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Contents

FASB Proposes Changes to Accounting for Down-Round Financial Instruments

A recent FASB proposal would require companies to disregard down-round features when determining whether certain equity-linked financial instruments should be classified as liabilities or equity.[1] Down-round features likewise would not affect ongoing measurement of financial instruments (when liability-classified) and would only be accounted for when they are triggered.

The proposed Accounting Standards Update (ASU) also would create a scope exception for mandatorily redeemable financial instruments of certain nonpublic entities and noncontrolling interests. The proposed ASU is not expected to change practice for these instruments, but rather, to make the accounting guidance easier to use.

Key Facts

- The proposed ASU would affect classification and accounting for equity-linked instruments with down-round features. These instruments include warrants and convertible debt instruments that have an equity conversion option for which other guidance does not require separation of the equity conversion option from the debt host.
- The down-round feature would not be considered when determining the accounting treatment for a free-standing or embedded equity-linked instrument.
- When it is triggered, the fair value of the down-round feature would be recognized either as a dividend (when the instrument is classified as equity) or as a charge to net income (when the instrument is classified as a liability).

[1] FASB Proposed Accounting Standards Update, Distinguishing Liabilities from Equity: I. Accounting for Certain Financial Instruments with Down Round Features and II. Replacement of the Indefinite Deferral for Mandatorily Redeemable Financial Instruments of Certain Nonpublic Entities and Certain Mandatorily Redeemable Noncontrolling Interests with a Scope Exception, December 7, 2016, available at www.fasb.org.

Key Impacts

- A company no longer would have to account for freestanding and embedded financial instruments with down-round features as liabilities subject to fair value measurement on an ongoing basis, if they otherwise qualify for equity classification.
- The consequences of down-round features would be reflected only when triggered rather than including the down-round feature in ongoing fair value measurements of the instrument.

Financial Instruments with Down-Round Features

A down-round feature is a provision in an equity-linked instrument that reduces the strike price of a financial instrument if the company:

- Sells additional shares of its common stock for an amount less than the current strike price of the equity-linked instrument; or
- Issues an equity-linked financial instrument with a strike price below the current strike price of the financial instrument.

Thus, a down-round feature exists to protect certain investors from a decline in a company's share price. Although a down-round feature normally is not a significant driver of the fair value of the instrument, the fair value of that instrument is somewhat greater than a similar equity-linked instrument without a down-round feature.

Under U.S. GAAP, instruments with a down-round feature generally are not considered to be indexed to a company's own stock.[2] Therefore, the financial instrument often is classified as a liability and is measured at fair value with changes in fair value recognized in net income. Because the down-round feature is intended to protect the holder from downward changes in the company's share price, the fair value of the down-round feature moves in the opposite direction to the company's share price. As a consequence, if the share price increases and the down-round feature is not triggered, the fair value of the instrument could decline, which would cause the company to report a gain in net income.

Conversely, if the share price decreases, the company would recognize the change in the fair value of the instrument (which would be increased by the company's share price decline) in net income even though the company has not conducted an equity offering at the lower price. Some stakeholders have argued that these fair value adjustments do not reflect the economics of the down-round features because they see down-round features as akin to protective rights.

What is the Proposed Scope?

The proposed ASU would apply to all equity-linked financial instruments (e.g., warrants) or embedded features (e.g., the conversion option of a convertible debt instrument) that includes a down-round feature.

[2] FASB ASC paragraph 815-10-15-74(a)(1), available at www.fasb.org.

However, convertible instruments would only be in the scope if a company is not required to apply the existing separation guidance for the convertible debt.[3]

KPMG Observation

Many convertible debt instruments likely will not fall within the scope of the proposed ASU because they are in the scope of other separation guidance. However, freestanding warrants with down-round features issued by many private companies, and convertible instruments that do not require separation of the conversion option from the host, likely would be within the scope of the proposed ASU.

Instruments within the scope would be less likely to be separately accounted for as derivatives with fair value adjustments being recorded in net income.

What is the Proposed Accounting?

When determining whether a financial instrument (including embedded features) should be classified as equity or a liability, a company would not consider a down-round feature when it assesses whether the instrument is indexed to its own stock.

Instead, it would recognize the effect of that feature only when the strike price of the related financial instrument has been reduced by the company's subsequent equity offering at a lower price.

The company would measure that value by comparing the (1) fair value of the instrument without the down-round feature based on the pre-adjusted strike price to (2) the fair value of the instrument without the down-round feature based on the adjusted strike price.

The company would recognize the effect of the down-round feature based on whether the related instrument is classified as equity or a liability.

- **Equity instruments** – the change in fair value attributable to the triggered feature would be recognized in equity as a dividend.
- **Liabilities** – the change in fair value attributable to the triggered feature would be recognized in net income with a corresponding adjustment to the carrying amount of the liability. This adjusted carrying amount would be subsequently accreted to net income using the effective interest method.[4]

In the period in which the down-round feature is triggered, a company would disclose:

- That the feature has been triggered;
- The value of the feature; and
- The financial statement line item in which the effect is recorded.

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[3] FASB ASC Subtopic 470-20, Debt--Debt with Conversion and Other Options, available at www.fasb.org.

[4] FASB ASC Topic 835, Interest, available at www.fasb.org.

Example: Comparison of Accounting under U.S. GAAP to Proposed ASU

Entity Z issues 10-year warrants that are exercisable at any time. They permit the holder to buy 100 shares of Z’s common stock at a strike price of $10 per share. The warrants have a down-round feature that reduces the strike price to equal the most recent price of Z’s common stock issued in any future offering that is less than $10.

Analysis under U.S. GAAP

The settlement amount of the warrants would not equal the difference between the fair value of a fixed number of Entity Z's equity shares and a fixed strike price.

The warrants are not considered to be indexed to Z’s own equity. Thus, the warrants would be classified as derivatives and recorded at their fair value with subsequent changes in fair value recorded in net income. This would result in the company recording a gain in net income when its share price increases and recording a loss when its price decreases (when all other fair value inputs remain unchanged). This would occur because the fair value of the warrant liability would increase or decrease, in part, based on changes in the company’s share price.

Analysis under Proposed ASU

Down-round features would not be considered when determining whether the warrants are indexed to Entity Z’s own equity.

Assuming the warrant otherwise qualifies for equity classification, the warrant would be classified as equity. No additional amount would be recognized unless the down-round feature is triggered, in which case the change in the warrant’s value attributable to the down-round feature would be recorded as a dividend.

KPMG Observation

The proposed ASU would reduce the volatility in the income statement produced by financial instruments that are classified as liabilities only because they contain a down-round feature.

A company would need to monitor its capital-raising activities to identify triggering events, and would need to measure fair value when the triggering events occur. Measuring the fair value would be complex for some financial instruments.

In addition to the specific disclosures that would be required when a down-round feature is triggered, a company would need to determine the appropriate disclosures to describe the rights and privileges of its outstanding securities that include down-round features.[5]

Scope Exception for Mandatorily Redeemable Financial Instruments

U.S. GAAP allows certain nonpublic entities to indefinitely defer applying liability classification requirements for mandatorily redeemable financial instruments and certain mandatorily redeemable noncontrolling interests.[6]

The proposed ASU would replace the indefinite deferral with a scope exception. It would not change the accounting guidance. The FASB's primary objective for this provision is to make it easier to understand the guidance because it would no longer be labeled as pending content.

Comments are due by February 6, 2017.

Effective Date and Transition

Provisions of the Proposed ASU	
Effective Date	To be determined after comments are evaluated.
Transition Guidance	• Transition guidance for Part 1 of the proposed ASU will be determined once comments are received. • No transition guidance is required for Part II because those changes would not affect current accounting requirements.

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Earlier editions are available at: kpmg.com/us/frn

[5] FASB ASC paragraph 505-10-50-3, available at www.fasb.org.

[6] FASB ASC Topic 480, Distinguishing Liabilities from Equity; FSP FAS 150-3, Effective Date, Disclosures, and Transition for Mandatorily Redeemable Financial Instruments of Certain Nonpublic Entities and Certain Mandatorily Redeemable Noncontrolling Interests under FASB Statement No. 150, November 7, 2003; and FASB Statement No. 150, Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity, May 2003; all available at www.fasb.org.