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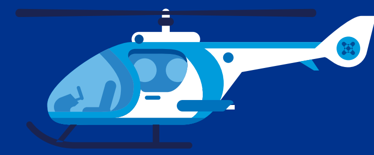

Defining Issues®

FASB changes accounting and EPS for certain instruments with down round features

July 17, 2017

KPMG reports on ASU 2017-11[1], under which down round features will not cause certain instruments to be accounted for as derivatives.

Applicability

Companies that issue equity-linked financial instruments (e.g. warrants, convertible instruments) that contain down round features.

What is a down round feature?

A down round feature is a provision in an equity-linked financial instrument that reduces the strike price of the 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 instrument with a strike price below the current strike price of the financial instrument.

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

Key facts and impacts

Equity-linked instruments or embedded equity-linked features will not be accounted for as a liability solely because there is a down round feature.

This means that fewer free-standing equity-linked instruments with down round features will be accounted for as liabilities than under current accounting. Likewise, fewer embedded equity-linked features with down round features will be bifurcated from the host contract.

A company will still need to evaluate other features in the equity-linked instrument to determine whether the instrument or embedded feature should be accounted for as a liability.

A company that presents EPS information will reflect the effect of a down round feature of free-standing equity-linked financial instruments in EPS only if it is triggered. The ASU prescribes how the company will measure the effect of the down round feature, which will be accounted for as a deemed dividend when computing income available to common shareholders in basic EPS.

1 ASU 2017-11, (Part I) Accounting for Certain Financial Instruments with Down Round Features, and (Part 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, issued July 13, 2017

What did the ASU change?

Current requirements	New requirements
Instruments with a down round feature are not considered to be indexed to a company's own stock.[2] Therefore, a free-standing equity-linked financial instrument is **classified as a liability** and is measured at fair value with changes in fair value recognized in net income. The **equity-linked embedded feature in an equity host instrument** is not bifurcated from the host contract and accounted for separately as a liability. The **equity-linked embedded feature in a debt host instrument** is bifurcated from the host contract and accounted for separately as a liability if that feature meets the definition of a derivative.	The down round feature will not be considered when determining whether the instrument is indexed to a company's own stock. If the instrument is otherwise indexed to and settled in the company's own stock, a free-standing equity-linked financial instrument will be **classified as equity**. An equity-linked embedded feature will not be separated from the host contract and other GAAP will be applied because the guidance in this ASU does not apply.[3] The company still evaluates whether the instrument or embedded feature is: — considered a liability under accounting guidance on distinguishing liabilities from equity;[4] — meets the other scope exceptions from derivative accounting guidance;[5] or — requires separation under accounting guidance for debt with conversion and other options.
Current accounting guidance requires changes in fair value of an instrument with a down round feature to be recognized in earnings for both increases and decreases in share price, even though an increase in share price will not cause a down round feature to be triggered and a decrease will cause an adjustment to the strike price only if and when an entity engages in a subsequent equity offering.	If the free-standing equity-linked financial instrument is equity-classified, a company does not account for the changes in fair value attributable to the down round feature through the income statement regardless of whether the down round feature is triggered. Instead, only public entities and other entities that voluntarily present EPS information will reflect the effect of a down round feature in a free-standing equity-linked financial instrument in EPS. An equity-linked embedded feature will not be separated from the host contract if it contains a down round feature and will not be subject to this ASU. Instead, other GAAP will be applied.

Computing EPS

Companies that present EPS information[6] will reflect the effect of a down round feature in a free-standing equity-linked financial instrument that is equity-classified in their basic EPS only in the period(s) in which the feature is triggered.

When triggered, the effect of the down round feature will be treated as a deemed dividend and will reduce the income available to common shareholders for computing basic EPS.

The effect of the down round feature that is triggered will be measured as the difference

[2] ASC paragraph 815-10-15-74(a)(1)

[3] ASC 470-20, Debt—Debt with Conversion and Other Options

[4] ASC 480, Distinguishing Liabilities from Equity

[5] ASC 815-40, Derivatives and Hedging—Contracts in Entity's Own Equity

[6] ASC 260, Earnings Per Share

between the fair value of the free-standing equity-linked financial instrument *without* the down round feature and the strike price for the instrument immediately:

— **before** the reduction in strike price (i.e. based on the previous strike price); and
— **after** the reduction strike price (i.e. based on the new strike price).

A nonpublic company that chooses not to present EPS information will not reflect a down round feature either in accounting for the financial instrument or in presentation.

However, a nonpublic entity that subsequently becomes a public entity will need to consider the need to capture the effect of triggered down round features in its historical EPS information included in a public SEC filing.

Disclosures

Companies that have issued financial instruments with down round features (whether those instruments are free standing or embedded within another instrument) will need to disclose the terms that may change the conversion or exercise price of the instrument (other than standard anti-dilution provisions).

Additionally, in periods in which a down round feature is triggered, companies will need to disclose the:

— fact that the feature has been triggered; and
— value of the effect of the down round feature that has been triggered.

Scope exception for mandatorily redeemable financial instruments

US GAAP allows certain nonpublic entities to indefinitely defer applying liability classification requirements for mandatorily redeemable financial instruments and certain mandatorily redeemable noncontrolling interests.

The ASU replaces the indefinite deferral with a scope exception. Because it does not change the accounting guidance, there is no effective date or transition guidance for Part II of the ASU.

The FASB's primary objective was to make it easier for stakeholders to understand the guidance in the Codification because it will no longer be labeled as pending content.

Effective date and transition for down round features

	Public business entities	Other entities
Effective date	For annual and interim periods in fiscal years, beginning after December 15, 2018.	For annual periods in fiscal years beginning after December 15, 2019, and interim periods in fiscal years beginning after December 15, 2020.
Early adoption	Early adoption is permitted, including in an interim period. If adopted at other than the beginning of a fiscal year, adjustments are reflected as of the beginning of the fiscal year.	
Transition	— Cumulative-effect adjustment as of the beginning of the fiscal year; or — Retrospectively adjust all prior reporting periods using the guidance for accounting changes.[7]	

[7] ASC 250, Accounting Changes and Error Corrections

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KPMG's Financial Reporting View

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