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BDO FLASH REPORT
FASB

SUBJECT

FASB SIMPLIFIES ACCOUNTING FOR INSTRUMENTS WITH DOWN ROUNDS

SUMMARY

The FASB recently issued ASU 2017-11[1] to simplify the accounting for certain financial instruments with down round features. This new standard will reduce income statement volatility for many companies that issue warrants and convertible instruments containing such features. It is available here, and becomes effective for public companies in 2019 and all other entities in 2020.

DETAILS

Background

A down round feature is a contractual term to protect the investor in an equity-linked instrument such as a warrant or convertible debt from declines in the issuer's share price under certain circumstances. It results in the strike price being reduced on the basis of the pricing of future equity offerings. Down rounds are common in warrants, convertible preferred shares, and convertible debt instruments issued by private companies and development-stage public companies. Under existing GAAP, a down round feature often results in liability classification for a warrant or in bifurcation of a conversion option, which is then remeasured to fair value through earnings each period. Part I of the ASU addresses the accounting for such instruments.

The FASB previously issued an indefinite deferral of accounting requirements in Topic 480[2] for mandatorily redeemable financial instruments of certain nonpublic entities and certain mandatorily redeemable noncontrolling interests. This indefinite deferral resulted in a large amount of pending guidance in Topic 480, making it difficult to read. Part II of the ASU addresses this difficulty.

[1] (Part I) Accounting for Certain Financial Instruments with Down Round Features, (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
[2] Distinguishing Liabilities from Equity

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Main Provisions

Part I of the ASU changes the classification analysis of certain equity-linked financial instruments, such as warrants and embedded conversion features, such that a down round feature is disregarded when assessing whether the instrument is indexed to an entity's own stock under Subtopic 815-40. As a result, a down round feature—by itself—no longer requires an instrument to be remeasured at fair value through earnings each period, although all other aspects of the indexation guidance under Subtopic 815-40 continue to apply.

For freestanding equity-classified financial instruments, the ASU requires entities that present earnings per share (EPS) to recognize the effect of the down round feature when it is triggered, i.e., when the exercise price of the related equity-linked financial instrument is adjusted downward because of the down round feature. The amount of the EPS adjustment is determined as the difference between the fair value of the instrument immediately before and after the strike price is adjusted. That amount is recorded as a dividend and as a reduction of income available to common shareholders in basic EPS. An entity may also be required to adjust its diluted EPS calculation.

Convertible instruments with embedded conversion options that have down round features will be accounted for under existing specialized guidance for contingent beneficial conversion features in Subtopic 470-20,[3] including the related EPS guidance.

The ASU does not change the accounting for liability-classified financial instruments where classification resulted from a term or feature other than a down round feature.

The ASU requires entities to disclose the existence of down round features in the instruments they issue, when the down round features result in a strike price adjustment, and the amount of any such adjustment.

Part II of the ASU recharacterizes the indefinite deferral of certain provisions of Topic 480 (currently presented as pending content in the Codification) as a scope exception. No change in practice is expected as a result of these amendments.

EFFECTIVE DATE AND TRANSITION

For public business entities, the amendments in Part I of the ASU are effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. For all other entities, the amendments in Part I of the ASU are effective for fiscal years beginning after December 15, 2019, and interim periods within fiscal years beginning after December 15, 2020.

Early adoption is permitted for all entities, including adoption in an interim period. If an entity early adopts the amendments in an interim period, any adjustments should be reflected as of the beginning of the fiscal year that includes that interim period.

The amendments should be applied on a full retrospective basis or on a modified retrospective basis through a cumulative adjustment to opening retained earnings in the year of initial application.

The amendments in Part II have no accounting impact and therefore do not have an associated effective date.

[3] Debt—Debt with Conversion and Other Options