement of these instruments subject to the scope of ASC 480, consider:

- Whether the instrument is within the scope of ASC 815; if so, it would be subsequently measured in accordance with ASC 815, generally at fair value with changes in fair value recognized in earnings, and subject to the disclosure requirements of ASC 815
- Specific guidance for forward contracts that require physical settlement in exchange for cash

All other instruments (including 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) should be measured subsequently at fair value, with changes in fair value recognized in earnings, unless a different subtopic specifies another measurement attribute.

Certain physically settled forward purchase contracts

As outlined beginning at ASC 480-10-30-3, forward contracts that require physical settlement by repurchase of a fixed number of the issuer's shares in exchange for cash are measured initially at the fair value of the shares at inception, adjusted as necessary for any consideration or unstated rights and privileges. The fair value of the shares can be obtained by:

- Determining the amount of cash that would be paid under the conditions specified in the contract if the shares were repurchased immediately
- Discounting the settlement amount at the rate implicit at inception

The initial liability for these contracts is established by reducing equity by an amount equal to the fair value of the shares at inception. In accordance with ASC 480-10-35-3, the contracts are subsequently measured:

- At the present value of the amount to be paid at settlement, accruing interest cost using the rate implicit at inception, if both the amount to be paid and the settlement date are fixed
- 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 if either the amount to be paid or the settlement date varies based on specified conditions

The following example from ASC 480-10-55-14 through 55-16 illustrates the initial and subsequent measurement for forward contracts that require physical settlement.

Example 5-2: Physically settled forward purchase contract (ASC 480-10-55-14 through 55-16)

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.

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.

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.

5.2.2 ASC 815 considerations

Subtopics within ASC 815 that are relevant in determining the appropriate balance sheet classification and measurement for an equity-linked instrument or embedded feature include:

- ASC 815-10, to determine whether the instrument or feature in question is a derivative within the scope of ASC 815 (refer to Section 5.2.2.3)
- ASC 815-15, to determine whether an embedded feature requires separate recognition as a derivative (for derivatives embedded in debt, refer to Section 3.3; for derivatives embedded in preferred and similar stock, refer to Section 4.3)
- ASC 815-40, to determine if the equity-linked instrument or feature is indexed to the entity's own stock and classified in equity (discussion follows)

5.2.2.1 Determining if the instrument is indexed to the entity's own stock

The guidance relevant to this determination is contained within ASC 815-40-15 (the related implementation guidance is contained in ASC 815-40-55) and should be considered for:

- Freestanding financial instruments that are potentially settled in the entity's own stock and not within the scope of ASC 480 (regardless of whether the instrument has all the characteristics of a derivative), to determine the balance sheet classification

- Equity-linked embedded features that are derivatives that are not clearly and closely related to the host contract, to determine if the feature qualifies for the scope exclusion at ASC 815-10-15-74(a) for contracts that are both indexed to the entity's own stock (addressed in the paragraphs that follow) and classified in stockholders' equity in its balance sheet (addressed at Section 5.2.2.2)

ASC 815-40-15-7 outlines a two-step approach for determining whether an instrument is indexed to an entity's own stock. The first step is to evaluate the instrument's contingent exercise provisions, if any, and the second step is to evaluate the instrument's settlement provisions. To be considered indexed to the entity's own stock, the instrument must pass both steps in this process.

Step 1: Evaluate contingent exercise provisions

Master Glossary – 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.

Common provisions include those that allow either party to exercise the instrument upon reaching a certain level of sales or upon the completion of an IPO.

Exercise contingencies would not preclude an instrument (or embedded feature) from being considered indexed to an entity's own stock under ASC 815-40-15-7A unless they are based on an observable market other than the market for the issuer's stock or are based on an observable index other than an index calculated or measured solely by reference to the issuer's own operations, such as sales; earnings before interest, taxes, depreciation and amortization; net income; or total equity of the issuer.

RSM COMMENTARY: Examples of exercise contingencies

The following exercise contingencies are illustrated in three distinct examples in ASC 815-40-55-26 through 55-28, in which Entity A issues a warrant that becomes exercisable:

1. If it completes an IPO
2. When it attains cumulative total sales of $100 million
3. If the Standard & Poor's S&P 500 index increases 500 points within any given calendar year

The first two are examples of exercise contingencies that do not preclude the warrant from being indexed to Entity A's stock. However, in the third example, the warrant is not indexed to Entity A's stock, given that the exercise contingency is based on an observable index unrelated to Entity A's own operations.

Step 2: Evaluate the instrument's settlement provisions

If the evaluation of Step 1 does not preclude an instrument from being considered indexed to the entity's own stock, consideration is next given to the instrument's settlement provisions. For an instrument to be considered indexed to an entity's own stock, as is pointed out at ASC 815-40-15-7C, the settlement amount needs to equal the difference between the fair value of a fixed number of the entity's equity shares and a fixed monetary amount or a fixed amount of a debt instrument issued by the entity. An example follows.

Example 5-3: An instrument with fixed settlement terms

Company A issues an instrument with the following terms:

- The holder of the instrument can purchase 10 shares of Company A's stock for $15 per share.
- The instrument will expire five years from the date of issuance and is exercisable at any time.

Assume that there are no contractual provisions that could change these terms and that the fair value of the stock on the date of exercise is $25 per share.

In this example, the settlement amount is $100, or the difference between the fair value of $250 (ten shares x $25 per share fair value at the date of exercise) and the fixed exercise price of $150 ($15 per share exercise price x 10 shares). Because both the exercise price ($15) and the number of shares (ten) are fixed, this instrument would meet the settlement provisions criteria to be indexed to the entity's own stock.

In reality, instruments are rarely this simple, as they commonly provide for potential adjustments to either the strike price or the number of shares to be issued ($15 and ten shares, respectively, in the previous example) if certain circumstances occur. Therefore, these adjustment provisions must be analyzed under ASC 815-40, regardless of the probability of such adjustments occurring or whether such adjustments are within the entity's control.

As indicated in ASC 815-40-15-7D, an instrument (or embedded feature) with potential adjustments would 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 calculation of a fixed-for-fixed forward or option on equity shares. The most widely known fixed-for-fixed fair value option model is the Black-Scholes-Merton model. As stated at ASC 815-40-15-7E, inputs to such calculations generally include the entity's stock price, as well as the following types of variables:

- Strike price
- Term of the instrument
- Expected dividends or other dilutive activities
- Stock borrow cost
- Interest rates
- Stock price volatility
- The entity's credit spread
- The ability to maintain a standard hedge position in the underlying shares

As discussed at ASC 815-40-15-7E, determinations and adjustments related to the settlement amount (including the determination of the ability to maintain a standard hedge position) must be commercially reasonable. An instrument (or embedded feature) would 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, or if the instrument contains a feature (such as a leverage factor) that increases exposure to the additional variables listed earlier in a manner that is inconsistent with a fixed-for-fixed forward or option on equity shares.

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. 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 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, as is reinforced at ASC 815-40-15-7G, 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.

ASC 815-40-15-7H acknowledges that some equity-linked financial instruments give the issuer the unilateral ability to modify the terms of the instrument at any time. If this ability is limited to modifications that would be for the benefit of the counterparty, such as modifications to induce exercise, such a provision would not affect the determination of whether the instrument (or embedded feature) is considered indexed to the entity's own stock.

If the strike price of an equity-linked financial instrument is denominated in a currency that is not the functional currency of the issuer, as is pointed out at ASC 815-40-15-7I, the instrument (or embedded feature) is not considered to be indexed to the entity's own stock, regardless of the currency (or currencies) in which the underlying shares trade.

As indicated at ASC 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 would not be considered indexed to the entity's own stock.

Comprehensive examples

The following examples illustrate the application of the guidance relevant to determining whether an instrument (or embedded feature) is indexed to an entity's own stock.

Adjustments to the number of shares based on a percentage of fully diluted shares outstanding

Rather than a fixed number of shares, an instrument (or an embedded feature) may require settlement in a variable number of shares based on a stated percentage of the entity's outstanding stock. For example, a warrant may provide the holder with the right to acquire 3% of the entity's outstanding shares at the time of exercise. In this scenario, the number of shares varies based on any subsequent issuances or redemptions of the entity's stock. As changes in the number of shares outstanding will cause the settlement amount to vary and is not an input to the fair value of a fixed-for-fixed option pricing model, the instrument or embedded feature would not be considered indexed to the entity's own stock.

Adjustments triggered by contractual changes to the strike price of another instrument

Master Glossary – 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 anti-dilution provision is not considered a down round feature.

In practice, we have most commonly observed down round features in warrants, as well as convertible debt and preferred stock. A down round feature is most commonly outlined in an adjustments section of a convertible preferred stock certificate, convertible debt agreement, warrant agreement or other equity-linked instrument.

Example 9 in ASC 815-40-55-33 illustrates a down round in the context of a warrant to buy 100 shares of the entity's common stock for $10 per share. The terms of the warrant specify that 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. Additionally, 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. (In other words, if the entity were to issue a convertible instrument with a conversion price below $10, or other warrants with a strike or exercise price below $10, the strike price of the warrant to buy 100 shares would be adjusted down to that lower price.)

While in this example, the strike price is adjusted down to equal the issuance or exercise price of the subsequently issued shares, the definition of a down round extends to adjustments that are limited by a floor or based on a formula, as well as those that provide for a reduction to the strike price below the current issuance price. However, standard anti-dilution provisions that provide for adjustments to the strike price for equity restructuring transactions such as stock dividends and splits, spinoffs, rights offerings or recapitalization through a large, recurring cash dividend are not considered to be down round features. Rather, standard anti-dilution provisions are an implicit input to the fair value calculation of a fixed-for-fixed forward or option on equity shares and, as a result, do not impact the classification of the instrument or the analysis of whether the instrument is indexed to the entity's own stock.

ASC 815-10-15-75A specifies that down round features are excluded when determining whether an instrument is indexed to the entity's stock. That is, the existence of a down round provision would not prevent an instrument from being considered indexed to the entity's own stock.

The definition of a down round provides for reductions to the strike price when the issuer sells or issues shares at a lower price; it does not extend to changes to the strike price of another instrument. Since changes to the strike price of another instrument are not an input to the fair value of a fixed-for-fixed option pricing model, an instrument or embedded feature that has an adjustment provision that could be triggered by contractual changes to the strike price of another instrument would not be considered indexed to the entity's own stock.

Changes to settlement amount based on the holder of the instrument

On April 12, 2021, the SEC issued a Staff Statement on Accounting and Reporting Considerations for Warrants Issued by Special Purpose Acquisition Companies ("SPACs"), which highlighted a number of important financial reporting considerations for SPACs. Most notably, the statement describes fact patterns that are common in warrants issued in connection with a SPAC's formation and initial registered offering.

One of the fact patterns highlighted is related to warrants that include provisions providing for potential changes to the settlement amounts dependent upon who holds the warrant. These provisions often exist in the context of private placement warrants issued to the SPAC sponsor or its affiliates, whereby settlement amounts or adjustments to the terms of the warrants may differ depending on whether the sponsor continues to hold the warrants. While less common, certain public warrants issued by SPACs have settlement amounts or adjustments to the terms that differ if the warrants are held by executives or directors. Because the holder of the instrument is not an input to the fair value of a fixed-for-fixed option pricing model, the warrants are precluded from being indexed to the entity's stock.

Share-settled earn-out arrangements

Entities sometimes enter into arrangements in conjunction with mergers that require them to issue shares at a future date if the company's stock price exceeds a certain threshold. For example, SPACs may enter into these arrangements with their sponsors or with the target's shareholders. Sometimes, rather than the arrangements requiring additional shares to be issued at a future date, the arrangements may provide for certain shares to be forfeited if stock price levels or other conditions are not met. Generally, the guidance discussed within this chapter, including the guidance in this section on determining whether the instrument is indexed to the entity's stock, should be applied to both arrangements that obligate the entity to issue shares as well as those that could result in the forfeiture of shares unless the arrangement is within the scope of ASC 718. If the arrangement provides solely for a fixed number of shares (e.g., one million) to be issued upon the occurrence of a certain stock price threshold being met or the occurrence of a certain event taking place (e.g., a business combination), it likely would meet the indexation requirements for equity classification, given that if shares are issued, the number is fixed at one million shares and the exercise contingency that determines whether the shares are issued is based on the entity's stock price or occurrence of a business combination, neither of which are inconsistent with the indexation requirements for exercise contingencies. In many cases, earn-out arrangements are structured in a manner that could result in differing amounts of shares being issued. An example of this is an arrangement in which if the stock price reaches $15 within a pre-defined period, one million shares will be issued, and if the stock price reaches $30 within the pre-defined period, an additional one million shares will be issued. Since an entity's stock price is an input to an option pricing model, variability that is solely attributable to the entity's stock price is not inconsistent with the indexation requirements; however, if the full two million shares would become issuable upon the occurrence of an event, such as a change in control, the arrangement would not be indexed to the entity's stock because a change in control would change the settlement amount and is not an input to an option pricing model. (The settlement amount may be zero shares, one million shares or two million shares; this variability is due in part to the occurrence of a change in control).

Early settlement upon fundamental transactions

Entities often issue warrants for the purchase of their common stock that include a provision providing for early settlement of the warrant at its Black-Scholes value upon the occurrence of certain fundamental transactions such as an acquisition of the entity, a change in control or another corporate event. These warrants typically specify that if the fundamental transaction is not within the entity's control, the warrant holder is only entitled to receive from the entity the same type or form of consideration that is transferred to the entity's common stockholders.

Rather than utilizing current market inputs as of the settlement date, the warrant agreement may specify that the settlement amount (i.e., Black-Scholes value) be determined using a pre-specified volatility input. One common scenario is for the settlement amount to be based on the greater of a fixed volatility percentage specified at the inception of the warrant *or* the market volatility determined at the time of the settlement based on a reasonable historical average (for example, the greater of 100% volatility *or* the 100-day historical average volatility). When the entity is able to assert that the fixed volatility specified at inception to price the warrant is within the range of volatility that could be used to determine the Black-Scholes value settlement amount, there are mixed views as to whether the warrant should be considered indexed to the entity's own stock.

When evaluating the settlement provisions under Step 2 of the indexation model, some believe the stock price volatility is a fair value input to an option on equity shares. In the scenario described above, the "greater of" provision effectively sets a floor for the volatility input in the Black-Scholes option pricing model, which the entity has determined to be appropriate because the fixed volatility specified at the inception of the warrant is within the range of volatility that could be used in determining the Black-Scholes value at the time of the settlement. Consistent with the application guidance in Example 15 in ASC 815-40-55-40, supporters of this view believe floors (and caps) on inputs to an option pricing model do not prevent an instrument from being considered indexed to the entity's own stock. Therefore, assuming all other inputs to the Black Scholes value are based on current market inputs on the settlement date, the warrant is not precluded from being considered indexed to the entity's own stock. There may also be other arguments to support the view that the warrant *is not precluded* from being considered indexed to the entity's own stock.

Others believe the warrant in this scenario *is precluded* from being considered indexed to the entity's own stock (i.e., the contract should be evaluated under ASC 815-10 to determine if it represents a derivative. If the contract is not a derivative, classify the contract as an asset or liability). Some supporters of this view believe that the "greater of" provision for the volatility input may result in the holder receiving an amount in excess of the current value of the instrument upon a fundamental transaction (i.e., the greater of feature introduces leverage) and a leverage factor on a fair value input is prohibited under ASC 815-40-15-7F. Some supporters of this view also note that a fundamental transaction is not an input to an option pricing model.

Based on the circumstances described above, and the significant diversity we have observed in practice, we believe either conclusion is acceptable. However, an entity would need to contemporaneously and clearly document its basis for conclusion, which should be applied consistently. Based on discussions with the SEC staff, we understand they too would not object to either conclusion in the circumstances described above; however, the SEC staff expressed no view as to the appropriateness of the basis of conclusions for the alternative views. Accordingly, there may be other analysis and guidance to support the indexation conclusions. Importantly, if circumstances differ from those described above, entities are encouraged to consult with the SEC staff.

Similarly, warrants may include a provision that specifies the stock price input to be used in calculating the Black-Scholes value is based on the greater of the sum of the price per share being offered in the fundamental transaction or the volume weighted average price immediately preceding the public announcement of the fundamental transaction. Again, there are mixed views as to whether the warrant should be considered indexed to the entity's own stock.

When evaluating the settlement provisions under Step 2 of the indexation model, assuming an entity has determined the clause is commercially reasonable and customary in the industry, and that the intent of the clause was not to provide investors with leverage above and beyond observable market prices, some argue the "greater of" provision effectively establishes a floor (i.e., the price offered in the fundamental transaction) for the stock price input in the option pricing model. Consistent with the application guidance in Example 15 in ASC 815-40-55-40, floors and caps on inputs to an option pricing model do not prevent an instrument from being considered indexed to the entity's own stock. Therefore, assuming all other inputs to the Black Scholes value are based on current market inputs on the settlement date, the warrant *is not precluded* from being considered indexed to the entity's own stock.

Others believe the warrant in this scenario *is precluded* from being considered indexed to the entity's own stock (i.e., the contract should be evaluated under ASC 815-10 to determine if it represents a derivative. If the contract is not a derivative, classify the contract as an asset or liability). A possible basis for this conclusion is that the "greater of" provision for the stock price input may result in the holder receiving an amount in excess of the current value of the instrument upon a fundamental transaction (i.e., introduces leverage), and a leverage factor on a fair value input is prohibited under ASC 815-40-15-7F. Also, the occurrence of a fundamental transaction is not an input to an option pricing model.

Based on the circumstances described above, and given the significant diversity we have observed in practice, we believe either conclusion is acceptable. However, an entity would need to contemporaneously and clearly document its basis for conclusion, which should be applied consistently. Based on discussions with the SEC staff, we understand they would not object to the conclusion, in the circumstances described above, that such a provision would *not preclude* the warrant from being considered indexed to the entity's own stock. In our discussions with the SEC staff, they expressed no view on the conclusion that such a provision would preclude the warrant from being considered indexed to the entity's own stock, nor did they express a view on the appropriateness of the basis of conclusions for the alternative views. Accordingly, there may be other analysis and guidance to support the indexation conclusions. Importantly, if circumstances differ from those described above, entities are encouraged to consult with the SEC staff.

Cash dividends paid to warrant holders

A warrant for the purchase of an entity's common stock may include a participation feature that provides the warrant holder with the right to share in dividends along with common stockholders. The holder is entitled to the same distribution the holder would have received if they owned the warrant shares. Participation in the dividends is based on the quantity of shares the warrants are exercisable for, without consideration to the strike price of the warrants (i.e., regardless of whether the warrants are in the money). For example, if a warrant provides the holder with a right to purchase 100 shares, the participation right allows the holder to participate in dividends in the same manner as if they held the 100 shares.

When evaluating the settlement provisions under Step 2 of the indexation model, we are aware of diversity in practice. Some believe that the warrant *is not precluded* from being considered indexed to the entity's own stock. Some supporters of this view argue that the adjustment provision (i.e., the receipt of the dividend) constitutes a standard antidilution provision. An adjustment to the settlement amount for a dilutive event, such as a cash dividend, would not cause an instrument to fail Step 2 of the indexation guidance if the adjustment neutralizes the effect of the dilutive event on the fair value of the underlying share. This is consistent with the guidance in ASC 815-40-55-42 and 55-43. The dividend amount would reflect the direct effect that the occurrence of the dilutive event has on the price of the underlying shares.

Others believe that the warrant *is precluded* from being considered indexed to the entity's own stock. Some supporters of this view acknowledge that an adjustment to the settlement amount for a dilutive event, such as a cash dividend, would not cause an instrument to fail Step 2 of the indexation guidance if the adjustment just neutralizes the effect of the dilutive event on the fair value of the instrument (i.e., the warrant). However, in this case, the adjustment (i.e., the receipt of the dividend) does not necessarily correspond to the effect of the dilutive event on the fair value of the warrant. For example, if the warrant is not exercised, its fair value may change, as a result of the dividend, by an amount that is less than the full dividend value. However, the warrant holder is entitled to the same dividend as the common shareholder.

In the circumstances described above, we believe either conclusion is acceptable. However, an entity would need to contemporaneously and clearly document its basis for conclusion, which should be applied consistently. Based on discussions with the SEC staff, we understand they too would not object to either conclusion in the circumstances described above; however, the SEC staff expressed no view as to the appropriateness of the basis of conclusions for the alternative views. Accordingly, there may be other analysis and guidance to support the indexation conclusions. Importantly, if circumstances differ from those described above, entities are encouraged to consult with the SEC staff.

The examples that follow are contained within ASC 815-40-55-26 through 55-47.

Example 5-4: Evaluating whether an instrument is considered indexed to an entity's own stock (ASC 815-40-55-26 through 55-47)

Example 2: Variability Involving Completion of an Initial Public Offering

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

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

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

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

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

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

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

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.

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.

See paragraph 260-10-45-12B for earnings-per-share considerations, paragraph 260-10-25-1 for recognition considerations, and paragraphs 505-10-50-3 through 50-3A for disclosure considerations.

Example 10: Variability Involving Regulatory Approval

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

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

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

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

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

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

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

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.

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

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

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.

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

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.

Ramifications of being indexed to the entity's own stock

If after giving consideration to the two-step test, a conclusion is reached that the freestanding instrument or embedded feature is indexed to the entity's own stock, consideration is given to the section that follows (Section 5.2.2.2) to conclude on the balance sheet classification for that instrument or feature. If the conclusion is reached that an instrument or embedded feature is not indexed to the entity's own stock, it cannot be classified as equity and is accounted for as an asset or a liability (as appropriate), with an initial carrying amount based on fair value. If the instrument or feature meets the definition of a derivative[5] (refer to Section 5.2.2.3), ASC 815-10-35-2 requires ongoing fair value measurement, with changes in fair value reflected in earnings (assuming that the derivative is not designated in a hedge). If an instrument is not indexed to the entity's own stock and is not a derivative, ASC 815-40-35-4 requires ongoing fair value measurement, with changes in fair value reported in earnings.

Refer also to Section 5.2.2.4 for the continuous need to reassess the accounting analysis for these instruments.

5.2.2.2 Requirements to be classified in stockholders' equity

This section is relevant to determining the balance sheet classification of instruments or embedded features that were required to be evaluated under Section 5.2.2.1 and determined to be indexed to the entity's own stock.

As discussed within Section 5.2, the settlement methods associated with instruments drive whether or not the instruments will be eligible for equity classification. Balance sheet classification is governed by the guidance in ASC 815-40-25 and is based on the general concept that contracts that include any provision that requires net cash settlement are assets or liabilities and contracts that require settlement in shares are equity instruments. Nuances to this general concept outlined in ASC 815-40-25-1 through 25-9 include:

- If the contract provides the company with a choice of net cash settlement or settlement in shares, settlement in shares is assumed (if the settlement alternatives have the same economic value). Conversely, if the contract provides the counterparty (e.g., the investor or holder) with a choice of net cash settlement or settlement in shares, net cash settlement is generally assumed.
- Instruments with settlement alternatives that do not have the same economic value or have a settlement alternative that is fixed or contains caps or floors should be accounted for based on the

[5] Note that ASC 815-40 is not relevant to embedded features that are not derivatives.

economic substance of the transaction. This is illustrated through the following example contained at ASC 815-40-25-3: "… 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."

- ASC 815-40-25-36 through 25-38 address contracts that have differing settlement alternatives, depending on whether the contract is in a gain or loss position. If the company is required to pay net cash when the contract is in a loss position, the contract should be accounted for as an asset or liability. Conversely, contracts that require the company to receive net cash when the contract is in a gain position, but pay net stock (or net cash at the company's option) when the contract is in a loss position, would be classified as equity if all other criteria are met, as long as the contract is not 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.
- If net cash settlement is triggered only upon the occurrence of a specified event, it is not appropriate to give consideration to the unlikelihood that the event will occur. Consideration should, however, be given to whether the event is within the control of the company. In other words, if the company is in control of whether or not any event occurs that could require net cash settlement, net cash settlement would not be presumed.
- Generally, if an event that is not within the company's control could require net cash settlement, then the contract must be classified as an asset or a liability. However, if the net cash settlement requirement can only be triggered in limited circumstances in which the holders of the shares underlying the contract also would receive cash, equity classification would not be precluded. ASC 815-40-55-2 through 55-6 elaborate on this in the context of a change in control and nationalization event. To illustrate, an event that causes a change in control of a company is not within the company's control, and therefore, if a contract such as a warrant requires net-cash settlement upon a change in control, the warrant must be classified as a liability unless the holders of the class of shares that can be purchased through the warrants are contractually entitled to the same form of consideration (in this case, cash) upon the occurrence of the change in control. If instead of, or in addition to, cash, holders of the underlying shares are entitled to different forms of consideration (for example, debt), equity classification would be precluded. As indicated at ASC 815-40-55-2 through 55-5, change-in-control provisions that specify that all stockholders will receive stock of an acquiring company upon a change in control do not affect the classification of the contract.

On April 12, 2021, the SEC issued a Staff Statement on Accounting and Reporting Considerations for Warrants Issued by Special Purpose Acquisition Companies ("SPACs"), which highlighted a number of important financial reporting considerations for SPACs. Most notably, the statement describes fact patterns that are common in warrants issued in connection with a SPAC's formation and initial registered offering.

One of the fact patterns highlighted related to warrants that included a provision that, in the event of a tender or exchange offer made to and accepted by holders of more than 50% of the outstanding shares of a single class of common stock, all holders of the warrants would be entitled to receive cash for their warrants. The SEC staff concluded (with reference to the guidance in ASC 815-40-25-7 and 25-8 and related implementation guidance in ASC 815-40-55-2 through 55-6) that, in this fact pattern, equity classification is not appropriate, given that a tender offer is outside the control of the entity and, while all warrant holders would be entitled to cash, only certain of the holders of the underlying shares of common stock would be entitled to cash. This fact pattern specifically addressed the circumstance in which an entity has a dual class structure and the tender offer provision pertained to a non-controlling class of shares. The SEC staff subsequently has clarified that equity classification is precluded in this fact pattern because, as a consequence of this dual class structure, a change in control would not always occur upon this provision being triggered and therefore the limited exception discussed above does not apply. Entities that have a different fact pattern either before or after a SPAC merger may not be precluded from equity classification as a consequence of this provision (e.g., under a single class structure if the tender or exchange offer as described would always result in a change in control and otherwise meets the requirements of ASC 815-40-55-3 through 55-5).

- If cash settlement can only be triggered upon the final liquidation of the entity, equity classification is not precluded.
- The equity classification requirements within ASC 815-40-25-7 through 25-30 and ASC 815-40-55-2 through 55-6 do not apply if the hybrid contract is a convertible debt instrument pursuant to which the holder can only realize the value of the conversion option by exercising the option and receiving the entire proceeds in a fixed number of shares or an equivalent amount of cash (at the discretion of the issuer). (Refer to Section 3.3.2.2 for additional information.)

Additional equity classification requirements

If the instrument is not convertible debt for which the holder can only realize the value of the conversion option by exercising the option and receiving the entire proceeds in a fixed number of shares or an equivalent amount of cash at the discretion of the issuer (as discussed in Section 3.3.2.2), the following equity classification requirements in ASC 815-40-25-10 (and further explained in ASC 815-40-25-11 through 25-38) are also relevant:

- The entity has sufficient authorized and unissued shares.
- The contract contains an explicit share limit.
- There is no required cash payment if the entity fails to timely file.
- There are no cash settled top-off or make-whole provisions.

In the event one or more of these requirements is not met, the instrument or feature cannot be classified in equity.

Each of these requirements is discussed in the sections that follow.

Under ASC 815-40-25-10A, an entity is not required to consider the following conditions for an instrument or feature to be classified in equity, except as described below.

- Settlement is permitted in unregistered shares. A requirement to settle in registered shares would not preclude equity classification unless the contract explicitly states that an entity must settle the instrument or feature in cash if registered shares are unavailable.
- There are no counterparty rights that rank higher than shareholder rights. Even if the instrument or feature provides the counterparty with rights that rank higher than those of the holder of the underlying shares, equity classification would not be precluded.
- There is no collateral required. Equity classification would not be precluded if the contract includes a requirement to post collateral.

Spotlight on change

While ASU 2020-06 eliminated the requirement to consider these three conditions (ASC 815-40-25-10A) such that cash settlement is no longer presumed in such circumstances under ASC 815-40-25, corresponding changes have not been made to the SEC guidance in ASC 480-10-S99 on temporary equity classification. Specifically, there is some uncertainty around how the changes to ASC 815-40 impact the application of the SEC guidance in ASC 480-10-S99-3A in determining whether instruments that meet the requirements in ASC 815-40 for equity treatment should be classified as temporary or permanent equity in light of the scope of this SEC guidance and the requirement in ASC 480-10-S99-3A(6) to consider the guidance in ASC 815-40-25 when determining whether an issuer can control share settlement. Based on informal discussions with the SEC staff, the references in ASC 480-10-S99-3A are to the legacy guidance in ASC 815-40-25 (i.e., guidance in place prior to ASU 2020-06). Entities are encouraged to consult with the SEC in light of this uncertainty and monitor future developments.

ASC 815-40-25-18 also specifies that if a settlement alternative includes a penalty that would be avoided by an entity under other settlement alternatives, the uneconomic settlement alternative should be disregarded in classifying the contract.

Entity has sufficient authorized and unissued shares

The sufficiency of authorized and unissued shares to address all outstanding commitments that the company has to issue shares needs to be considered because the company cannot control share settlement of the contract under evaluation if it is or may become necessary to obtain shareholder approval to increase authorized shares. This evaluation needs to be performed on an ongoing basis and entails comparing the following two amounts:

1. 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:
    - Outstanding convertible debt that is convertible during the contract period
    - Outstanding stock options that are or will become exercisable during the contract period
    - Other derivative financial instruments indexed to, and potentially settled in, an entity's own stock
2. The maximum number of shares that could be required to be delivered under share settlement (either net share or physical) of the contract

When performing this comparison, keep in mind:

- The maximum number of shares that could be required to be delivered under a registration payment arrangement should be considered a commitment, regardless of whether the instrument being evaluated is subject to the arrangement.
- If the company has the option to either net-share settle a contract or physically settle by delivering the full number of shares, the alternative that results in the lesser number of maximum shares should be included in this calculation.
- If a contract is classified as an asset or liability because the counterparty has the option to require settlement in cash, the maximum number of shares that the counterparty could require to be delivered upon physical or net share settlement should be included in this calculation.
- If the contract provides for adjustments to the number of shares that may need to be issued and the events that would trigger the adjustment are within the control of the company, any additional shares that may need to be issued are not included as a commitment until triggered or not within the company's control.

If the amount in (1) exceeds the amount in (2), and all other conditions are met, share settlement is within the control of the company and the contract should be classified as equity. If there is a shortfall at any point in time, an accounting policy election can be made (so long as it is consistently applied) to allocate available shares to the various commitments to determine what contracts (or portions of contracts for contracts that permit partial net share settlement) that are subject to the equity classification guidance need to be classified (or reclassified) as an asset or liability rather than equity. Refer to Section 5.2.2.4 for additional discussion of this policy election and reclassification.

Contract contains an explicit share limit

For certain contracts, the number of shares that could be required to be delivered upon net-share settlement is essentially indeterminate, in which case the company is not able to conclude that is has sufficient available and unissued shares to settle that contract. Assume, for example, that a perpetual preferred stock instrument with a $1 million carrying amount can be converted into an unlimited variable number of common shares, with the number of shares to be determined based on the issuer's common share price at the date of conversion. If the common share price is $10, the issuer would be required to issue 100,000 shares. If the share price is $.01, the issuer would be required to issue 100 million shares. Since there is no limit on how low the share price can go, and therefore no limit on the number of shares the company may need to issue, the company cannot control share settlement for this contract and other share-settled instruments. (No consideration can be given to the improbability that the stock price will decline below a certain amount.) When such an instrument exists, the accounting policy election referred to earlier, and discussed in more depth at Section 5.2.2.4, would come into play in determining which of the contracts that are subject to the equity classification requirements of ASC 815-40 cannot be classified as equity given the existence of a contract that requires settlement in an unlimited number of shares. If, for example, the company's policy is that contracts with the latest inception date will be reclassified first (i.e., available shares will be allocated to contracts with the earliest inception date first), this would not pose a problem for contracts issued before the contract that requires settlement in an unlimited number of shares, but would be problematic for subsequently issued contracts that are subject to ASC 815-40. For this reason, it is important to carefully consider potential future ramifications when establishing the accounting policy.

Some contracts contain a cap on the number of shares that will be issued in settlement of the contract and may also require that the issuer deliver the shares in excess of the capped amount when authorized unissued shares become available. The entity is typically required to use its best efforts to authorize sufficient shares to satisfy the obligation. 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, these additional shares would not need to be considered when determining whether the entity has sufficient, authorized, unissued shares to net share settle the contract. However, if the contract provides that the number of shares that must be delivered to settle the excess obligation will be based on the market value of the shares at the time the excess obligation is settled (to result in a fixed dollar amount of value rather than a fixed number of shares), the excess obligation represents stock-settled debt and equity classification of the contract would be precluded.

No required cash payment if entity fails to timely file

If the contract requires net cash settlement in the event the company does not make timely filings with the SEC, equity classification would be precluded. The ability to make timely filings is not deemed to be within an entity's control. Penalty payments that do not result in the settlement of the instrument do not preclude equity classification.

No cash settled top-off or make-whole provisions

Certain contracts include top-off or make-whole provisions that are generally structured to reimburse the counterparty for any losses it incurs, or to transfer to the company any gains the counterparty recognizes, for the difference between the settlement date value and the value received by the counterparty in subsequent sales of the securities within a specified time after the settlement date. If this provision must be cash settled or can be cash settled at the counterparty's option, equity classification for the contract would be precluded. If, on the other hand, this provision can be net share settled at the company's option, and the maximum number of shares that could be required to be delivered under the contract is fixed and 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 earlier), a top-off or make-whole provision would not preclude equity classification.

Accounting treatment if equity classification requirements are met

If an embedded derivative feature is both indexed to the entity's own stock and meets the requirements to be classified in equity as discussed earlier, it qualifies for the scope exception from derivative treatment under ASC 815-10-15-74(a). In that case, the feature should not be separately recognized as a derivative. (For convertible debt instruments, refer to Section 3.4, as conversion features may need to be recognized as a separate component of equity under ASC 470-20.) Freestanding equity-linked instruments that are indexed to the entity's own stock and meet the equity classification requirements discussed earlier are generally classified as additional paid in capital and either initially measured at fair value or proportionately allocated proceeds, as described at Section 2.3, if issued contemporaneously with other financial instruments. Except as noted in the section that follows, the carrying amount of equity-classified instruments is not subsequently adjusted unless the instrument is modified or requires reclassification. (Refer to the discussion at Section 5.2.2.4 on the need to continuously reassess the accounting treatment for these instruments.) SEC registrants and entities that apply the SEC guidance should give consideration to ASC 480-10-S99 (discussed in Section 4.2.3) to determine whether temporary equity presentation and subsequent adjustments to the carrying amount are necessary for an instrument that meets the equity classification requirements.

Subsequent measurement considerations for freestanding equity-classified financial instruments with down round features

Entities that are required to or voluntarily present EPS are required to account for the effect of a down round feature (i.e., the value created through the reduction to the strike price) each time the down round feature is triggered (i.e., the strike price is reduced) in a freestanding equity-classified financial instrument. The effect is accounted for as a dividend through a reduction to retained earnings and an increase to the instrument's carrying amount (e.g., additional paid in capital for warrants). This dividend also reduces income available to common shareholders in the computation of basic EPS. The carrying amount of the equity-classified instrument is not subject to further adjustment unless the down round feature is triggered again.

The amount to be recognized as a dividend is the difference between the following two amounts, determined in accordance with ASC 820 immediately after the down round feature is triggered:

1. The fair value of the financial instrument (ignoring the down round feature) with the strike price that was in effect before the strike price reduction
2. The fair value of the financial instrument (ignoring the down round feature) with the reduced strike price resulting from the down round being triggered

It should be noted that while the down round feature is ignored when determining the fair value of the instrument for the purpose of this computation, all features of an instrument (including a down round feature) should be considered when it is necessary to determine the fair value of an instrument for other purposes (such as to establish its initial carrying amount). An example of this accounting from ASC 260-10-55-95 through 55-97 follows. This accounting does not apply to liability classified instruments, which generally require ongoing fair value measurement. Additionally, as noted previously, entities that do not present EPS do not recognize the effect of triggering a down round feature.

Example 5-5: Equity-classified freestanding financial instruments that include a down round feature (ASC 260-10-55-95 through 55-97)

Assume Entity A issues warrants that permit the holder to buy 100 shares of its common stock for $10 per share and that Entity A presents EPS in accordance with the guidance in this Topic. The warrants have a 10-year term, are exercisable at any time, and contain a down round feature. The warrants are classified as equity by Entity A because they are indexed to the entity's own stock and meet the additional conditions necessary for equity classification in accordance with the guidance in Subtopic 815-40 on derivatives and hedging—contracts in entity's own equity (see paragraphs 815-40-55-33 through 55-34A for an illustration of the guidance in Subtopic 815-40 applied to a warrant with a down round feature). Because the warrants are an equity-classified freestanding financial instrument, they are within the scope of the recognition and measurement guidance in this Topic. The terms of the down round feature specify that if Entity A issues additional shares of its common stock for an amount less than $10 per share or issues an equity-classified financial instrument with a strike price below $10 per share, the strike price of the warrants would be reduced to the most recent issuance price or strike price, but the terms of the down round feature are such that the strike price cannot be reduced below $8 per share. After issuing the warrants, Entity A issues shares of its common stock at $7 per share. Because of the subsequent round of financing occurring at a share price below the strike price of the warrants, the down round feature in the warrants is triggered and the strike price of the warrants is reduced to $8 per share.

In accordance with the measurement guidance in paragraphs 260-10-30-1 through 30-2, Entity A determines that the fair value of the warrants (without the down round feature) with a strike price of $10 per share immediately after the down round feature is triggered is $600 and that the fair value of the warrants (without the down round feature) with a strike price of $8 per share immediately after the down round feature is triggered is $750. The increase in the value of $150 is the value of the effect of the triggering of the down round feature.

The $150 increase is the value of the effect of the down round feature to be recognized in equity in accordance with paragraph 260-10-25-1, as follows:

Retained earnings	$150	
Additional paid-in capital		$150

Additionally, Entity A reduces income available to common stockholders in its basic EPS calculation by $150 in accordance with the guidance in paragraph 260-10-45-12B. Entity A applies the treasury stock method in accordance with paragraphs 260-10-45-23 through 45-27 to calculate diluted EPS. Accordingly, the $150 is added back to income available to common stockholders when calculating diluted EPS. However, the treasury stock method would not be applied if the effect were to be antidilutive.

Accounting treatment if equity classification requirements are not met

Refer to Section 3.3.3 for debt instruments or Section 4.3.5 for preferred or similar stock if an embedded derivative within the instrument, such as a conversion option, does not meet the equity classification requirements. If the conclusion is reached that an instrument or embedded feature subject to the scope of ASC 815-40 does not meet the equity classification requirements discussed earlier, the instrument or feature is accounted for as an asset or a liability (as appropriate), with an initial and subsequent fair value measurement amount and changes in fair value reflected in earnings (assuming that if the instrument is a derivative, it is not designated in a hedge). The section that follows should be considered to determine if the instrument is a derivative, because if so, the disclosure requirements in ASC 815 are relevant. Refer also to the discussion at Section 5.2.2.4 on the need to continuously reassess the accounting treatment for these instruments.

5.2.2.3 Derivative considerations

This section discusses application of the definition of a derivative to freestanding equity-linked instruments. For a discussion of derivative considerations for features that are embedded in debt, refer to Section 3.3, and refer to Section 4.3 for a discussion of derivative considerations for features that are embedded in preferred and similar stock.

The determination of whether a freestanding instrument is required to be accounted for and disclosed as a derivative entails determining if it has all the characteristics of a derivative and if it qualifies for a scope exception, as summarized at ASC 815-10-15-13. The exception for certain contracts involving an entity's own equity is most commonly relevant to the equity-linked instruments that are the subject of this chapter. As elaborated on at ASC 815-10-15-74, instruments that are both indexed to the entity's own stock in accordance with Section 5.2.2.1 and classified in stockholder's equity in accordance with Section 5.2.2.2 are excluded from the scope of ASC 815, in addition to forward purchase contracts for the entity's shares that require physical settlement. The characteristics of a derivative are outlined and elaborated on at ASC 815-10-15-83 through 15-139 and the related implementation guidance in ASC 815-10-55.

RSM COMMENTARY: Understanding the terminology

By definition, a derivative instrument has all of the following characteristics:

- One or more underlyings
- One or more notional amounts or payment provisions
- 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 can be settled net by any of the following means:
  - Its terms implicitly or explicitly require or permit net settlement.
  - It can readily be settled net by a means outside the contract.
  - It provides for delivery of an asset that puts the recipient in a position not substantially different from net settlement.

While an in-depth discussion of derivatives is beyond the scope of this guide, equity-linked instruments typically meet the first three characteristics listed and the derivative conclusion often hinges on whether the contract can be settled net. Consider, for example, a warrant or a forward contract to purchase or sell shares. The fair value of the shares constitutes an underlying. The number of shares that can be purchased through the warrant or must be purchased through the forward contract represent a notional amount. Any initial net investment that may be required to enter into a warrant or forward contract is typically significantly less than the investment that would be required to acquire the shares, in which case, the third characteristic is met.

As it relates to the fourth characteristic, net settlement can occur in various ways. As an example, the contract may provide for the issuer of a warrant to pay cash to the holder equal to the difference between the fair value of the shares at the exercise date and the exercise price of the warrant, or the contract could permit net share settlement such that rather than paying cash to exercise the warrant, the number of shares transferred to the holder upon exercise is reduced to compensate for the exercise price (often referred to as a cashless exercise). If contractual net settlement does not exist, consideration should be given to whether the underlying shares are readily convertible to cash. This typically depends on whether the shares are publicly traded and, if so, the daily transaction volume.

RSM COMMENTARY: Are the shares readily convertible to cash?

The determination of whether the shares are readily convertible to cash needs to be considered on an ongoing basis throughout a contract's life. Delisting, an IPO or significant changes in the level of trading activity are examples of factors that could influence the conclusion, as consideration needs to be given to whether the smallest increment of shares that would be delivered in accordance with each individual contract is small relative to the daily transaction volume. Assume for example that a warrant gives the holder the ability to purchase 100,000 shares of publicly traded common stock. The average daily trading volume associated with the common stock is 50,000 shares. If the warrant is required to be exercised in total, the 100,000 shares are large relative to the daily transaction volume, and the common shares would not be considered to be readily convertible to cash. Most warrants permit exercise in whole or in part (i.e., in whatever increment the holder elects), in which case, generally, the common shares would be considered to be readily convertible to cash if they are actively traded. Refer to ASC 815-10-15-130 through 15-139 for additional information, including special considerations relevant to warrants to purchase shares that have restrictions on their sale or transfer. Additionally, the implementation guidance beginning at ASC 815-10-55-84 may be useful in determining if net settlement exists.

If a conclusion is reached that the equity-linked instrument meets the definition of a derivative, consideration should be given to the scope exceptions outlined at ASC 815-10-15-13. The exception that is most commonly relevant is ASC 815-10-15-74(a). If the instrument is indexed to the entity's stock and classified in stockholders' equity as discussed at Section 5.2.2.1 and Section 5.2.2.2, it would not be accounted for as a derivative. If the instrument does not qualify for this or any other scope exception, it should be accounted for as an asset or a liability (as appropriate) at fair value, with changes in fair value reflected in earnings (assuming the instrument is not designated in a hedge).

5.2.2.4 Reassessment of contracts for potential reclassification

ASC 815-40-35-8 requires the classification of a contract to be reassessed at each balance sheet date, given that the classification can change for various reasons, including:

- Modifications to the terms of the instrument
- Changes to the conclusion about whether an entity can demonstrate it has sufficient authorized shares to share settle a contract
- If settlement terms for a particular instrument are subject to adjustment for a limited period of time, after the terms are no longer subject to adjustment, an instrument that was not initially indexed to the entity's stock could become indexed
- Changes in the volume of share activity impact conclusions on whether the shares can be readily converted to cash such that net settlement exists and the instrument is a derivative

As is elaborated on in ASC 815-40-35, if the required classification of a contract changes as a result of events during the period, the contract should be reclassified as of the date of the event that triggered the reclassification. There is no limit on the number of times a contract may need to be reclassified. If a contract is reclassified from permanent or temporary equity to an asset or a liability, the asset or liability would be measured at its fair value at the reclassification date, with the change in fair value during the period the contract was classified as equity accounted for as an adjustment to stockholders' equity. The asset or liability would be subsequently adjusted to fair value through earnings. 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 are not reversed; however, the carrying amount is not subject to further adjustment as long as the contract continues to qualify for equity classification.

In some cases, it may be necessary to reclassify portions of contracts or multiple contracts. Assume, for example, that an entity does not have sufficient authorized shares to be able to demonstrate that it can control share settlement of a contract in its entirety. (See related discussion in Section Entity has sufficient authorized and unissued shares.) If the contract in question permits partial net share settlement, the portion that could be net share settled as of the balance sheet date would remain classified in permanent equity, and the remaining portion of the contract would be classified as an asset, a liability or temporary equity, as appropriate. Additionally, when the company cannot demonstrate that it has sufficient authorized shares for all of its outstanding commitments to issue shares, there needs to be an accounting policy in place and consistently applied to determine which contracts, or portions of contracts, that are subject to the scope of ASC 815-40 should be reclassified. ASC 815-40-35-12 acknowledges that different methods may be used to determine the contracts (or portions of contracts) that should be reclassified, and specifically mentions the following as examples of methods that would comply:

- Partial reclassification of all contracts on a proportionate basis
- Reclassification of contracts with the earliest inception date first
- Reclassification of contracts with the earliest maturity date first

- Reclassification of contracts with the latest inception or maturity date first
- Reclassification of contracts with the latest maturity date first

In any case, the method used should be systematic, rational and consistently applied. Refer to the discussion in Section Contract contains an explicit share limit for an example.

5.2.2.5 Modification or exchange of equity-linked instruments

Modification or exchange of equity-link instruments classified as equity

ASC 815-40-35-14 through 35-18 addresses the modification or exchange of an equity-classified freestanding written call option, such as a warrant. This guidance relates to instruments that remain equity classified subsequent to the modification or exchange. Provided another ASC Topic does not apply, such a transaction is treated as an exchange of the original instrument for a new instrument. The effect of the modification or exchange would be measured:

- For a modification or an exchange that is a part of or directly related to a debt modification or exchange, as the difference between the fair value of the modified or exchanged written call option and the fair value of that written call option immediately before it is modified or exchanged.
- For all other modifications or exchanges, as the excess, if any, of the fair value of the modified or exchanged written call option over the fair value of that written call option immediately before it is modified or exchanged.

The effect of the modification or exchange of the call option is recognized on the basis of the substance of the transaction to which it directly relates, in the same manner as if cash had been paid as consideration:

- For a financing transaction to raise equity (including through modifications to induce the exercise of the call option), the effect should be recognized as an equity-issuance cost in accordance with ASC 340.
- For a debt origination, the effect should be recognized as a debt discount or origination cost in accordance with ASC 835.
- For a debt modification or exchange, the effect should be recognized in accordance with ASC 470-50 and ASC 470-60.
- For modifications or exchanges to compensate for goods or services, the effect should be recognized in accordance with the guidance in ASC 718.
- For all other modifications or exchanges that are not within the scope of another topic within the FASB codification, the effect should be recognized as a dividend with an adjustment to net income or loss in the basic EPS calculation for entities that present EPS.

In a multiple-element transaction (e.g., one that includes both debt financing and equity financing), the total effect of the modification should be allocated to the respective elements in the transaction.

Modification or exchange of equity-link instruments classified as liabilities

If the instrument that is modified is classified as a liability and carried at fair value, the value attributable to the modification will be captured when the carrying amount of the instrument is subsequently adjusted to fair value. (Refer to Section 5.2.2.4 for further guidance on the accounting treatment if, as a consequence of the modification, the balance-sheet classification of the instrument changes.)

5.2.2.6 Settlement of equity-linked instruments

The settlement of an equity-linked contract generally results in the exchange of cash for shares. As such, upon settlement of an instrument that is classified as equity, cash is debited for the amount received or credited for the amount paid. The appropriate equity accounts are credited for the amount of cash received if shares are issued or debited if shares are purchased.

For those instruments that are required to be accounted for as an asset or liability at fair value through earnings, the instrument's carrying amount should be adjusted to its settlement-date fair value before transferring the carrying amount to equity.

ASC 470-50-40-5 indicates that if debt issued with warrants is permitted to be tendered towards the exercise price of the warrants, any such tendering would be accounted for in the same manner as a conversion of the debt.

5.3 Accelerated share repurchase program

Entities sometimes conduct accelerated share repurchase programs as a way of making an immediate purchase of a large number of shares, with the final purchase price of the shares based on an average market price over a fixed period of time. Such programs are used to obtain immediate share retirement benefits without disrupting the market. ASC 505-30 governs the accounting treatment for these arrangements and specifies that the arrangement should be accounted for as two separate transactions: a treasury stock purchase on the acquisition date and a forward contract indexed to the entity's common stock.

Example 5-6: Accelerated share repurchase program (ASC 505-30-55-3 and 55-5)

Treasury stock purchase

Investment Banker, an unrelated third party, borrows 1,000,000 shares of Company A common stock from investors, becomes the owner of record of those shares, and sells the shares short to Company A on July 1, 1999, at the fair value of $50 per share. Company A pays $50,000,000 in cash to Investment Banker on July 1, 1999, to settle the purchase transaction. The shares are held in treasury. Company A has legal title to the shares, and no other party has the right to vote those shares.

Forward contract

Company A simultaneously enters into a forward contract with Investment Banker on 1,000,000 shares of its own common stock. On the October 1, 1999, settlement date, if the volume-weighted average daily market price of Company A's common stock during the contract period (July 1, 1999, to October 1, 1999) exceeds the $50 initial purchase price (net of a commission fee to Investment Banker), Company A will deliver to Investment Banker cash or shares of common stock (at Company A's option) equal to the price difference multiplied by 1,000,000. If the volume-weighted average daily market price of Company A's common stock during the contract period is less than the $50 initial purchase price (net of a commission fee to Investment Banker), Investment Banker will deliver to Company A cash equal to the price difference multiplied by 1,000,000.

There are many variations of accelerated share repurchase programs, and the nuances of each can impact the accounting treatment. The approach outlined at Section 5.2 would be followed in determining the accounting treatment for the forward contract.

Appendix A: Acronyms and literature references

Several acronyms are used throughout this guide and numerous references are made to specific topics and subtopics in the ASC. Provided in this appendix are an acronym legend, which lists the acronyms used throughout this guide and their corresponding definitions, and a literature listing, which lists the topics and subtopics referred to throughout this guide and the corresponding titles.

Acronym legend

Acronym	Definition
AICPA	American Institute of Certified Public Accountants
APIC	Additional paid-in capital
ASC	FASB's Accounting Standards Codification
ASU	Accounting Standards Update
EITF	FASB Emerging Issues Task Force
EPS	Earnings per share
FAS	FASB Statements
FASB	Financial Accounting Standards Board
FSP	FASB Staff Positions
GAAP	Generally accepted accounting principles
IPO	Initial public offering
SEC	U.S. Securities and Exchange Commission
SPAC	Special-purpose acquisition company

Literature listing

ASC topic or subtopic	Title
260	Earnings Per Share
260-10	Earnings Per Share – Overall
340	Other Assets and Deferred Costs
450	Contingencies
450-20	Contingencies – Loss Contingencies
470-10	Debt – Overall
470-20	Debt – Debt with Conversion and Other Options
470-50	Debt – Modifications and Extinguishments
470-60	Debt – Troubled Debt Restructurings by Debtors
480	Distinguishing Liabilities from Equity
480-10	Distinguishing Liabilities from Equity – Overall
505-10	Equity – Overall
505-30	Equity – Treasury Stock
718	Compensation—Stock Compensation
718-20	Compensation—Stock Compensation – Awards Classified as Equity
815	Derivatives and Hedging

ASC topic or subtopic	Title
815-10	Derivatives and Hedging – Overall
815-15	Derivatives and Hedging – Embedded Derivatives
815-40	Derivatives and Hedging – Contracts in Entity's Own Equity
820	Fair Value Measurement
825-20	Financial Instruments – Registration Payment Arrangements
835	Interest
835-30	Interest – Imputation of Interest

Other literature	Title
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
ASU 2024-04	Debt – Debt with Conversion and Other Options (Subtopic 470-20): Induced Conversions of Convertible Debt Instruments
AICPA Technical Questions and Answers Section 4210.01	Dividends – Write-Off of Liquidating Dividends
AICPA Technical Questions and Answers Section 4210.04	Dividends – Accrual of Preferred Dividends
FAS 150	Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity
FSP FAS 150-5	Issuer's Accounting under FASB Statement No. 150 for Freestanding Warrants and Other Similar Instruments on Shares That Are Redeemable

Appendix B: Definitions

Several terms with specific meanings are used throughout this guide. Those terms and the corresponding definition, based primarily on the Master Glossary of the Codification, are provided in the following table. If a definition is not from the Master Glossary of the Codification, that fact is noted along with sources, if applicable.

Term	Definition
Contingently convertible instruments	Contingently convertible instruments are instruments that have embedded conversion features that are contingently convertible or exercisable based on either of the following: a. A market price trigger b. Multiple contingencies if one of the contingencies is a market price trigger and the instrument can be converted or share settled based on meeting the specified market condition. A market price trigger is a market condition that is based at least in part on the issuer's own share price. Examples of contingently convertible instruments include contingently convertible debt, contingently convertible preferred stock, and the instrument described by paragraph 260-10-45-43, all with embedded market price triggers.
Conversion shares [non-Master Glossary definition]	The shares into which a convertible instrument can be converted. In other words, if preferred stock or debt is convertible into common stock, the conversion shares are the common stock that would be received in satisfaction of the convertible instrument upon conversion.
Convertible debt [non-Master Glossary definition]	A convertible debt instrument generally provides an option to the holder to convert the instrument into a predetermined number of common or preferred shares rather than receive repayment of the face amount in cash or cash equivalents. [derived from ASC 470-20-05-04 and 05-06]
Convertible security	A security that is convertible into another security based on a conversion rate. For example, convertible preferred stock that is convertible into common stock on a two-for-one basis (two shares of common for each share of preferred).
Derivative instrument [non-Master Glossary definition]	A financial instrument or other contract with all of the following characteristics: a. Underlying, notional amount, payment provision. The contract has both of the following terms, which determine the amount of the settlement or settlements, and, in some cases, whether or not a settlement is required: 1. One or more underlyings 2. One or more notional amounts or payment provisions or both. b. Initial net investment. 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. c. Net settlement. The contract can be settled net by any of the following means:

Term	Definition
	1. Its terms implicitly or explicitly require or permit net settlement. 2. It can readily be settled net by a means outside the contract. 3. It provides for delivery of an asset that puts the recipient in a position not substantially different from net settlement. [ASC 815-10-15-83]
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.
Embedded derivative	Implicit or explicit terms that affect 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.
Equity restructuring	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, spinoff, rights offering, or recapitalization through a large, nonrecurring cash dividend.
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.
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.

Term	Definition
Firm commitment	An agreement with an unrelated party, binding on both parties and usually legally enforceable, with the following characteristics: a. The agreement specifies all significant terms, including the quantity to be exchanged, the fixed price, and the timing of the transaction. The fixed price may be expressed as a specified amount of an entity's functional currency or of a foreign currency. It may also be expressed as a specified interest rate or specified effective yield. The binding provisions of an agreement are regarded to include those legal rights and obligations codified in the laws to which such an agreement is subject. A price that varies with the market price of the item that is the subject of the firm commitment cannot qualify as a fixed price. For example, a price that is specified in terms of ounces of gold would not be a fixed price if the market price of the item to be purchased or sold under the firm commitment varied with the price of gold. b. The agreement includes a disincentive for nonperformance that is sufficiently large to make performance probable. In the legal jurisdiction that governs the agreement, the existence of statutory rights to pursue remedies for default equivalent to the damages suffered by the nondefaulting party, in and of itself, represents a sufficiently large disincentive for nonperformance to make performance probable for purposes of applying the definition of a firm commitment.
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.
Host contract [non-Master Glossary definition]	A hybrid instrument exclusive of the embedded derivative. [derived from ASC 815-15-05-1]
Hybrid instrument	A contract that embodies both an embedded derivative and a host contract.
Interest method	The method used to arrive at a periodic interest cost (including amortization) that will represent a level effective rate on the sum of the face amount of the debt and (plus or minus) the unamortized premium or discount and expense at the beginning of each period.
Make-whole provision	A cash payment to a counterparty if the shares initially delivered upon settlement are subsequently sold by the counterparty and the sales proceeds are insufficient to provide the counterparty with full return of the amount due. While the exact terms of such provisions vary, they generally are intended to reimburse the counterparty for any losses it incurs or to transfer to the entity any gains the counterparty recognizes on the difference between the following: a. The settlement date value

Term	Definition
	b. The value received by the counterparty in subsequent sales of the securities within a specified time after the settlement date.
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.
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.
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.
Notional amount	A number of currency units, shares, bushels, pounds, or other units specified in a derivative instrument. Sometimes other names are used. For example, the notional amount is called a face amount in some contracts.
Obligation	A conditional or unconditional duty or responsibility to transfer assets or to issue equity shares. This definition is applicable only for items within the scope of Topic 480.
Payment provision	A payment provision specifies a fixed or determinable settlement to be made if the underlying behaves in a specified manner.
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.
Public business entity	A public business entity is a business entity meeting any one of the criteria below. Neither a not-for-profit entity nor an employee benefit plan is a business entity. a. It is required by the U.S. Securities and Exchange Commission (SEC) to file or furnish financial statements, or does file or furnish financial statements (including voluntary filers), with the SEC (including other entities whose financial statements or financial information are required to be or are included in a filing). b. It is required by the Securities Exchange Act of 1934 (the Act), as amended, or rules or regulations promulgated under the Act, to file or furnish financial statements with a regulatory agency other than the SEC. c. It is required to file or furnish financial statements with a foreign or domestic regulatory agency in preparation for the sale of or for purposes of issuing securities that are not subject to contractual restrictions on transfer. d. It has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market. e. It has one or more securities that are not subject to contractual restrictions on transfer, and it is required by law, contract, or regulation to prepare U.S. GAAP financial statements (including notes) and make them publicly

Term	Definition
	available on a periodic basis (for example, interim or annual periods). An entity must meet both of these conditions to meet this criterion. An entity may meet the definition of a public business entity solely because its financial statements or financial information is included in another entity's filing with the SEC. In that case, the entity is only a public business entity for purposes of financial statements that are filed or furnished with the SEC.
Put option	A contract that allows the holder to sell a specified quantity of stock to the writer of the contract at a fixed price during a given period.
Readily convertible to cash	Assets that are readily convertible to cash have both of the following: a. Interchangeable (fungible) units b. Quoted prices available in an active market that can rapidly absorb the quantity held by the entity without significantly affecting the price.
Securities and Exchange Commission (SEC) filer	An entity that is required to file or furnish its financial statements with either of the following: a. The Securities and Exchange Commission (SEC) b. With respect to an entity subject to Section 12(i) of the Securities Exchange Act of 1934, as amended, the appropriate agency under that Section. Financial statements for other entities that are not otherwise SEC filers whose financial statements are included in a submission by another SEC filer are not included within this definition.
Standard antidilution provisions	Standard antidilution provisions are those that result in adjustments to the conversion ratio in the event of an equity restructuring transaction that are designed to maintain the value of the conversion option.
Underlying	A specified interest rate, security price, commodity price, foreign exchange rate, index of prices or rates, or other variable (including the occurrence or nonoccurrence of a specified event such as a scheduled payment under a contract). An underlying may be a price or rate of an asset or liability but is not the asset or liability itself. An underlying is a variable that, along with either a notional amount or a payment provision, determines the settlement of a derivative instrument.

Appendix C: Summary of significant changes since last edition

The following list summarizes the significant changes to this guide since our last edition (March 2022):

Chapter 1 – Forward

- Renumbered the Forward to Chapter 1
- Removed the references to "after adoption of ASU 2020-06," as the guidance is now in effect
- Removed content superseded upon adoption of ASU 2020-06
- Updated information on scope and recent updates to the guide

Chapter 2 – Accounting for the issuance of multiple instruments or embedded features

- Renumbered from Chapter 1 in the prior guide to Chapter 2
- Removed the material discussing guidance prior to the adoption of ASU 2020-06 and removed the differentiation between prior to and after the adoption of ASU 2020-06, as the guidance is now in effect

Chapter 3 – Accounting for debt with conversion options and other embedded features

- Renumbered from Chapter 2 in the prior guide to Chapter 3
- Removed the references to "after adoption of ASU 2020-06," as the guidance is now in effect
- Added Section 3.5.3.1 to address accounting for an induced conversion subsequent to adoption of ASU 2024-04
- Added Section 3.5.3.2 for existing guidance on induced conversions prior to adoption of ASU 2024-04

Prior Chapter 3 – Accounting for debt with conversion options and other embedded features – Before adoption of ASU 2020-06

- Deleted chapter as the guidance is now in effect

Chapter 4 – Accounting for preferred and similar stock

- Removed the material discussing guidance prior to the adoption of ASU 2020-06 and removed the differentiation between prior to and after the adoption of ASU 2020-06, as the guidance is now in effect
- In Section 4.2.3.1, added excerpt from ASC 480-1-S99-3A(3)(f) and table addressing common deemed liquidation events

Chapter 5 – Accounting for warrants and other equity-linked instruments

- Removed the material discussing guidance prior to the adoption of ASU 2020-06 and removed the differentiation between prior to and after the adoption of ASU 2020-06, as the guidance is now in effect
- Added guidance on simple agreements for future equity to Section 5.2.1.1
- Moved guidance from Appendix on ASU 2017-11 to Section Adjustments triggered by contractual changes to the strike price of another instrument
- Removed guidance from prior to adoption of ASU 2017-11
- Added new section, Early settlement upon fundamental transactions
- Added new section, Cash dividends paid to warrant holders

- Removed guidance superseded upon adoption of ASU 2021-04

Appendices

- Appendix A was updated for relevant Codification guidance and other literature
- Appendix B was updated to include additional definitions as a result of recently issued ASUs
- Prior Appendix C was deleted as ASU 2020-06 is now in effect
- Prior Appendix D was deleted as ASU 2017-11 is now in effect
- Appendix C was added to summarize the changes to the guide since the last edition

A GUIDE TO ACCOUNTING FOR DEBT AND EQUITY INSTRUMENTS IN FINANCING TRANSACTIONS

This edition of a guide to accounting for debt and equity instruments in financing transactions has been produced by the National Professional Standards Group of RSM US LLP.

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