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EITF reaches consensus-for-exposure on accounting for modifications of equity classified derivatives

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KPMG reports on EITF discussion of accounting for modifications made to equity classified derivatives[1]

Applicability

The consensus-for-exposure proposes that an issuer that modifies an equity classified derivative[2] would apply a principles-based framework to determine the accounting treatment that best reflects the economic substance of the transaction. The framework would not override existing principles, but would establish a recognition and measurement model to interpret and clarify which guidance applies based on the substance of the modification. Modifications resulting in a decrease in value of the derivative would have no accounting effect.

Measurement

The consensus-for-exposure proposes a measurement model that would require the value granted to the holder on modification be measured as the excess of (1) the fair value of the derivative immediately after the modification over (2) the fair value of the derivative immediately before the modification. This approach aligns with the guidance for modifications of stock options[3], and reflects the view that there need not be a distinction between extinguishments and modifications of these instruments for purposes of measurement.[4] The measurement guidance would apply regardless of the manner in which the modification is recognized.

Recognition

The consensus-for-exposure proposes a recognition model that includes four categories of transactions, and corresponding accounting treatment for each category. Issuers of these derivatives would be required to categorize their modification based on the substance of the transaction. The 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 derivative paid cash rather than modifying the derivative.

[1] EITF Issue No. 19-C, Warrant Modifications: Issuers' Accounting for Modifications of Equity Classified Freestanding Call Options That Are Not within the Scope of Topic 718, Compensation—Stock Compensation, or Topic 815, Derivatives and Hedging

[2] The scope of the guidance would apply to equity classified derivative instruments that remain equity classified after the modification. These instruments are referred to as derivatives throughout the remainder of this publication.

[3] Topic 718, Compensation—Stock Compensation

[4] 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.

Financing transaction to raise equity

If an entity is planning to raise equity, and a derivative modification is determined to be directly attributable to the offering, the consensus-for-exposure proposes that the effect of the modification be accounted for as an equity issuance cost.[5] The incremental value of the derivative would be deferred, reducing offering proceeds.

This treatment reflects the view that a derivative 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 consensus-for-exposure proposes that a derivative modification in conjunction with a modification of existing debt or an issuance of new debt would be accounted for by applying Topic 470 as follows:

- **Modification in connection with issuance of new debt would be accounted for as a debt issuance cost.** If the derivative holder is the lender of the new debt, the effect of the modification would be considered akin to a debt discount. If the derivative holder is not the lender of the new debt, the effect of the modification would be considered akin to a debt issuance cost. The incremental value of the derivative would be amortized through earnings over the expected term of the debt using the effective interest method.
- **Modification in connection with debt modification would be treated as a 'Day 1 outflow' in applying the debt modification guidance.[6]** If the derivative modification is made in connection with a modification of debt, the issuer would be required to apply the guidance on modifying debt in a nontroubled situation to determine whether the debt modification represents an extinguishment or a modification.

  Here is an overview of how the consensus-for-exposure proposes to recognize the incremental value from a derivative modification based on the debt modification guidance.

Debt extinguishment	Debt modification
If derivative holder is the lender[7] of the debt being analyzed …	
Incremental value resulting from derivative modification would be: — associated with the extinguishment of the old debt instrument, and — included in determining the gain or loss on extinguishment.	Incremental value resulting from derivative modification would be: — associated with the replacement or modified debt instrument, and — 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).
If derivative holder is not the lender[8] of the debt being analyzed …	
Incremental value resulting from derivative modification would be: — associated with the new debt instrument, and	Incremental value resulting from derivative modification would be expensed as incurred.

5 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.

6 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.

7 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.

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

Debt extinguishment	Debt modification
— amortized over the term of the new debt instrument using the effective interest method in a manner similar to debt issue costs.	

Transaction to transfer goods or services in a reciprocal arrangement

Guidance for share-based arrangements with employees, nonemployees and customers already exists.[9] Therefore, the consensus-for-exposure proposes to require this guidance be followed, which would involve judgment in determining both the manner (i.e. capitalize versus expense) and the pattern of recognition for the incremental value from derivative modifications.

The issue of accounting for derivative modifications as a type of compensation for goods or services only arises in cases in which the derivative holder is a lender or investor providing financing to the issuing entity; such transactions are specifically scoped out of existing guidance.[10] However, the principles in the employee share-based compensation model are typically applied by analogy in accounting for these arrangements; the consensus-for-exposure proposes that this practice be required under the proposed framework.

Other derivative modifications not related to financing or compensation

The consensus-for-exposure proposes that modifications that do not represent a cost of financing or compensation in a reciprocal transaction 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 value of a modified derivative 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.[11]

Transition, disclosure and effective date

The consensus-for-exposure proposes to permit entities to choose between either a prospective approach or a fully retrospective approach.[12] No further disclosures would be needed beyond what is already required for a change in accounting principle.[13] However, the change in accounting principle disclosures about the effects of the change on current and prior period financial information would not be required.[14] The consensus-for-exposure proposes to permit early adoption.

9 Topic 718 and Topic 606, Revenue from Contracts with Customers

10 Topic 718 is not applicable to transactions involving equity instruments granted to nonemployees who provide financing to the entity.

11 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.

12 Paragraphs 250-10-45-5 through 45-10

13 Paragraph 250-10-50-1

14 Paragraphs 250-10-50-1(b)(2) and 50-3

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