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## EITF reached a consensus on accounting for modifications of equity-classified warrants

March 12, 2021

The EITF reached a consensus on accounting for modifications of freestanding equity-classified written call options and discussed licensing contract modifications.

## Applicability

- Issuers' accounting for freestanding equity-classified written call options.[1]
  - All companies that modify or exchange equity-classified written call options that remain equity-classified after the modification or exchange.[2]
- Licensors that modify licenses of intellectual property (IP).[3]

## Key facts and impacts

On March 11, the EITF reached a consensus, subject to the FASB's ratification, about a proposed ASU on an issuer's accounting for modifications or exchanges of freestanding equity-classified written call options (referred to as warrants in this publication). The comment deadline was December 28, 2020.

The EITF consensus would amend the proposed ASU to limit its scope to an issuer's accounting for modifications of warrants that remain equity-classified after modification. The EITF also reached a consensus to require additional quantitative and qualitative disclosures about the circumstances and the accounting for such warrant modifications.

The EITF separately recommended that EITF Issue No. 19-B, Revenue Recognition—Contract Modifications of Licenses of Intellectual Property, be removed from its agenda and referred back to the FASB. The FASB will consider the underlying accounting issues at a future public meeting and will determine whether to undertake further standard setting or consider the issues as part of its post-implementation review process for Topic 606.

[1] EITF Issue No. 19-C, Issuer's Accounting for Certain Modifications of Freestanding Equity-Classified Forwards and Options

[2] The scope of the guidance would not apply to financial instruments that are in the scope of other standards such as Topic 718.

[3] EITF Issue No. 19-B, Revenue Recognition—Contract Modifications of Licenses of Intellectual Property

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## Issuer's accounting for modifications of freestanding equity-classified warrants

### Scope

The proposed ASU would have applied to all equity-classified forwards and options that remain equity-classified after modification. Some stakeholders expressed concerns about potential unintended consequences if certain financial instruments such as purchased options were included in the scope of the final ASU. Based on this feedback, the EITF reached a consensus to limit the final ASU to written call options.

### Recognition

The EITF affirmed its consensus-for-exposure that proposed a recognition model comprising four categories of transactions and corresponding accounting treatment for each category. The category that would apply to a modification or an exchange of an equity-classified warrant would depend on the substance of the modification transaction (e.g. a financing transaction to raise equity versus one to raise debt). This recognition model is premised on the idea that the accounting for the transaction should not differ from what it would have been had the issuer of the warrants paid cash instead of modifying the warrants.

The categories in the recognition model are discussed below.

#### — Financing transaction to raise equity

The EITF affirmed its consensus-for-exposure that the incremental value of a warrant modification directly attributable to a proposed or an actual equity offering generally would be accounted for as an equity issuance cost.[4]

This accounting reflects the view that a warrant modification executed to induce exercise and raise equity is akin to a cost of raising additional capital and therefore should be deferred and charged against the gross proceeds of the offering.

#### — Financing transaction to raise or modify debt

The EITF affirmed its consensus-for-exposure that a warrant modification in conjunction with a modification of existing debt or issuance of new debt would be accounted for by applying Topic 470 as follows.

- **Modification in connection with the issuance of new debt would be accounted for as a debt issuance cost.** If the warrant holder is the lender of the new debt, the effect of the modification would be considered akin to a debt discount. If the warrant holder is not the lender of the new debt, the effect of the modification would be considered akin to debt issuance cost. The incremental value of the warrant would be amortized through earnings using the effective interest method.
- **Modification in connection with a nontroubled debt modification would be treated as a 'Day 1 outflow (for fair value increases) or inflow (for fair value decreases)' in applying the debt modification guidance.[5]** If the warrant modification is made in connection with a nontroubled debt modification, the issuer would be required to apply Subtopic 470-50 to determine whether the debt modification represents an extinguishment or a continuation of the existing debt instrument. The EITF reached a consensus to amend the proposed ASU to require both increases and decreases in fair value from a warrant modification to be considered under the requirements of Subtopic 470-50.

[4] Paragraph 340-10-S99-1 states that specific incremental costs directly attributable to a proposed or actual offering of equity securities may properly be deferred and charged against the gross proceeds of the offering.

[5] For purposes of applying the 10% cash flow test in paragraph 470-50-40-10 to determine whether the debt modification would be accounted for as an extinguishment or modification of the existing debt.

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The following table summarizes the recognition guidance for increases or decreases in fair value resulting from a warrant modification that is a part of or directly related to a nontroubled debt modification.

<table>
<tr><th>Debt extinguishment</th><th>Debt modification (continuation of the existing debt instrument)</th></tr>
<tr><td colspan="2">If the warrant holder is the lender[6] of the debt being analyzed …</td></tr>
<tr><td>Increases or decreases in fair value resulting from a warrant modification would be:<br>— associated with the extinguishment of the old debt instrument; and<br>— included in determining the gain or loss on extinguishment.</td><td>Increases or decreases in fair value resulting from a warrant modification would be:<br>— associated with the replacement or modified debt instrument; and<br>— amortized as an adjustment of interest expense over the remaining term of the replacement or modified debt instrument using the effective interest method (along with any existing unamortized premium or discount).</td></tr>
<tr><td colspan="2">If the warrant holder is not the lender[7] of the debt being analyzed …</td></tr>
<tr><td>Incremental fair value resulting from warrant modification would be:<br>— associated with the new debt instrument, and<br>— amortized over the term of the new debt instrument using the effective interest method in a manner similar to debt issue costs.</td><td>Incremental fair value resulting from warrant modification would be expensed as incurred.</td></tr>
</table>

### — Transaction to transfer goods or services in a reciprocal arrangement

Guidance for share-based arrangements with employees, nonemployees and customers already exists.[8] Therefore, the EITF affirmed its consensus-for-exposure to require this guidance be followed for warrant modifications. This would require judgment in determining both the manner (i.e. capitalize versus expense) and the pattern of recognition for the incremental value from warrant modifications related to the transfer of goods or services.

### — Other warrant modifications not related to financing or compensation

The EITF affirmed its consensus-for-exposure that modifications that do not represent a cost of financing or compensation in a reciprocal transaction would be treated as a deemed dividend (i.e. an adjustment to retained earnings and an adjustment to the numerator when calculating EPS).

This treatment reflects the view that the incremental fair value of a modified warrant is akin to a distribution to equity holders in their capacity as owners, and is consistent with the principles in the down-round feature guidance.[9]

## Measurement

The EITF affirmed its consensus-for-exposure that the value granted to the warrant holder on modification would be measured for transactions to raise or modify debt as the difference between (1) the fair value of the warrant immediately after the modification and (2) the fair value of the warrant immediately before the

[6] Treatment based on paragraph 470-50-40-17, which provides guidance on accounting for fees between debtor and creditor as part of an exchange or modification of debt.

[7] Treatment based on paragraph 470-50-40-18, which provides guidance on accounting for third-party costs of an exchange or modification of debt.

[8] Topic 718 and Topic 606.

[9] Paragraphs 260-10-25-1 and 45-12B provide that for freestanding equity-classified financial instruments, entities recognize the effect of the down-round feature when triggered as a dividend and as a reduction of income available to common shareholders in basic EPS.

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modification, and for all other transactions as the excess of (1) the fair value of the warrant immediately after the modification over (2) the fair value of the warrant immediately before the modification. This approach reflects the view that there need not be a distinction between extinguishments and modifications of these instruments for measurement purposes.[10]

### Disclosures

The EITF reached a consensus to require entities to provide additional quantitative and qualitative disclosures that describe the circumstances surrounding a warrant modification and its accounting effect.

### Effective dates and transition

| | All entities |
|---|---|
| Annual and interim periods in fiscal years beginning after | December 15, 2021 |
| Early adoption permitted | Yes |

The EITF reached a consensus to require prospective transition and to require entities to disclose the nature of and reasons for the change in accounting, the transition method, and a qualitative description of the financial statement line items affected by the change.

## Contract modifications of IP licenses

There is diversity in accounting for modifications of licensing arrangements under Topic 606. First, there are different views about whether revenue resulting from the modification of a license of functional IP should be recognized at the date of the modification or at the start of the renewal period (i.e. whether the Topic 606 renewals guidance should apply to such modifications). Second, there are different views about how to recognize revenue for contracts that include, whether from inception or by subsequent modification, a feature that allows the customer to convert a term software license to a software as a service (SaaS) arrangement.

The EITF previously deliberated these issues as part of EITF Issue No. 19-B and did not reach a consensus. Based on the FASB staff recommendation, the EITF agreed that this Issue should be removed from its agenda and referred back to the FASB. The FASB will consider the underlying accounting issues at a future public meeting and determine whether to undertake further standard setting or consider the issues as part of its post-implementation review process for Topic 606.

**Contributing authors**
P.K. Barot; Kimber Bascom

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[10] This view is based on the guidance in paragraph 815-40-35-2 that subsequent changes in the fair value of equity contracts should not be recognized as long as the contracts continue to be equity-classified.

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