BLUEPRINT: A BDO SERIES

Issuer's Accounting for Complex Financial Instruments

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TABLE OF CONTENTS

Introduction

As the design of financial instruments evolves, public and private entities are entering increasingly complex financing transactions that often involve the issuance of debt, preferred shares, warrants to purchase the entity's shares, and other equity-linked instruments. Accounting for complex financial instruments is challenging because of the nearly limitless ways they can be designed. Further, the accounting for financial instruments involves applying various topics in U.S. generally accepted accounting principles (GAAP), whose interpretations are constantly evolving.

It is important that entities read contracts thoroughly to identify all the terms that may require recognition in the financial statements. Contracts come in many forms. If an agreement is based on standardized forms published by the International Swaps and Derivatives Association (ISDA), an entity must analyze the contract (typically in a trade confirmation), including any side letter agreements, in conjunction with the ISDA Master Agreement, ISDA Definitions, and ISDA Equity Derivatives Definition to fully understand the parties' contractual rights and obligations.

Entities face additional challenges if the terms of a financing are highly structured, incorporating nonstandard terms negotiated by the parties, or when the terms are scattered across multiple agreements. For example, capital-raising transactions with private equity investors frequently include securities purchase agreements, financial instrument contracts (for example, warrant agreements), voting agreements, and registration rights agreements.

The analysis of financial instruments also depends on understanding the economics of the arrangement and the parties' business reasons in negotiating the contractual terms.

This Blueprint discusses the accounting under U.S. GAAP that applies to **issuers** of financial instruments, including:

- ASC 470, *Debt*
- ASC 480, *Distinguishing Liabilities from Equity*
- ASC 480-10-S99-3A, *SEC Staff Announcement: Classification and Measurement of Redeemable Securities*
- ASC 505, *Equity*
- ASC 815-10, *Derivatives and Hedging — Overall*
- ASC 815-15, *Derivatives and Hedging — Embedded Derivatives*
- ASC 815-40, *Derivatives and Hedging — Contracts in Entity's Own Equity*
- ASC 825, *Financial Instruments*
- ASC 835-30, *Interest — Imputation of Interest*.

COMPLEX FINANCIAL INSTRUMENTS — IN A NUTSHELL

To account for financial instruments, an entity must assess whether:

- The financial instrument must be classified as an asset, a liability, or within permanent or temporary equity.
- The financial instrument includes embedded derivatives that must be bifurcated and accounted for separately from the host instrument.

The evaluation of a financial instrument depends on the instrument's nature. The evaluation for a hybrid instrument differs from the evaluation of an equity-linked instrument.

	HYBRID INSTRUMENT ACCOUNTING MODEL	EQUITY-LINKED INSTRUMENT ACCOUNTING MODEL
Type of financial instrument	A hybrid instrument consists of a host contract and an embedded derivative.	An equity-linked instrument is a contract that is potentially indexed to, and potentially settled in, an entity's own equity.
Accounting model	▶ An entity must first assess whether a hybrid instrument is a liability (or asset in some cases) within the scope of ASC 480. • Some instruments must be initially and subsequently measured at fair value. • Other instruments are not remeasured at fair value each period. ▶ Whether or not the hybrid instrument is within the scope of ASC 480, if the instrument is not remeasured at fair value, the entity must determine whether any embedded derivatives must be bifurcated and accounted for separately as a derivative asset or liability. • A bifurcated derivative is separated from the host contract and initially and subsequently measured at fair value, with changes in fair value recognized in earnings. • The host contract (including any features that do not require bifurcation) is accounted for under other applicable U.S. GAAP (for example, ASC 470, ASC 480, ASC 480-10-S99-3A (if applicable), or ASC 505).	▶ An entity must first assess whether an equity-linked instrument is a liability within the scope of ASC 480. ▶ If the equity-linked instrument is not within the scope of ASC 480, the entity must apply ASC 815-40 to determine whether to classify the instrument as: • Equity (in which case, the instrument is not remeasured) • An asset or a liability (in which case, the instrument is initially and subsequently measured at fair value, with changes in fair value recognized in earnings).
U.S. GAAP	ASC 470, 480, ASC 480-10-S99-3A (if applicable), ASC 505, ASC 815-15, and ASC 815-40	ASC 480, ASC 815-15, ASC 815-40
Chapter reference	Chapters 2, 3, 4, 5, and 6	Chapters 2, 4, 5, and 6
Examples	Debt and preferred stock	Options (such as warrants) and forward contracts on an entity's shares

DISTINGUISHING LIABILITIES FROM EQUITY

ASC 480 requires entities to account for as liabilities (or assets in some cases) some financial instruments with characteristics of both liabilities and equity. ASC 480 applies only to freestanding financial instruments, not embedded features, and only to financial instruments that embody an obligation to transfer assets or issue shares.

Three different classes of financial instruments are in the scope of ASC 480:

- Mandatorily redeemable shares
- Financial instruments (other than shares) that do or may obligate the entity to buy back its equity shares (or are indexed to such an obligation) in exchange for cash or other assets
- Obligations the entity must or may settle with a variable number of equity shares if, at inception, the monetary value is based solely or predominantly on **any** of the following:
  - A fixed monetary amount known at inception
  - A variable other than the fair value of the entity's equity shares, such as a market index
  - A variable inversely related to changes in the fair value of the entity's equity shares.

Most financial instruments within the scope of ASC 480 are initially and subsequently measured at fair value. However, some instruments, such as mandatorily redeemable shares, some physically settled forward purchase contracts, and some share-settled obligations, are not accounted for at fair value. If the financial instrument is a hybrid instrument that is not remeasured at fair value, the entity must evaluate it for bifurcation of any embedded derivatives in accordance with ASC 815-15.

HYBRID INSTRUMENTS AND EMBEDDED DERIVATIVES

ASC 815 requires entities to account for financial instruments that are derivatives in their entirety as derivative assets or liabilities measured at fair value. Financial instruments are accounted for as derivatives in their entirety if they meet the definition of a derivative instrument in accordance with ASC 815-10 and do not qualify for any derivative scope exceptions.

Conversely, financial instruments are not accounted for as derivative instruments in their entirety under ASC 815 if they do not meet the definition of a derivative instrument or if a derivative scope exception applies. However, they may contain embedded derivatives (terms embedded in a host contract that would be derivative instruments if they were freestanding), in which case they are referred to as "hybrid instruments," consisting of a host contract and an embedded derivative.

An entity accounts for an embedded derivative separately from the host contract when **all** the following criteria are met:

- The host contract and embedded derivative have economic characteristics and risks that are **not** clearly and closely related.
- The hybrid instrument is **not** remeasured at fair value through earnings.
- The embedded derivative would be considered a derivative instrument under ASC 815-10 if it were freestanding. When evaluating this criterion, an entity considers both the definition of a derivative instrument in ASC 815-10 and the scope exceptions from derivative accounting.

If a hybrid instrument has more than one embedded feature that must be bifurcated, the embedded features are bundled as a single, compound embedded derivative that is then bifurcated and accounted for separately from the host contract. The bifurcated embedded derivative is recognized as a derivative asset or liability and is initially and subsequently measured at fair value.

The initial carrying amount of the host contract (the instrument that remains after bifurcation) is recognized as the difference between the proceeds allocated to the hybrid instrument and the embedded derivative's initial fair value. Subsequently, the host contract is accounted for under other U.S. GAAP (for example, ASC 470, ASC 480, ASC 480-10-S99-3A, or ASC 505).

If the entity elects the fair value option for an eligible instrument, the embedded derivative is not bifurcated, and the entire hybrid instrument is accounted for at fair value.

CONTRACTS IN AN ENTITY'S OWN EQUITY

An entity may issue a financial instrument indexed to, and sometimes settled in, its own equity for various reasons (most often to raise capital). The financial instrument may be freestanding or embedded in another instrument and may include multiple settlement choices for the issuer and holder. Such financial instruments are commonly referred to as "equity-linked instruments." U.S. GAAP does not define "equity-linked instrument," but that term generally refers to instruments involving an entity's own equity (for example, contracts to issue or buy back the entity's shares or contracts with settlement based on the value of the entity's shares) that must be evaluated under ASC 815-40.

The entity assesses those instruments under ASC 815-40, which applies to **both**:

- Freestanding instruments, in determining whether an entity must classify the financial instrument as equity
- Embedded derivatives, in determining whether an entity must separate an embedded derivative from the host contract for accounting purposes.

When evaluating a freestanding equity-linked instrument, the entity first evaluates whether the instrument is a liability (or an asset in some cases) under ASC 480. If the instrument is not within the scope of ASC 480, the entity evaluates whether it meets the definition of a derivative instrument in ASC 815-10. If the freestanding equity-linked instrument meets the definition of a derivative instrument, the entity evaluates whether the instrument meets the scope exception from derivative accounting in ASC 815-10-15-74(a) (which refers to ASC 815-40). However, an entity must also evaluate any freestanding financial instrument that is potentially indexed to and settled in its own stock under ASC 815-40 regardless of whether it meets the definition of a derivative instrument in ASC 815-10.

There are two key components to the ASC 815-40 assessment. The entity must assess whether the equity-linked instrument **both**:

- Is indexed to the entity's own stock under ASC 815-40-15
- Meets the criteria for equity classification in ASC 815-40-25.

A freestanding equity-linked instrument that does not qualify as equity is accounted for as an asset or liability that is measured at fair value on a recurring basis, with changes in fair value recognized in earnings. An equity-linked instrument that qualifies as equity is not remeasured as long as the indexation and equity classification criteria continue to be met.

Similarly, an entity must evaluate an embedded equity-linked feature (such as a conversion option) to determine whether it qualifies for the derivative scope exception in ASC 815-40 if the embedded feature (1) is not clearly and closely related to the host contract, (2) is embedded in an instrument that is not remeasured at fair value, and (3) meets the definition of a derivative. If the embedded feature qualifies for the scope exception, the entity does not separate it from the host contract and the entity accounts for the entire instrument (assuming no other embedded features require bifurcation) in accordance with other U.S. GAAP (for example, ASC 470, ASC 480, ASC 480-10-S99-3A, or ASC 505). If the embedded feature does not qualify for the derivative scope exception in ASC 815-40, the entity accounts for it separately from the host contract as a derivative liability (or derivative asset in some cases) and remeasures it at fair value, with changes in fair value recognized in earnings.

TEMPORARY EQUITY

Entities that prepare financial statements in accordance with SEC Regulation S-X and other entities that elect to follow the SEC's temporary equity guidance must determine whether to classify a redeemable equity instrument as permanent or temporary equity if the instrument is not accounted for as a liability under ASC 480.

ASC 480-10-S99-3A requires classifying equity instruments in temporary equity if they are redeemable or may become redeemable for cash or other assets in **any** of the following circumstances:

- At a fixed or determinable price on a fixed or determinable date
- At the instrument holder's option
- Based upon the occurrence of an event that is not solely within the issuer's control.

An entity presents its temporary equity between liabilities and permanent equity (often referred to as "mezzanine") on the balance sheet. The temporary equity classification highlights an entity's future potential cash obligation to redeem an instrument and distinguishes it from the entity's permanent capital. If an instrument's redemption is solely within an entity's control, the entity presents the instrument in permanent equity.

OTHER TOPICS

After an entity determines the appropriate classification of debt and equity instruments and bifurcates derivatives, if necessary, the entity must determine the appropriate accounting for the debt or equity host instrument. This Blueprint provides guidance for the initial and subsequent measurement of debt and equity. It also discusses the accounting for other debt and equity related topics, including:

- Debt and equity issuance costs
- Debt extinguishments and conversions
- Paid-in-kind (PIK) interests and PIK dividends
- Sales of future revenues
- Indexed debt
- Increasing-rate debt and increasing-rate preferred stock
- Treasury stock
- Stock splits and dividends
- Preferred stock extinguishments and conversions
- Preferred stock amendments
- Deemed dividends and deemed contributions
- Registration payment arrangements.

DEBT RESTRUCTURINGS, MODIFICATIONS, AND EXCHANGES

An entity may renegotiate and amend its debt arrangements with existing lenders for various reasons, such as to increase borrowings to finance an expansion of its operations, refinance debt that is nearing maturity, or manage cash flow difficulties. The debtor and creditor may agree to modify an existing loan agreement or exchange one debt instrument for another. For accounting purposes, the legal form of the transaction does not matter. Anytime a debtor and creditor change the terms of their relationship by amending a loan agreement, exchanging one instrument for another, or entering an incremental debt instrument, the debtor must determine the appropriate accounting model to apply to the restructured debt arrangement.

If the debtor pays off the original loan's creditor with proceeds from a new lender, it accounts for the original loan as an extinguishment and the new loan as a separate borrowing. However, if the debtor restructures a loan arrangement with the same creditor, it must first consider the troubled debt restructuring (TDR) guidance in ASC 470-60, *Troubled Debt Restructurings by Debtors*. If the debt restructuring is not a TDR, the debtor applies the guidance in ASC 470-50, *Modifications and Extinguishments*, to determine the appropriate accounting to apply.

See BDO's publication, **Troubled Debt Restructuring, Debt Modification, and Extinguishment** for more guidance.

PRESENTATION AND DISCLOSURES

The accounting determination for debt and equity instruments dictates how an entity must present and disclose the instruments when preparing the financial statements. The presentation and disclosures of debt generally provide users of the financial statements with information regarding potential cash outlays of the obligation, such as principal, interest, discounts and premiums, creditor rights and privileges, and the timing of when obligations are due. Equity disclosures focus on the rights, privileges, and ownership of the investors' holdings.

This Blueprint specifically addresses the presentation and disclosure requirements for the following topics related to debt and equity:

- Debt instruments, including current and noncurrent presentation
- Equity instruments
- Assets and liabilities within the scope of ASC 480
- Hybrid instruments and embedded derivatives
- Freestanding equity-linked contracts
- Incremental presentation and disclosure requirements for debt and equity instruments issued by SEC registrants.

ABOUT THE BLUEPRINT

This Blueprint summarizes key aspects of U.S. GAAP that apply to an issuer's accounting for financial instruments and includes practical examples and interpretive guidance to help issuers and practitioners account for debt and equity instruments. It is organized into chapters in the order an issuer generally evaluates a financial instrument. Contracts for financial instruments are highly customizable, which means the accounting for each instrument may vary based on the specific facts and circumstances and may therefore differ from the illustrations in this Blueprint.

This Blueprint includes amendments from the following Accounting Standards Updates (ASUs):

- ASU 2020-06, *Debt — Debt With Conversion and Other Options (Subtopic 470-20) and Derivatives and Hedging — Contracts in Entity's Own Equity (Subtopic 815-40): Accounting for Convertible Instruments and Contracts in an Entity's Own Equity* (ASU 2020-06)
- ASU 2024-04, *Debt — Debt With Conversion and Other Options (Subtopic 470-20): Induced Conversions of Convertible Debt Instruments* (ASU 2024-04).

This Blueprint focuses on U.S. GAAP. More information on accounting for financial instruments under International Financial Reporting Standards (IFRS) is available **here**.

This Blueprint does not include guidance for the accounting of financial instruments designated as hedging instruments.

The following arrow shows the organization of this Blueprint.

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Chapter 1 — Scope

1.1 OVERVIEW

While an entity sometimes might issue a single financial instrument, often it will issue multiple instruments in a single transaction. Also, some financial instruments include embedded features that may need to be accounted for separately. As such, the accounting analysis begins with identifying all the financial instruments issued in a transaction.

After identifying all the individual financial instruments, to determine the applicable accounting guidance, entities must answer several questions for each freestanding instrument, including:

- Has the fair value option, if eligible, been elected for the financial instrument?
- For instruments for which the fair value option has not been elected:
  - Is the financial instrument within the scope of ASC 480 (see Chapter 2)?
  - Does the financial instrument include embedded derivatives? If so, the issuer must assess whether it must bifurcate any of the embedded derivatives from the host contract under ASC 815-15 (see Chapter 3).
  - Does a freestanding equity-linked instrument meet the ASC 815-10-15-74(a) scope exception (see Chapter 4)?
  - Are redeemable shares (or other redeemable equity instruments) within the scope of ASC 480-10-S99-3A (see Chapter 5)?

The discussion and examples in this Blueprint will assist entities in answering those questions and determining the appropriate accounting for their financial instruments.

1.2 ENTITIES

The information in this Blueprint applies to all entities. However, there are some differences in the requirements for public and private entities, as noted in the table.

CHAPTER	ENTITIES
Chapter 2 — Distinguishing Liabilities From Equity	▶ Applies to all entities ▶ Scope exceptions exist for non-SEC registrants that issue specific types of mandatorily redeemable financial instruments (see Section 2.2.4)
Chapter 3 — Hybrid Instruments and Embedded Derivatives	▶ Applies to all entities
Chapter 4 — Contracts in an Entity's Own Equity	▶ Applies to all entities
Chapter 5 — Temporary Equity	▶ Applies to SEC registrants ▶ Applies to non-SEC registrants whose financial statements are included in an SEC filing (for example, in accordance with S-X Rules 3-05, 3-09, 3-10 and 8-04) ▶ Optional for private entities
Chapter 6 — Other Topics	▶ Applies to all entities (ASC 405, ASC 470, ASC 505, ASC 825, and ASC 835-30)
Chapter 7 — Debt Restructurings, Modifications, and Exchanges	▶ Applies to all entities
Chapter 8 — Presentation and Disclosures	▶ Applies to all entities • Some disclosures are required only for public business entities or SEC registrants • Private entities are not precluded from providing disclosures required for public business entities or SEC registrants

1.3 FINANCIAL INSTRUMENTS

FASB REFERENCES

ASC Master Glossary: Financial Instrument and Issuer

U.S. GAAP defines the term "financial instrument" as cash, evidence of an ownership interest in an entity, or a contract that **both**:

Imposes on one entity a contractual obligation to **either**:

- Deliver cash or another financial instrument to a second entity
- Exchange other financial instruments on potentially unfavorable terms with the second entity.

Conveys to that second entity a contractual right to **either**:

- Receive cash or another financial instrument from the first entity
- Exchange other financial instruments on potentially favorable terms with the first entity.

The use of the term "financial instrument" in this definition is recursive (because the term "financial instrument" is included in the definition), but it is not circular. The definition requires a chain of contractual obligations that ends with the delivery of cash or an ownership interest in an entity. Any number of obligations to deliver financial instruments can be links in a chain that qualifies a particular contract as a financial instrument.

Contractual rights and obligations encompass those that are conditioned on the occurrence of a specified event and those that are not. Some contractual rights (obligations) that are financial instruments may not be recognized in financial statements (that is, they may be off-balance-sheet) because they fail to meet some other criterion for recognition.

For some financial instruments, the right is held by, or the obligation is due from (or the obligation is owed to or by) a group of entities rather than a single entity.

This Blueprint discusses the accounting for financial instruments from the perspective of the **issuer** (the entity that issued the financial instrument or may be required to issue its equity shares under the terms of the financial instrument). The Blueprint uses the terms "issuer" or "entity" interchangeably.

In contrast, the **holder** of the instrument (the entity that has the contractual right to receive cash or another financial instrument from the issuer) must apply other U.S. GAAP to account for the transaction, such as:

- ASC 310, *Receivables*
- ASC 320, *Investments — Debt Securities*
- ASC 321, *Investments — Equity Securities*
- ASC 323, *Investments — Equity Method and Joint Ventures*
- ASC 325, *Investments — Other*
- ASC 810, *Consolidation*
- ASC 815, *Derivatives and Hedging*
- ASC 825, *Financial Instruments*

This Blueprint does not provide guidance for the accounting for financial instruments from the holder's perspective. It also does not provide guidance for share-based compensation arrangements within the scope of ASC 718, *Compensation — Stock Compensation*.

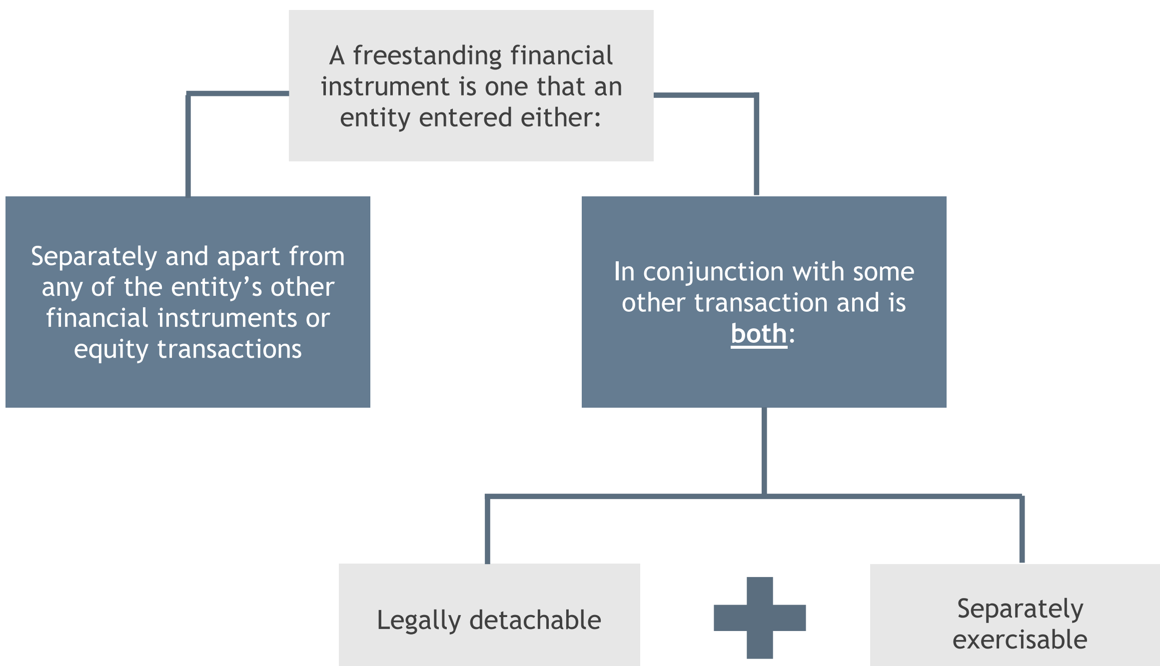
1.4 UNIT OF ACCOUNT

FASB REFERENCES

ASC Master Glossary: Freestanding Financial Instrument and Unit of Account

In evaluating financial instruments, an entity must first determine the unit of account to which the accounting guidance is applied. The unit of account is the level at which an entity aggregates or disaggregates an asset or liability for recognition.

For instance, financing transactions often involve issuing multiple instruments to the same counterparty. Therefore, an entity must identify each freestanding financial instrument issued in the transaction to determine the appropriate accounting under ASC 480, which applies only to freestanding financial instruments (see Section 2.3).



Also, some financial instruments include embedded features that may need to be accounted for as separate financial instruments. Often, those instruments contain more than one embedded feature. Therefore, an entity must identify all embedded features in an instrument and determine the appropriate unit of analysis using a consistent and rational approach to determine the appropriate accounting under ASC 815-15 (see Section 3.3).

The unit of account for freestanding instruments determined in ASC 480 (or ASC 815-15 for embedded features) is used to apply the guidance in other U.S. GAAP, such as ASC 815-40 (see Section 4.3).

The table includes common scenarios that arise and often require an assessment of the unit of account.

SCENARIO	EXAMPLE
An entity issues multiple financial instruments in a single financing transaction (often referred to as a "basket transaction").	▶ Shares issued with warrants ▶ Debt issued with warrants
An entity issues a single instrument (or contract) with multiple components.	▶ Equity collar (combination of purchased and written option) ▶ Forward or option contracts with multiple components ▶ Contingent consideration with multiple earn-out targets ▶ Instruments with multiple obligations (or settlement options or components) ▶ Subscription agreement for shares or debt with tranche issuance
An entity issues shares or debt with options or forward contracts in separate agreements.	▶ Shares subject to redemption agreement ▶ Debt issued with call spread overlays or capped calls

1.5 INTERACTION WITH OTHER U.S. GAAP

FASB REFERENCES

ASC 480-10-15-8, ASC 480-10-35-4A, and ASC 718-10-35-10 through 35-14

An issuer's evaluation of financial instruments is challenging, in part because an entity often must evaluate a given financial instrument under multiple topics within U.S. GAAP to determine which guidance to apply. For all freestanding financial instruments, the analysis begins by assessing whether the instrument is in the scope of ASC 480. If not, an assessment must be made to determine whether the instrument is an equity-linked contract under ASC 815-40 or a hybrid financial instrument with an embedded derivative under ASC 815-15. Further, for equity-classified instruments, the issuer may need to apply the SEC's temporary equity guidance in ASC 480-10-S99-3A.

Also, sometimes more than one topic within U.S. GAAP applies and the issuer must comply with the requirements of multiple topics. For example, an instrument within the scope of ASC 480 might also meet the definition of a derivative under ASC 815-10, thus requiring the issuer to comply with both topics, including disclosure requirements.

As another example, instruments that were initially in the scope of ASC 718 typically stay within the scope of ASC 718 (and thus would not be in the scope of ASC 480 or ASC 815). However, those instruments would need to be analyzed under the financial instruments guidance in this Blueprint if they are modified after **any** of the following:

- A grantee vests in the award and is no longer providing goods or services
- A grantee vests in the award and is no longer a customer
- A grantee is no longer an employee.

Similarly, an option granted to an employee would be within the scope of ASC 718; however, the shares that are issued upon the exercise of the vested option may be outside the scope of ASC 718 and would need to be analyzed under the financial instruments guidance in this Blueprint (for example, a mandatorily redeemable share issued upon exercise of a stock option would be a liability under ASC 480).

An entity must also consider the guidance in ASC 805, *Business Combinations*, when accounting for contingent and noncontingent consideration. Although entities must apply ASC 480 and ASC 815-40 to determine classification of those financial instruments, they are recognized in accordance with ASC 805-30, *Business Combinations — Goodwill or Gain From Bargain Purchase, Including Consideration Transferred*. See Section 5.4.5 (for guidance on contingent consideration in a business combination) and Appendix C, Section C.3.4 (for guidance on contingent consideration in an asset acquisition) of our Blueprint, **Business Combinations Under ASC 805**.

Further, for financial instruments classified as assets or liabilities and that are required to be remeasured at fair value under ASC 480 or ASC 815-40, an entity must determine their fair value in accordance with the guidance in ASC 820, *Fair Value Measurement*.

Also, entities that present earnings per share (EPS) must consider the effect of financial instruments when computing EPS in accordance with ASC 260, *Earnings Per Share*.

DETERMINING WHICH U.S. GAAP TO APPLY IS CRITICAL

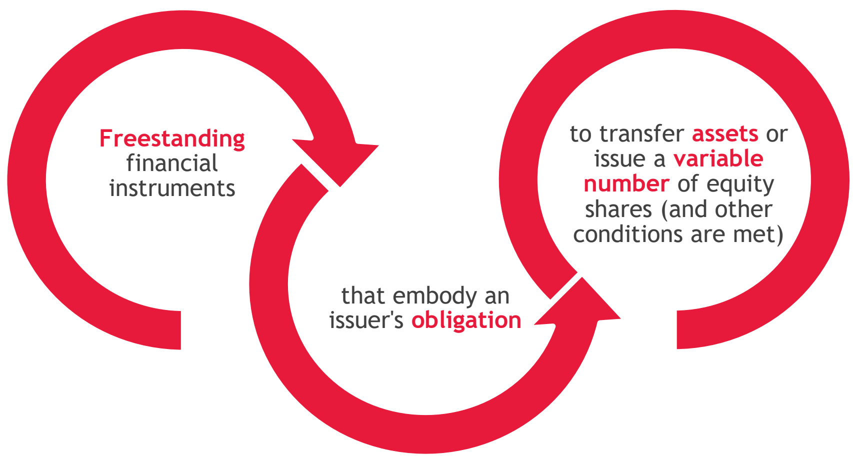
Because the accounting requirements are different under each topic, the issuer must identify the correct U.S. GAAP guidance to apply to a financial instrument. Determining which topic to apply can be challenging and requires the use of professional judgment based on the facts and circumstances.

Chapter 2 — Distinguishing Liabilities From Equity

2.1 OVERVIEW

ASC 480 requires entities to account for as liabilities (or assets in some cases) some financial instruments with characteristics of both liabilities and equity.

ASC 480 applies only to freestanding financial instruments, not to embedded features. Further, it applies only to financial instruments that embody an obligation to transfer assets or issue shares. However, not all obligations are equal for all instruments. For instruments that are outstanding shares, the obligation must be unconditional. For all other instruments, the obligation may be unconditional or conditional.



For instance, a freestanding financial instrument may unconditionally require an entity to transfer assets even though that instrument is in the legal form of a share, such as a mandatorily redeemable preferred stock. In that case, the share functions more like a debt instrument and, unless a scope exception applies (see Section 2.2), an entity classifies it as a liability under ASC 480; accounting for the financial instrument based on its substance rather than its form.

Some financial instruments embody, or are indexed to, an entity's obligation to repurchase its equity shares by transferring assets. Other financial instruments embody an entity's obligation to issue shares but do not expose the instrument holder to the risks and rewards of owning the entity's equity (because the obligation's monetary value does not fluctuate in response to changes in the entity's share price). Those obligations are accounted for as liabilities (or assets in some cases) in accordance with ASC 480.

In evaluating financial instruments under ASC 480, an entity first determines the unit of account, which requires identifying all freestanding financial instruments issued as part of the same transaction (see Section 2.3.1). Generally, each freestanding financial instrument is a separate unit of account unless required to be combined with other freestanding financial instruments under ASC 815 (see Section 2.3.2).

The entity then accounts for all freestanding financial instruments that fall within any of the three classes of instruments under ASC 480 (applying ASC 480 to each freestanding financial instrument in its entirety, including those composed of more than one component, option, or forward contract (see Section 2.3.3)).

CLASS OF INSTRUMENTS	APPLICABLE TO	ASC 480 PARAGRAPH	GUIDANCE
Mandatorily redeemable shares	Shares	ASC 480-10-25-4	Section 2.4
Financial instruments that do or may obligate the entity to buy back its equity shares (or are indexed to such an obligation) in exchange for cash or other assets	Financial instruments (other than shares)	ASC 480-10-25-8	Section 2.5
Obligations the entity must or may settle with a variable number of equity shares if, at inception, the monetary value is based solely or predominantly on **any** of the following: ▶ A fixed monetary amount known at inception ▶ A variable other than the fair value of the entity's equity shares, such as a market index ▶ A variable inversely related to changes in the fair value of the entity's equity shares.	Financial instruments (whether in the form of shares or not)	ASC 480-10-25-14	Section 2.6

In practice, the classes of financial instruments within the scope of ASC 480 are often referred to using the paragraph reference in ASC 480-10-25. This chapter also uses those references to refer to the different classes of instruments in ASC 480.

Most financial instruments within the scope of ASC 480 are initially and subsequently measured at fair value. However, some instruments, such as mandatorily redeemable shares, some physically settled forward purchase contracts, and some share-settled obligations, are not accounted for at fair value (see Section 2.8.1).

If the entity issues multiple financial instruments in a single transaction, it allocates the proceeds received among the freestanding financial instruments issued. The subsequent measurement of the instruments issued (that is, fair value or other than fair value) affects how the entity allocates the transaction proceeds (see Section 2.8).

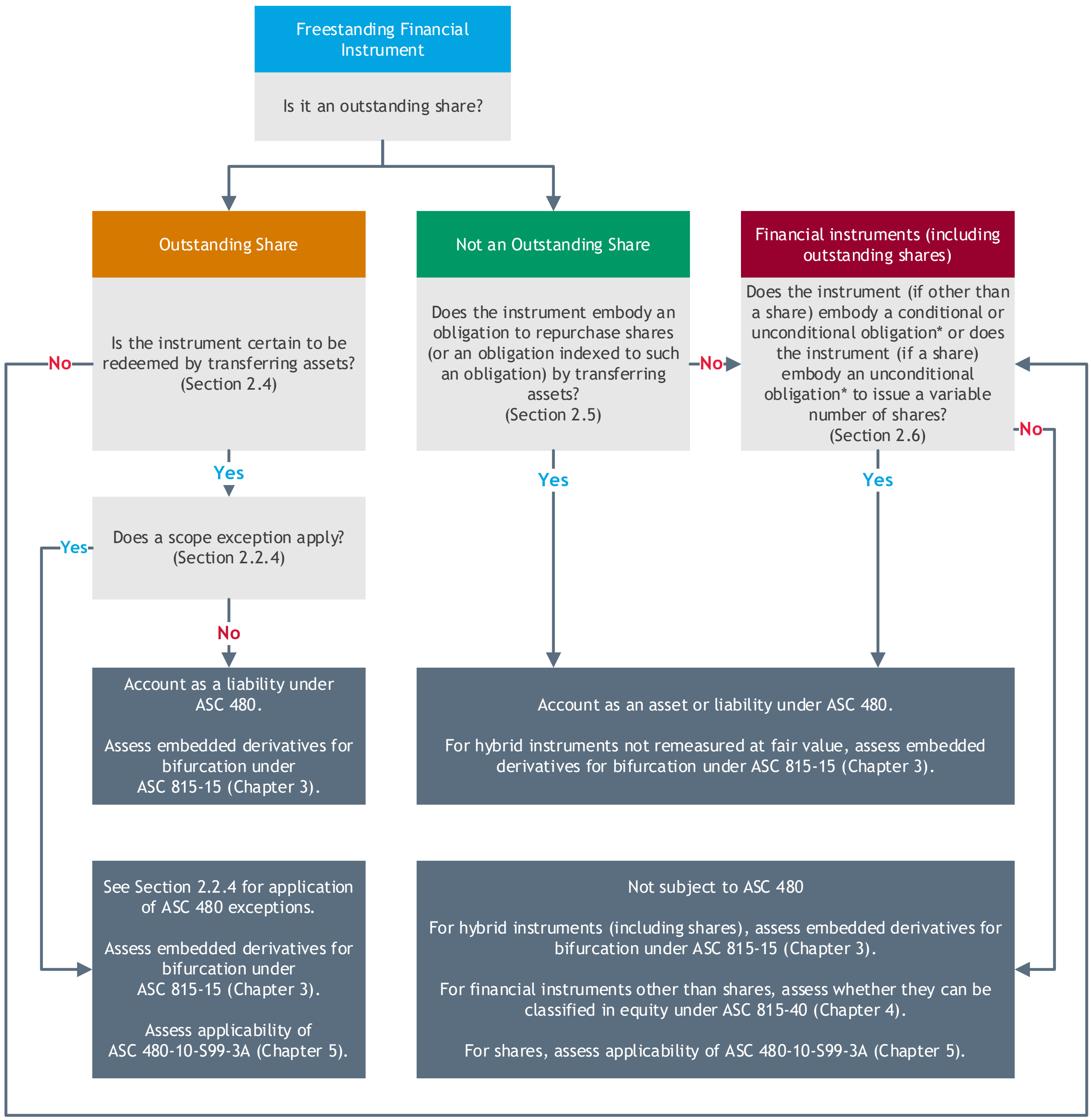
Generally, entities evaluate whether a financial instrument is within the scope of ASC 480 only at the instrument's inception and when it is modified. Also, if a conditionally redeemable financial instrument becomes mandatorily redeemable, an entity reclassifies that instrument from equity to liability at its then fair value, reducing equity by the same amount. Thus, the entity recognizes no gain or loss on reclassification (see Section 2.4.6).

If the financial instrument is a hybrid instrument that is not remeasured at fair value, the entity must evaluate it for bifurcation of any embedded derivatives in accordance with ASC 815-15 (see Section 2.10 and Chapter 3).

Also, while ASC 480 requires entities to classify some financial instruments as liabilities (or assets in some cases), it does not specifically address when entities must classify a financial instrument as equity. For some instruments (for example, preferred stock), if they are not accounted for under ASC 480, the entity classifies them in equity.

However, for other financial instruments (for example, warrants), if they are not under ASC 480, the entity cannot automatically classify them in equity. The entity must perform more analysis under other U.S. GAAP (for example, ASC 815-40) before it can classify those financial instruments as equity (see Chapter 4). Further, financial instruments that are not accounted for under ASC 480, including those that meet the scope exceptions, may need to be presented in temporary equity (see Chapter 5).

The flowchart illustrates how to evaluate a freestanding financial instrument under ASC 480.



*With a monetary value based solely or predominantly on any of the conditions in ASC 480-10-25-14.

INSTRUMENTS WITH CHARACTERISTICS OF LIABILITIES AND EQUITY AND, IN SOME CASES, OF ASSETS

Freestanding financial instruments accounted for under ASC 480 have characteristics of both liabilities and equity and, in some cases, also have characteristics of assets (see Section 2.7.3).

For example, an entity may be obligated under a forward contract to purchase its equity shares at a future date under net cash settlement. Depending on the market price for the entity's equity shares at the reporting date, that obligation may result in a liability or an asset under ASC 480 (see Example 2-27).

2.2 SCOPE

ASC 480 applies to all entities that are issuers of financial instruments (see Section 2.2.1). However, some mandatorily redeemable financial instruments issued by non-SEC registrants are outside some or all of the ASC 480 guidance (see Section 2.2.4).

2.2.1 Entities

FASB REFERENCES

ASC 480-10-15-2 and ASC 480-10-20: Issuer

ASC 480 applies to all entities. This chapter discusses the accounting for financial instruments from the issuer entity's perspective. An issuer is the entity that issued a financial instrument or may be required to issue its equity shares under the terms of the financial instrument. This chapter uses the terms "issuer" and "entity" interchangeably.

2.2.2 Freestanding Instruments

FASB REFERENCES

ASC 480-10-15-3, ASC 480-10-15-5, and ASC 480-10-25-2

ASC 480 applies only to financial instruments that are **freestanding** (see Section 2.3.1), including those that comprise more than one option or forward contract (see Section 2.3.3). As such, an entity does not apply ASC 480 to features embedded in a financial instrument that is not a derivative instrument in its entirety (see Appendix A). Instead, when evaluating embedded features for bifurcation from a hybrid instrument — including whether the embedded features meet the derivative scope exception as though they were separate instruments — an entity applies other U.S. GAAP (see Chapter 3).

Further, while ASC 480 applies to freestanding financial instruments that have characteristics of both liabilities and equity and, in some cases, also have characteristics of assets, it does not apply to freestanding financial instruments that have only characteristics of assets (see Section 2.7.3).

ASC 480 applies to any freestanding financial instrument that falls in any of the three classes of financial instruments:

Mandatorily redeemable shares (Section 2.4)	Obligations to repurchase equity shares (or indexed to such obligations) (Section 2.5)	Some share-settled obligations* (Section 2.6)
▶ Apply to financial instruments that are outstanding shares.	▶ Apply to financial instruments other than outstanding shares.	▶ Apply to financial instruments, including outstanding shares. *With monetary values based solely or predominantly on any of the conditions in ASC 480-10-25-14.

Common examples of freestanding financial instruments an entity evaluates to determine whether the instrument falls in any of the classes above include:

Equity Interests	▶ Shares of stock (for example, common, preferred) ▶ Partnership interests ▶ Limited liability company interests ▶ Noncontrolling or minority interests ▶ Cooperative membership interests
Equity Option Contracts	▶ Written put options (the option holder (that is, the investor) has the option, but not the obligation, to sell the entity's equity shares back to the entity) ▶ Written call options (the option holder (that is, the investor) has the option, but not the obligation, to buy the entity's equity shares), the most common example of which is a warrant to purchase an entity's equity shares
Equity Forward Contracts	▶ Forward sale contracts (the entity is obligated to sell its equity shares, and the investor is obligated to buy those shares) ▶ Forward purchase contracts (the entity is obligated to buy its equity shares, and the investor is obligated to sell those shares) Common types of forward contracts include variable share forwards, which include a fixed forward price and a variable number of shares, and range forwards, which are variable share forwards with upper and lower stock price thresholds
Equity Collars	▶ Net written options (a combination of a written option and purchased option, and at inception the written option's fair value exceeds that of the purchased option) ▶ Net purchased options (a combination of a written option and purchased option, and at inception the purchased option's fair value exceeds that of the written option) ▶ Zero-cost collars (a combination of purchased and written options with equal and opposite fair values at issuance) ▶ Call spread or capped call options (a combination of a purchased call option at a low strike and a written call option at a high strike)

Other Contracts	
Other Contracts	▶ Contingent share consideration or earn-out consideration (settleable in shares) issued in a business combination ▶ Accelerated share repurchase (ASR) arrangements ▶ Simple agreement for future equity (SAFE) instruments ▶ Share-settled debt ▶ Other financial instruments that the entity must or may settle by issuing its redeemable equity shares

Some equity option contracts do not embody an obligation for the entity because the entity is the holder of the option (the entity has a right, not an obligation), so they are not accounted for under ASC 480 (see Section 2.2.3). For example:

- Purchased put options (the entity has the option, but not the obligation, to sell its equity shares to the option seller (that is, the investor))
- Purchased call options (the entity has the option, but not the obligation, to buy its equity shares from the option seller (that is, the investor)).

Those contracts are evaluated under other U.S. GAAP, such as ASC 815-10 and ASC 815-40.

2.2.3 Obligations

FASB REFERENCES

ASC 480-10-05-1 through 05-3 and ASC 480-10-20: Obligation and Equity Shares

Only freestanding financial instruments that embody **an obligation** of an entity are within the scope of ASC 480. Under ASC 480, an obligation is "*a conditional or unconditional duty or responsibility to transfer assets or to issue equity shares*." Accordingly, ASC 480 applies only to financial instruments (including duties or responsibilities to issue equity shares) and not to contracts for services and other types of contracts, to which other U.S. GAAP applies. The term "equity shares" refers only to shares an entity accounts for as equity.

When applying ASC 480, an entity (issuer) must determine whether it has an obligation to transfer assets or issue equity shares and, if so, whether that obligation is conditional or unconditional.

CONDITIONAL OBLIGATION	UNCONDITIONAL OBLIGATION
The entity does not have an obligation to perform unless a specified condition is met.	The entity has an obligation to perform regardless of future events or conditions (for example, an obligation based only on passage of time).

The distinction between conditional and unconditional is key because some conditional obligations are outside the scope of ASC 480. Specifically, instruments in the form of **shares** are in the scope of ASC 480 only if they relate to an **unconditional** obligation (see Sections 2.4.2 and 2.6.1).

Outstanding share	Financial instrument other than an outstanding share
↓	↓
Obligation must be unconditional.	Obligation may be conditional or unconditional.

Generally, an entity does not incur an obligation solely by issuing shares of stock; issuing shares of stock does not create an obligation for the entity to transfer assets or issue additional equity shares. However, some types of stock do create an obligation requiring the entity to transfer assets (for example, mandatorily redeemable preferred stock (see Section 2.4)) or to issue shares (for example, mandatorily convertible preferred stock (see Section 2.6)).

A freestanding financial instrument that embodies an entity's obligation is accounted for under ASC 480 as a liability (or an asset in some cases) if it falls in any of the three classes of financial instruments:

Mandatorily redeemable shares (Section 2.4)	Obligations to repurchase equity shares (or indexed to such obligations) (Section 2.5)	Some share-settled obligations* (Section 2.6)
▶ Apply to financial instruments that are outstanding shares. ▶ Apply to unconditional obligation to redeem equity shares (where shares are certain to be redeemed).	▶ Apply to financial instruments other than outstanding shares. ▶ Apply to unconditional or conditional obligation to repurchase equity shares (or indexed to such an obligation) by transferring assets.	▶ Apply to financial instruments, including outstanding shares. ▶ Apply to both unconditional and conditional obligation to issue variable number of equity shares (for financial instruments other than shares). ▶ Apply to unconditional obligation to issue variable number of equity shares (for outstanding shares). *With monetary values based solely or predominantly on any of the conditions in ASC 480-10-25-14.

Below are common examples of financial instruments that do or do not embody an obligation to transfer assets or issue equity shares (and for those that embody an obligation, that must be evaluated whether they fall in any of the three classes of financial instruments under ASC 480).

Financial instruments that embody an obligation	Examples: ▶ Mandatorily redeemable share (see Section 2.4.2 for more guidance on whether an obligation to redeem shares is unconditional) ▶ Written put option that could require the entity to repurchase its equity shares ▶ Physically settled forward purchase contract that requires the entity to repurchase its equity shares at a fixed date ▶ Net-cash or net-share settled forward purchase contract that requires the entity to repurchase its equity shares ▶ Written call option (for example, a warrant) that could require the entity to sell its equity shares ▶ Forward sale contract that requires the entity to sell its equity shares ▶ Earn-out arrangement that could require the entity to issue its equity shares upon meeting specified targets ▶ Share-settled stock (see Section 2.6.1 for more guidance on whether the obligation is unconditional) ▶ Other share-settled obligations

Financial instruments that do not embody an obligation	Examples: ▶ A purchased call option that gives the entity the right, but not the obligation, to buy its equity shares ▶ A purchased put option that gives the entity the right, but not the obligation, to issue equity shares ▶ A forward purchase contract that requires the entity to buy its equity shares based on the occurrence of an event that is within its control

Financial instruments that meet the definition of an obligation in ASC 480-10-20 are not all automatically in the scope of ASC 480. For example, while a written put option requires liability classification under either ASC 480-10-25-8 or 25-14, depending on its terms, a written call option (for example, a warrant) might not be in the scope of ASC 480. Accordingly, more analysis is required for some instruments to determine whether they fall in any of the classes of instruments in ASC 480 (see Sections 2.4, 2.5, and 2.6.).

On the other hand, financial instruments that **do not** embody an obligation to transfer assets or issue equity shares are outside the scope of ASC 480 and therefore must be assessed under other U.S. GAAP (for example, ASC 815-40).

2.2.4 Scope Exceptions

FASB REFERENCES

ASC 480-10-15-7A through 15-7B, ASC 480-10-15-7D through 15-7F, ASC 480-10-20: Nonpublic Entity and Securities and Exchange Registrant, and ASC 480-10-25-4

Financial instruments that meet specific conditions are not within the scope of the classification, measurement, or disclosure requirements of ASC 480. Those instruments and conditions are summarized in the following table. If a financial instrument qualifies for any of the scope exceptions, the entity determines the accounting for the instrument in accordance with other U.S. GAAP (for example, the temporary equity guidance in ASC 480-10-S99-3A, if applicable).

TYPE OF INSTRUMENT	CONDITIONS TO MEET THE SCOPE EXCEPTION	ASC 480 EXCEPTION (DOES AN ENTITY NEED TO APPLY THE FOLLOWING GUIDANCE?)		
		CLASSIFICATION	MEASUREMENT	DISCLOSURE
Mandatorily redeemable financial instruments of nonpublic entities[a][b]	Issued by a non-SEC registrant and **either**: ▶ Not redeemable for a fixed amount or an amount determined by reference to an interest rate index, currency index, or another external index (for example, redeemable at fair value) ▶ Not redeemable at a fixed date (for example, redeemable upon the holder’s death)	No	No	No[c]
Mandatorily redeemable noncontrolling interests in parent’s consolidated financial statements[d]	Redeemable only upon the subsidiary’s liquidation or termination	No	No	Yes
Mandatorily redeemable noncontrolling interests in parent’s consolidated financial statements and subsidiary’s standalone financial statements [d][e]	Issued before November 5, 2003	Yes	No	Yes
Specific mandatorily redeemable financial instruments[d]	Redeemable only upon the entity’s liquidation or termination	No	No	No

(a) An SEC registrant is not eligible for this exception even if it meets the definition of a nonpublic entity.

(b) An entity conducting an initial public offering is not eligible for this exception for all financial statement periods presented.

(c) The requirements of ASC 505-10, *Equity-Overall*, still apply. In particular, disclosures of the rights and privileges of the outstanding securities (including mandatory redemption requirements) and redemption amounts for all shares redeemable at fixed or determinable prices on fixed or determinable dates in each of the next five years.

(d) The applicable exceptions apply to all entities (public and nonpublic) if the conditions are met. All public and nonpublic entities that are SEC registrants must follow the disclosure requirements under ASC 480-10-50-1 through 50-3 and other applicable guidance.

(e) These include mandatorily redeemable noncontrolling interests other than those redeemable only upon the subsidiary’s liquidation or termination.

As shown in the notes to the preceding table, the definitions of the terms "nonpublic entity" and "SEC registrants" are important in determining whether the first scope exception applies. The table describes those concepts.

NONPUBLIC ENTITY	SEC REGISTRANT
An entity that does **not** meet **any** of the following: ▶ Has equity securities trading in a public market either on domestic or foreign stock exchange or in an over-the-counter market (including securities quoted only locally or regionally) ▶ Files with a regulatory agency in preparation for the sale of any class of equity securities in a public market ▶ Is controlled by an entity that meets any of the two criteria above. An entity that has only debt securities trading in a public market (or that has filed with a regulatory agency in preparation to trade only debt securities) is a nonpublic entity.	An entity (or an entity controlled by another entity) that meets **any** of the following: ▶ Has issued or will issue debt or equity securities traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local or regional markets) ▶ Provides financial statements for the purpose of issuing any class of securities in a public market ▶ Is required to file financial statements with the SEC.

NONPUBLIC ENTITY IS NOT ALWAYS THE SAME AS NON-SEC REGISTRANT

A mandatorily redeemable share is outside the scope of ASC 480 if it is issued by a nonpublic entity that is also a non-SEC registrant and its redemption date is not fixed or the redemption price is neither fixed nor determined by reference to an interest rate index, currency index, or other external index.

ASC 480 and U.S. GAAP define the terms "SEC registrant" and "nonpublic entity" and — perhaps counter-intuitively — their definitions are not complete opposites. Further, their definitions differ from those in other U.S. GAAP.

Nonpublic entities include entities with only debt securities trading in a public market (or entities that filed with a regulatory agency in preparation to trade only debt securities). Because those nonpublic entities are SEC registrants, they do not qualify for the scope exception applicable to non-SEC registrants.

2.2.5 Interaction With Other U.S. GAAP

FASB REFERENCES

ASC 480-10-15-8 through 15-10

ASC 480 does not apply to an obligation under a share-based compensation arrangement accounted for in accordance with ASC 718. For example, an entity accounts for shares in employee stock ownership plan (ESOP) or freestanding agreements to repurchase those shares not under ASC 480 but under ASC 718-40, *Compensation — Stock Compensation — Employee Stock Ownership Plans*. However, a freestanding financial instrument issued under a share-based arrangement that is no longer subject to ASC 718 (for example, a mandatorily redeemable share issued upon exercise of a stock option) must be evaluated under ASC 480. Further, ASC 718 requires an entity to apply the classification criteria in ASC 480 to determine whether an instrument granted as compensation must be classified as a liability.

Also, ASC 480 does not apply to registration payment arrangements within the scope of ASC 825-20, *Financial Instruments — Registration Payment Arrangements*.

Further, an entity must apply ASC 480 in determining how to classify a financial instrument issued as consideration (whether contingent or noncontingent) in a business combination. However, the entity recognizes and initially measures the instrument in accordance with ASC 805-30.

See Section 2.10 for discussion of the interaction between ASC 480 and ASC 815.

2.3 DETERMINING THE UNIT OF ACCOUNT

FASB REFERENCES

ASC 480-10-25-1, ASC 480-10-25-15, and ASC 480-10-55-29

In evaluating financial instruments, an entity must first determine the unit of account to which the accounting guidance is applied. That requires an entity to identify each freestanding financial instrument issued in the transaction (see Section 2.3.1). The entity then evaluates each freestanding financial instrument separately under ASC 480 unless any must be combined with other freestanding financial instruments under ASC 815 (see Section 2.3.2). Further, the entity evaluates each freestanding financial instrument in its entirety, including those composed of more than one component, option, or forward contract (see Section 2.3.3).

2.3.1 Freestanding Financial Instruments

FASB REFERENCES

ASC 480-10-20: Freestanding Financial Instrument, ASC 480-10-15-3, and ASC 480-10-15-5

A financial instrument or component may be freestanding or embedded (that is, a nondetachable component within a freestanding financial instrument). ASC 480 applies only to freestanding instruments, not to embedded features in a financial instrument that is not a derivative instrument in its entirety.

A freestanding financial instrument is one entered separately and apart from other financial instruments or equity transactions (see Section 2.3.1.1) or, if entered with another transaction (see Section 2.3.1.2), is **both** legally detachable and separately exercisable.

Financing transactions often involve issuing multiple instruments to the same counterparty. In those cases, an entity must identify all freestanding instruments it issued in the transaction, which involves considering all key contractual terms and understanding the arrangement's substance and economics. Documenting the transaction in a single contract versus multiple contracts is not determinative when identifying the unit of account. For example, an obligation to issue multiple tranches of shares documented in a single contract may include more than one freestanding instrument. On the other hand, an entity may be required to combine a debt instrument and a nondetachable warrant issued in two separate contracts into one freestanding financial instrument for accounting purposes.

2.3.1.1 Entered Separately and Apart From Other Instruments or Transactions

Financial instruments issued to different counterparties are entered separately and apart from each other. While the individual contracts may be part of a single financing transaction from the entity's perspective, the financial instruments are typically documented in separate contracts with distinct rights and obligations related to each counterparty.

Contracts with the same counterparties may also be entered separately and apart from each other if they clearly are not issued in contemplation of each other (for example, if a substantive period passes between the issuance of the financial instruments). In reaching a conclusion, an entity must evaluate all relevant facts and circumstances, including the arrangement's economics and the business or legal reason for the timing of issuances.

2.3.1.2 Entered in Conjunction With Another Transaction

If an entity issues a financial instrument with other financial instruments or in conjunction with (entered contemporaneously or in contemplation of) another transaction, it evaluates whether each instrument or component is legally detachable (see Section 2.3.1.2.1) and separately exercisable (see Section 2.3.1.2.2).

2.3.1.2.1 Legally Detachable

While U.S. GAAP neither specifically defines the term "legally detachable" nor provides implementation guidance, generally, an instrument that can be separated and transferred to another party is considered legally detachable.

BDO INSIGHTS — MEANING OF LEGALLY DETACHABLE

The lack of specific guidance in U.S. GAAP can make it difficult to determine whether a financial instrument is legally detachable.

Some contracts include explicit terms governing the transferability of the parties' rights and obligations, while others do not. If a contract expressly allows the transfer of a financial instrument or component without requiring the transfer of another instrument or component, that instrument or component is generally legally detachable. On the other hand, if a contract expressly requires two or more financial instruments or components to always be held by the same party (for example, one instrument cannot be transferred without the other), the financial instruments may not be legally detachable. If the contract is silent, an entity may need to discuss the arrangement with its legal counsel to identify each party's legal rights.

A financial instrument with conditional transfer rights may be legally detachable if one party does not have the unilateral ability to prevent the other party from transferring the instrument. For example, a financial instrument may be legally detachable if the holder of the instrument can transfer it, even if the transfer is subject to any of the following:

- An effective registration statement or an exemption from securities registration under the 1933 Securities Act
- A holding or lock-up period that expires before the end of the instrument's term
- The issuer's consent, which cannot be unreasonably withheld per the contractual terms.

In those situations, the contract explicitly contemplates the ability (or possibility) for the holder to legally transfer or sell the instrument. In contrast, if the issuer of the instrument must provide its consent for the transfer or sale — which it may withhold at its sole discretion — that may indicate the instrument is not legally detachable.

Also, if transferring a financial instrument or component would significantly affect the remaining instruments or components (for example, the transfer of one component terminates the other components), the financial instruments or components may not be legally detachable even though one of the instruments or components can be transferred to another party (see Example 2-1). On the other hand, an instrument that can exist unaffected by another instrument may be legally detachable. For example, an instrument or component that is separately exercisable without settling the other instrument may indicate that it is legally detachable (because it can be separated from the other instruments or components to exercise it).

Further, while not discussed in the context of legally detachable and separately exercisable, ASC 480-10-15-7C notes that if an entity issues equity shares and enters a related agreement that requires redemption of the **specific underlying shares**, the two agreements form one unit of account and the shares are mandatorily redeemable (in other words, the redemption option in the related agreement is not freestanding). On the other hand, if the separate agreement does not require a redemption of specific shares but could be settled by delivering any equivalent shares, it may be freestanding.

For some contracts, components that relate to the same underlying and risk exposure may indicate that the components are part of a single unit of account rather than separate units of account (see Example 2-3). For example, contingent consideration issued in a business combination may include multiple components. To be treated as separate units of account, the components must operate independently and relate to different risk exposures. See Section 5.4.5.1 of our Blueprint, Business Combinations Under ASC 805.

Reaching a conclusion about whether a financial instrument is legally detachable requires the application of professional judgment based on the facts and circumstances.

SINGLE DOES NOT ALWAYS MEAN ONE FREESTANDING FINANCIAL INSTRUMENT

Generally, a financial instrument is freestanding if it was not issued with other financial instruments or in conjunction with another transaction. However, a single financial instrument may have multiple components that an entity must evaluate to determine whether each component is a separate unit of account (see Example 2-1) or part of the freestanding financial instrument as a single unit of account (see Example 2-3).

If the entity determines that each component is a freestanding instrument, it cannot combine the components as one unit of account unless required by ASC 815 (see Section 2.3.2). If the entity determines that the multiple components are part of a single freestanding instrument, it assesses the instrument in its entirety under ASC 480 as one unit of account (see Section 2.3.3).

EXAMPLE 2-1: FORWARD SALE CONTRACT

FACTS

On January 1, 20X4, Issuer A enters a contract to issue 5 million shares (the initial shares) to Investor X on December 31, 20X4, for $10 per share. Under the contract terms, if 30 days after December 31, 20X4 (the measurement date), Issuer A's stock price is below $10 but not less than $8, Issuer A must issue 0.06 additional share to Investor X for each initial share that Investor X holds at the measurement date (up to 300,000 additional shares) for no additional consideration. However, for any initial shares that Investor X transfers or sells during the measurement period, Issuer A is not required to issue the additional share(s) to Investor X or to the transferee (buyer) of the initial share(s).

CONCLUSION

The arrangement consists of one freestanding financial instrument, which is a contract to issue up to 5.3 million shares of Issuer A.

ANALYSIS

Because the obligation to issue 5 million shares cannot be transferred without affecting the obligation to issue the 300,000 additional shares, the two obligations are not legally detachable. Therefore, they represent one freestanding financial instrument.

2.3.1.2.2 Separately Exercisable

Typically, an instrument or component is considered separately exercisable if it can be exercised without terminating the other instruments or components. Likewise, an instrument or component that expires without terminating or affecting the other instruments or components indicates the separately exercisable condition is met.

Generally, a financial instrument is not freestanding if exercising it (such as through redemption or conversion) terminates the other instrument. On the other hand, if the financial instrument can be exercised while the other remains outstanding, and if the instruments are also legally detachable (see Section 2.3.1.2.1), they are considered freestanding.

EXAMPLE 2-2: PREFERRED STOCK TRANCHE ISSUANCE

FACTS

On January 1, 20X4, Issuer A issues 10 million shares of preferred stock for $10 per share to a third-party investor. As part of this issuance, Issuer A also issues to the same investor a written call option to buy up to 2 million additional shares of preferred stock for $10 per share in the next six months. Under the contract terms, the investor can transfer the first 10 million shares to another party and continue holding the option.

CONCLUSION

The arrangement consists of the following two freestanding financial instruments, each of which Issuer A must assess under ASC 480:

- Initial issuance of preferred stock
- Written call option that gives the investor the right to buy up to 2 million additional shares of preferred stock.

ANALYSIS

Because the investor can transfer the initial 10 million shares without also transferring the written call option, the outstanding shares of preferred stock and the option can be held by two different parties and are therefore legally detachable. The exercise of the written call option also does not affect the initial shares issued and is therefore separately exercisable. The shares of preferred stock and the written call option are freestanding from each other.

EXAMPLE 2-3: CONTINGENT CONSIDERATION

FACTS

On January 1, 20X4, Issuer A acquired Company X in a business combination. As part of the acquisition, Issuer A agreed to issue contingent consideration of up to 1 million shares to former owners of Company X if the post-combination revenues for the 24-month period after acquisition are:

- At least $100 million but less than $200 million, in which case Issuer A issues 500,000 shares
- At least $200 million but less than $300 million, in which case Issuer A issues 750,000 shares
- At least $300 million, in which case Issuer A issues 1 million shares.

CONCLUSION

The contingent consideration is accounted for as a single unit of account. In other words, there is only one freestanding financial instrument.

ANALYSIS

The contingent payments share the same risks (that is, they both relate to the post-combination revenues for the same period) and do not operate independently from each other. See Sections 5.4.5.1 and 5.4.5.2 of our Blueprint, Business Combinations Under ASC 805, for more guidance on contingent consideration.

2.3.2 Contract Combination

FASB REFERENCES

ASC 480-10-25-15, ASC 480-10-55-35, ASC 815-10-15-9, and ASC 815-10-25-6

ASC 480 prohibits an entity from combining two or more freestanding financial instruments unless required by ASC 815.

ASC 815 states that an entity must not combine two or more separate financial instruments as a single unit of account unless they have been structured as separate instruments to circumvent the applicable accounting requirements. The following indicators are considered in the aggregate and, if all present, the entity must use judgment to determine whether it must view the separate instruments as one unit.

Transactions are contemporaneous and in contemplation of one another + Transactions are with same counterparty (or structured through intermediary) + Transactions relate to same risks + No economic need or business purpose for structuring transactions separately = Determine whether to combine separate instruments as one unit of account

Accordingly, an entity cannot analyze multiple freestanding financial instruments on a combined basis unless ASC 815 requires it to do so, therefore preventing an entity from bypassing the requirements of ASC 480 by combining multiple freestanding financial instruments as one instrument. For example, as illustrated in ASC 480-10-55-35, an entity cannot combine a freestanding written put option with an outstanding equity share and analyze them as one synthetic instrument. Doing so would circumvent the ASC 480 liability classification requirements for the freestanding written put option. See Example 2-22 for an illustration of freestanding financial instruments that are not combined.

2.3.3 Financial Instruments With Multiple Components

FASB REFERENCES

ASC 480-10-15-4 through 15-5, ASC 480-10-25-12, and ASC 480-10-55-29

As discussed in Section 2.3.2, an entity does not combine two or more freestanding instruments (for example, two or more freestanding options) as one unit of account unless required by ASC 815. In contrast, if the multiple options are issued as parts of a single freestanding financial instrument, the entity applies ASC 480 to the entire instrument as one freestanding financial instrument (see Section 2.7.2). For example, an entity evaluates the following instruments as one unit of account:

- Combination of written call option and written put option, such as a freestanding warrant composed of a written call option (allowing the holder to receive a fixed number of the entity's equity shares at a fixed price) and a written put option (allowing the holder to put the warrant back to the entity for a fixed amount in cash).
- Combination of purchased call option and written put option, such as a freestanding equity collar composed of a written put option (allowing the holder to put equity shares back to the entity at a specified date if the stock price is below a set price) and a purchased call option (allowing the entity to purchase its equity shares at a specified date if the stock price exceeds a set price).

Further, some freestanding financial instruments that embody obligations that cause the financial instrument to be under ASC 480 also may have characteristics of assets (see Section 2.7.3). That can include the equity collar example above, which is a combination of a written put option (an obligation of the entity) and a purchased call option (a right for the entity) if the fair value of the purchased call exceeds the fair value of the written put. An entity must present those financial instruments as single items — either assets or liabilities — depending on the instruments' fair value on the reporting date.

EXCEPTION FOR EMBEDDED FEATURES

As discussed in Section 2.3.1, ASC 480 applies to freestanding financial instruments only. It does not apply to a feature embedded in a financial instrument that is not a derivative instrument in its entirety. For example, ASC 480 does not apply to a redemption feature (put option) or other features embedded in a share such as a preferred stock host because typically the preferred stock does not meet the definition of a derivative instrument in its entirety (for example, the holder made a significant initial net investment and ASC 815-10-15-83(b) is not met).

2.4 MANDATORILY REDEEMABLE SHARES

FASB REFERENCES

ASC 480-10-20: Mandatorily Redeemable Financial Instrument, ASC 480-10-25-1, ASC 480-10-25-4 through 25-5, ASC 480-10-25-7, ASC 480-10-30-1, ASC 480-10-35-3, and ASC 480-10-55-11

ASC 480-10-25-4 requires entities to classify mandatorily redeemable shares as liabilities unless a scope exception applies (see Section 2.2.4). Mandatorily redeemable shares are instruments issued in the form of shares that an entity must redeem for cash or other assets at a fixed or determinable date(s) or upon an event that is certain to occur. That does not include instruments redeemable only upon the entity's liquidation or termination.

To meet the definition of a mandatorily redeemable financial instrument, the instrument must meet the following requirements:

Must be in the form of shares (Section 2.4.1) + Redemption must be certain to occur (Section 2.4.2) + Obligation must be satisfied by transferring assets (Section 2.4.3) = Mandatorily redeemable

When applying ASC 480, an entity must disregard the share's nonsubstantive or minimal features (see Section 2.7.1).

If shares are redeemable only upon the occurrence of an event that is not certain to occur, they are not considered mandatorily redeemable until the event occurs or becomes certain to occur. For example, a preferred stock that an entity must redeem at a stated date that also has a substantive conversion option (that the entity may or must settle in shares and is exercisable by the holder before redemption) does not meet the definition of a mandatorily redeemable share. That is because the holder could choose to convert the preferred stock, so there is a possibility that the stock will not be redeemed (see Section 2.4.2).

At each reporting date, and when circumstances change, an entity must reassess whether shares with conditional obligations have become mandatorily redeemable (that is, the event is no longer conditional because the event has occurred or become certain to occur or the condition is resolved). If so, the entity must reclassify the shares as liabilities under ASC 480 (see Section 2.4.6).

An entity initially measures mandatorily redeemable shares accounted for as liabilities at fair value (see Section 2.4.4). Subsequently, it measures them at the present value of the amount payable at settlement using the rate implicit at inception (if both the redemption amount and the redemption date are fixed) or at the amount that would be paid if the reporting date were the settlement date (if either or both the redemption amount and redemption date vary), with changes recognized as interest cost (see Section 2.4.5).

SCOPE EXCEPTIONS MAY APPLY

There are scope exceptions to the guidance on mandatorily redeemable shares. If an instrument meets any of those exceptions, it is characterized as a mandatorily redeemable financial instrument but is exempt from some or all of the requirements of ASC 480 (see Section 2.2.4).

2.4.1 Must Be Issued in the Form of Shares

FASB REFERENCES

ASC 480-10-20: Shares

ASC 480 broadly defines the term "shares" to encompass various forms of ownership interests, including interests that are not legally in the form of securities and interests that are liabilities in substance but not form. Common examples include shares of stock (such as common and preferred) of a corporation, partnership units, membership interests, and interests in mutual organizations. ASC 480 also applies to shares issued by a consolidated subsidiary to parties other than the parent.

2.4.2 Redemption Must Be Certain to Occur

FASB REFERENCES

ASC 480-10-15-7C, ASC 480-10-25-5 through 25-7, ASC 480-10-55-3, ASC 480-10-55-12, and ASC 480-10-55-38 through 55-40

For an instrument to be classified as mandatorily redeemable, the entity's obligation to redeem must be unconditional and certain to occur. That is, the entity is required to redeem the instrument at a specified or determinable date(s) or upon an event that is certain to occur. For example, a preferred stock redeemable at the holder's option at any time is not mandatorily redeemable because its redemption depends on the holder's exercising the option. However, once the holder gives the entity an irrevocable exercise notice requiring the entity to redeem the stock at a specified date, the stock becomes mandatorily redeemable.

Further, the amount that must be redeemed does not have to be fixed to meet this condition (for example, a share that an entity must redeem on a fixed date for the share's fair value at redemption is mandatorily redeemable).

If an instrument is redeemable only upon the occurrence of an event that is not certain to occur, it is not considered mandatorily redeemable. For example, if redemption is required automatically upon the occurrence of an event, such as an initial public offering (IPO) or other contingent event, the instrument is not considered mandatorily redeemable until the event occurs or becomes certain to occur.

An entity must reassess whether instruments with conditional obligations have become mandatorily redeemable. If they have, the entity must reclassify them as liabilities under ASC 480 (see Section 2.4.6).

EXAMPLE 2-4: REDEEMABLE PREFERRED STOCK

FACTS

On June 15, 20X4, Issuer A issues 2 million shares of Series B preferred stock at $10 per share with the following terms:

- Dividends: $0.50 per share dividends accrue on the first day of each calendar quarter (subject to adjustments in the event of any stock dividend, stock split, combination, or other recapitalization), whether or not declared, and they are cumulative.
- Redemption: Issuer A must redeem shares of Series B preferred stock in cash on June 15, 20X8, for the Series B original issue price of $10 per share plus any dividends accrued but unpaid thereon, whether or not declared, and any other dividends declared but unpaid thereon.

CONCLUSION

Issuer A must account for the Series B preferred stock as a liability in accordance with ASC 480.

ANALYSIS

The preferred stock is mandatorily redeemable. It must be redeemed for cash equal to the original issue price plus any accrued and unpaid dividends on June 15, 20X8, a fixed date.

EXAMPLE 2-5: REDEEMABLE AND CONVERTIBLE PREFERRED STOCK

FACTS

Assume the same facts as in Example 2-4, except that the Series B preferred stock also includes a holder conversion option for a fixed number of common shares exercisable at any time before June 15, 20X8.

CONCLUSION

Issuer A does not account for the Series B preferred stock as a liability under ASC 480. It must account for the stock in accordance with other U.S. GAAP (for example, ASC 505 (see Chapter 6) or ASC 480-10-S99-3A if the temporary equity guidance applies (see Chapter 5)).

ANALYSIS

The preferred stock is not mandatorily redeemable because the preferred stock's redemption is conditional upon the holder's not exercising the conversion option (redemption is not certain to occur). Therefore, the instrument does not meet the definition of a mandatorily redeemable financial instrument.

However, if the conversion price were extremely high in relation to the current share price, Issuer A would ignore the conversion option and the instrument would be considered mandatorily redeemable.

DETERMINING WHETHER REDEMPTION IS CERTAIN TO OCCUR

In evaluating whether redemption is certain to occur, an entity must consider all relevant terms of the arrangement, but it cannot factor probability, intent, and economic compulsion into the analysis. In other words, if redemption is subject to a condition, the entity must assess whether the condition will occur with certainty (for example, the holder's death or termination). A conclusion that it is highly probable the condition will be met is not sufficient.

For instance, an entity may issue preferred stock it can call at any time and that requires it to pay little to no dividends in initial periods but requires it to pay increasing-rate dividends in later periods as long as the instrument remains outstanding. While the terms might economically compel the entity to call the instrument to avoid paying the increasing-rate dividends, such economic compulsion does not make the instrument mandatorily redeemable.

Entities must also consider side agreements. For instance, ASC 480-10-15-7C notes that if an entity issues shares along with a related agreement that requires redemption of the specific underlying shares issued, the two agreements form one unit of account, and the shares are mandatorily redeemable.

Some instruments allow an entity to extend their terms or defer redemption until specified liquidity levels are reached (or have similar terms that may delay or accelerate the timing of required redemption). While those terms may affect the timing of redemption, they do not prevent an instrument from being considered mandatorily redeemable and accounted for as a liability under ASC 480. That guidance on liquidity conditions cannot be applied by analogy to other conditional terms.

The table illustrates the differences between an unconditional and conditional obligation to redeem an instrument, using preferred stock as an example. The scenarios are illustrative, not determinative; reaching a conclusion in a real fact pattern depends on the facts and circumstances.

SCENARIO	UNCONDITIONAL OBLIGATION TO REDEEM	CONDITIONAL OBLIGATION TO REDEEM
Redeemable on a fixed date	▶ Nonconvertible preferred stock the issuer must redeem on the five-year anniversary of issuance by paying cash ▶ Nonconvertible preferred stock the issuer must redeem on the five-year anniversary of issuance by issuing a note with a five-year payment term	▶ Convertible preferred stock the issuer must redeem on the five-year anniversary of issuance and that includes a substantive holder conversion option ▶ Preferred stock the holder may require the issuer to redeem on the five-year anniversary of issuance
Redeemable at any time	▶ Nonconvertible preferred stock the holder may put to the issuer at any time and that requires the issuer to redeem on the five-year anniversary of issuance if the holder has not exercised the put option	▶ Preferred stock the holder may require the issuer to redeem at any time (or after passage of time)
Redeemable upon occurrence of an event	▶ Preferred stock the issuer must redeem upon the holder's death ▶ Preferred stock the issuer must redeem upon the earlier of the holder's retirement or termination of employment	▶ Preferred stock the issuer must redeem upon the holder's bankruptcy ▶ Preferred stock the issuer must redeem upon a change in control ▶ Preferred stock the issuer must redeem upon failing to achieve set milestones during a specified period

SCENARIO	UNCONDITIONAL OBLIGATION TO REDEEM	CONDITIONAL OBLIGATION TO REDEEM
Redeemable based on level of liquidity	▶ Preferred stock the issuer must redeem on the earlier of the five-year anniversary of issuance and the date the issuer achieves a specified level of liquidity ▶ Preferred stock the issuer must redeem on the five-year anniversary of issuance, with a provision that defers redemption until a specified liquidity level is reached	▶ Preferred stock the holder can require the issuer to redeem if the issuer has available cash, determined at the issuer's discretion on a good faith basis

SHARES OF STOCK WITH EMBEDDED PUT AND CALL

An entity may issue shares of stock (for example, preferred stock) that is not mandatorily redeemable but includes both embedded features:

- Put option exercisable at the holder's discretion at any time after five years or upon a change in control (written put option)
- Call option exercisable at the entity's discretion at any time after five years (purchased call option).

While it may be highly likely to be redeemed, the stock is not mandatorily redeemable because redemption is optional and the options could expire at the money and unexercised. The combination of a written put option and purchased call option with the same terms is not the same as an embedded forward purchase contract under ASC 480. That treatment under ASC 480 is different from the guidance in ASC 815-10-25-10 on the combination of two embedded options (see Section 3.3.2).

The stock is not under ASC 480 because:

- It is not mandatorily redeemable under ASC 480-10-25-4, as discussed above.
- It is not under ASC 480-10-25-8 because it is an outstanding share (see Section 2.5).
- It is not a liability under ASC 480-10-25-14 because it is an outstanding share and the obligations are conditional (see Section 2.6).

ASC 480 applies to freestanding financial instruments, not embedded features, so the entity evaluates the embedded options not under ASC 480, but instead under ASC 815-15. If the embedded options meet the scope exception under ASC 815-10-15-74(a) (see Chapter 4), they are not separated from the shares. Had the entity issued the written put option as a freestanding financial instrument, it would be a liability under ASC 480-10-25-8 (see Section 2.5).

See Section 2.9 for a discussion of a parent's accounting for a similar transaction entered on the shares of a subsidiary with the noncontrolling interest holder, and which the parent accounts for as a financing of its purchase of the noncontrolling interest.

2.4.3 Redemption Must Be Satisfied by Transferring Assets

FASB REFERENCES

ASC 480-10-05-2(a), ASC 480-10-55-5, ASC 480-10-55-27 through 55-28, and ASC 480-10-55-64

To meet the definition of a mandatorily redeemable financial instrument, the entity must be required to satisfy its obligation by a future transfer of cash or other assets (that is, the entity has a nondiscretionary obligation to transfer assets). That condition is met even if an insurance contract would cover the redemption's cost (for example, for shares redeemable upon the holder's death).

An instrument that requires an entity to settle its obligation by issuing another instrument that ultimately requires settlement by transfer of assets (for example, an instrument that would be settled with a note payable in cash) also meets that condition.

However, if the terms allow or require the entity to settle the instrument in its equity shares, the condition is not met because an entity's equity shares are not considered the entity's assets. However, the entity must further assess the contract to determine whether it must be classified as a liability under ASC 480-10-25-14 (see Section 2.6).

2.4.4 Initial Measurement for Mandatorily Redeemable Shares

FASB REFERENCES

ASC 480-10-30-1 and ASC 815-15-30-2

Mandatorily redeemable financial instruments are initially measured at fair value. However, if the financial instruments are issued in a basket transaction, the entity must allocate the proceeds received among the instruments issued. The method of allocation depends on how the instruments are subsequently measured (see Section 2.8). The amount of proceeds allocated to the mandatorily redeemable financial instrument is its initial carrying amount. If the instrument has a bifurcated embedded derivative, the entity further reduces the initial carrying amount by the embedded derivative's fair value (see Section 3.7.1).

2.4.5 Subsequent Measurement for Mandatorily Redeemable Shares

FASB REFERENCES

ASC 480-10-35-3 and ASC 480-10-45-3

Mandatorily redeemable financial instruments are subsequently measured in one of the following ways, with changes recognized as interest cost:

If both the redemption amount and date are fixed…	…measure at the present value of the amount payable at settlement, accruing interest cost using the rate implicit at inception (that is, using the effective interest method).
If either (or both) the redemption amount and date are not fixed (for example, redeemable at fair value or redeemable upon the holder's death)…	…measure at the amount of cash that would be paid under the conditions specified in the contract as if settlement occurred as of the reporting date, recognizing the resulting change in that amount from the previous reporting date as interest cost.

Any amounts paid or payable to a holder of a mandatorily redeemable financial instrument in excess of the initial measurement are recognized as interest cost.

MANDATORILY REDEEMABLE FINANCIAL INSTRUMENTS WITH BIFURCATED EMBEDDED DERIVATIVES

In accordance with ASC 815-15, an entity must assess whether a hybrid instrument that is not remeasured at fair value includes embedded derivatives that must be bifurcated and separately accounted for as a derivative asset or liability. Because mandatorily redeemable financial instruments are not remeasured at fair value under ASC 480, the entity must assess any embedded derivatives in the instrument for bifurcation unless it elects to account for the instrument at fair value under the fair value option (see Section 3.4.2.1).

The fair value of any bifurcated embedded derivative reduces the initial carrying amount of the instrument (see Section 2.4.4). Subsequently, the entity adjusts the instrument's initial carrying amount based on one of the approaches discussed in this section.

2.4.6 Reclassification of Mandatorily Redeemable Shares

FASB REFERENCES

ASC 260-10-S99-2, ASC 480-10-25-7, ASC 480-10-30-2, and 480-10-55-10 through 55-11

At each reporting date, and when circumstances change, the entity must reassess whether shares with conditional obligations have become mandatorily redeemable. In other words, the event is no longer conditional because it has occurred or become certain to occur or the condition is resolved.

If a conditionally redeemable share becomes mandatorily redeemable, the entity reclassifies the share from equity to liability at its then fair value and reduces equity by the same amount. Thus, the entity recognizes no gain or loss on reclassification.

Further, reclassifications of preferred stock affect the computation of EPS in accordance with ASC 260-10-S99-2. Under that guidance, a reclassification of preferred stock from equity to liability is accounted for as redemption of equity by issuing a debt instrument. The difference between the share's carrying amount and its fair value on the date of reclassification is treated like dividends on preferred stock and is recognized as a charge to retained earnings (or additional paid-in capital (APIC) in the absence of retained earnings) and an adjustment to net income available to common shareholders in computing EPS.

EXAMPLE 2-6 (ADAPTED FROM ASC 480-10-55-10): CONDITIONALLY REDEEMABLE STOCK THAT BECOMES MANDATORILY REDEEMABLE

FACTS

On January 2, 20X4, an entity issues shares that are mandatorily redeemable six months after a change in control event. On December 30, 20X8, a change in control occurs, requiring the entity to redeem the shares on June 30, 20X9.

CONCLUSION

The shares are initially not mandatorily redeemable and therefore not presented as liabilities under ASC 480. However, on December 31, 20X8, the shares become mandatorily redeemable, so the entity reclassifies them as liabilities at fair value. The entity recognizes an offsetting reduction to equity, with no gain or loss.

ANALYSIS

At the time of issuance, the shares were contingently redeemable and did not meet the definition of a mandatorily redeemable financial instrument, so the entity recognized them within equity. The shares became mandatorily redeemable upon the change in control event because the entity must redeem them in six months (an event certain to occur).

EXAMPLE 2-7 (ADAPTED FROM ASC 480-10-55-11): REDEEMABLE PREFERRED STOCK WITH CONVERSION OPTION THAT EXPIRES

FACTS

On January 2, 20X4, an entity issues preferred shares redeemable 30 years after issuance, which, for the first 10 years, are also convertible into a fixed number of common shares at the holders' option. The conversion option is substantive.

CONCLUSION AND ANALYSIS

The shares are initially not mandatorily redeemable and therefore not presented as liabilities under ASC 480. At issuance and while the conversion option is effective, the preferred shares are not mandatorily redeemable because redemption is contingent upon the holder not exercising its conversion option. However, when the conversion option expires, the condition is resolved, and the shares become mandatorily redeemable, the entity would reclassify the shares as liabilities at fair value and recognize an offsetting reduction to equity with no gain or loss.

2.4.7 Entities With Outstanding Shares That Are All Mandatorily Redeemable

FASB REFERENCES

ASC 480-10-45-2 through 45-2B

If an entity has no equity instruments outstanding other than mandatorily redeemable shares classified as liabilities, it must:

- Distinguish those shares from other liabilities by describing them as "shares subject to mandatory redemption" in the balance sheet.
- Measure the shares based on the guidance discussed in Sections 2.4.4 and 2.4.5.
- Present payments to holders of those shares and related accruals separately from payments to and interest due to other creditors in the cash flow statement and income statement.

Entities with only outstanding shares that are all subject to mandatory redemption on the occurrence of events that are certain to occur (and are classified as liabilities) must present the following:

- Excess of liabilities over assets (deficit) — for the excess of the shares' redemption price over book value
- Excess of assets over liabilities (equity) — for the excess of the shares' book value over the shares' redemption price.

The shares' book value is the difference between the recorded amounts of the entity's assets and liabilities other than the shares subject to mandatory redemption. That guidance applies regardless of whether the redemption price is fixed or varies based on specified conditions.

2.5 OBLIGATIONS TO REPURCHASE SHARES (OR OBLIGATIONS INDEXED TO SUCH OBLIGATIONS)

FASB REFERENCES

ASC 480-10-25-1, ASC 480-10-25-8, ASC 480-10-25-12, ASC 480-10-30-3, ASC 480-10-30-7, ASC 480-10-35-3, and ASC 480-10-35-5

ASC 480-10-25-8 requires entities to classify instruments that have the following characteristics at inception as liabilities (or as assets in some cases):

It is a financial instrument other than an outstanding share (Section 2.5.1)	+	It embodies an obligation to repurchase the issuer's equity shares or is indexed to such an obligation (Section 2.5.2)	+	It requires (or may require) the issuer to settle the obligation by transferring assets (Section 2.5.3)	=	Liability (or asset in some cases)

Those financial instruments are liabilities under ASC 480 because they obligate the entity to repurchase its equity shares (or are indexed to such an obligation) and transfer assets. The financial instrument may comprise a single option or forward. If the instrument comprises more than one option or forward, the entity applies ASC 480 to the freestanding instrument in its entirety (see Sections 2.5.4 and 2.7.2). In some cases, the financial instrument could also represent an asset (see Section 2.7.3).

Further, when applying ASC 480, an entity must disregard the financial instrument's nonsubstantive or minimal features (see Section 2.7.1).

An entity initially and subsequently measures financial instruments under ASC 480-10-25-8 at fair value, with changes in fair value recognized in earnings. However, there is one exception: forward purchase contracts that require physical settlement by repurchase of a fixed number of shares in exchange for cash are initially measured at the fair value of the shares at inception. Subsequently, they are measured at **either**:

- The present value of the settlement amount (if the settlement amount and the settlement date are fixed)
- At the settlement amount as if settlement occurred at the reporting date (if either or both the settlement amount and the settlement date vary).

In both cases, the changes in carrying amount are recognized as interest cost.

2.5.1 Financial Instruments Other Than Outstanding Shares

FASB REFERENCES

ASC 480-10-25-10 and ASC 480-10-55-29

ASC 480-10-25-8 does not apply to financial instruments in the form of outstanding shares. Instead, it applies to contracts involving (or based on) the repurchase of an entity's equity shares. Examples of financial instruments that fall within ASC 480-10-25-8 include:

- Physically settled or net-cash-settled forward purchase contracts and written put options on the entity's shares
- Forwards and written call options (for example, warrants) for redeemable shares
- Puttable warrants.

If a freestanding financial instrument is composed of more than one option or forward contract (for example, a warrant that includes both a written call option and a put feature), ASC 480 applies to the financial instrument in its entirety (see Section 2.5.4).

Also, while ASC 480-10-25-8 does not apply to an outstanding share, the share may still be under ASC 480 under either ASC 480-10-25-4 (mandatorily redeemable shares (see Section 2.4)) or ASC 480-10-25-14 (for example, some mandatorily convertible shares required to be settled by issuing a variable number of shares (see Section 2.6)).

2.5.2 Obligations to Repurchase an Issuer's Equity Shares (or Obligations Indexed to Such Obligations)

FASB REFERENCES

ASC 480-10-20: Issuer's Equity Shares and Equity Shares, ASC 480-10-25-9, and ASC 480-10-55-31

ASC 480-10-25-8 applies to both conditional and unconditional obligations. The obligation may be to repurchase the entity's (issuer's) equity shares or an obligation indexed to such an obligation.

The terminology used in this requirement is important to understand:

- The term "equity shares" refers only to shares the entity accounts for as equity.
- The phrase "issuer's equity shares" includes the entity's equity shares and equity shares issued by any of its consolidated subsidiaries. Example 2-31 illustrates how an entity (the parent) accounts for options on shares issued by its consolidated subsidiary.
- The term "indexed to" is interchangeable with "based on variations in the fair value of." In other words, ASC 480-10-25-8 applies to an obligation to repurchase the entity's equity shares or that is indexed to the fair value of such obligation, as illustrated in the contrasting examples below.

ENTITY HAS AN OBLIGATION TO REPURCHASE ITS EQUITY SHARES	ENTITY HAS AN OBLIGATION INDEXED TO AN OBLIGATION TO REPURCHASE ITS EQUITY SHARES
▶ Physically settled forward purchase contracts on the entity's equity shares ▶ Physically settled written put options on the entity's equity shares	▶ Net-cash-settled forward purchase contracts on the entity's equity shares ▶ Net-cash-settled written put options on the entity's equity shares ▶ Puttable warrants
Those are liabilities under ASC 480 because they embody an entity's obligation to repurchase its equity shares.	Those are liabilities under ASC 480 because they are indexed to (that is, based on variations in the fair value of) the entity's obligation to repurchase its equity shares (see Example 2-8).

EXAMPLE 2-8 (ADAPTED FROM ASC 480-10-55-31): PUTTABLE WARRANT

FACTS

Entity A issues a puttable warrant to a holder.

- The warrant allows the holder to purchase one equity share at an exercise price of $10 on a specified date (a written call feature).
- The warrant also allows the holder to put the warrant back to Entity A on the specified date for $2, settleable in cash (a put feature).

CONCLUSION

The warrant is a liability under ASC 480-10-25-8 because it embodies Entity A's obligation indexed to an obligation to repurchase its equity shares and may require transferring cash (see Section 2.5.3).

ANALYSIS

If the share price on settlement is greater than $12, the holder is expected to exercise the warrant and pay Entity A $10 cash, and Entity A would issue a fixed number of shares. That feature would result in issuing equity shares, not repurchasing them, and therefore does not cause liability classification under ASC 480-10-25-8.

However, if the share price on settlement is equal to or less than $12, the holder is expected to exercise the put feature and put the warrant back to Entity A, and Entity A would pay $2 cash to redeem the warrant. As the share price decreases toward $12, the fair value of Entity A's obligation to stand ready to pay $2 increases. Therefore, the warrant's put feature is an obligation of Entity A indexed to (based on variations in the fair value of) an obligation to repurchase its shares.

2.5.3 Requires or May Require the Issuer to Settle the Obligation by Transferring Assets

FASB REFERENCES

ASC 480-10-25-8 through 25-9

ASC 480-10-25-8 applies to a freestanding financial instrument that either requires or may require future transfer of cash or other assets. This requirement includes two important elements:

- A transfer of assets (see Section 2.5.3.1)
- That transfer of assets may be unconditional or conditional (see Section 2.5.3.2).

If the obligation to transfer assets is conditional, the number of conditions leading up to the transfer is irrelevant. Further, the settlement amount does not have to be fixed.

2.5.3.1 Transfer of Assets

FASB REFERENCES

ASC 480-10-20: Physical Settlement, Net Cash Settlement, and Net Share Settlement, ASC 480-10-25-8 through 25-9, and ASC 480-10-25-13

The form of settlement is important when evaluating an instrument under ASC 480-10-25-8. The different forms of contract settlement (assuming the entity (issuer) is the party with a potential obligation to repurchase its equity shares) are:

Physical Settlement

The issuer delivers the full stated amount of cash or other financial instruments to the holder.

The holder delivers the full stated number of shares of stock to the issuer.

Net Cash Settlement

The party with a loss (which could be the issuer) delivers to the party with a gain cash equal to the gain.

Net Share Settlement

The party with a loss (which could be the issuer) delivers to the party with a gain shares of stock with a current fair value equal to the gain.

These two forms of settlement represent delivery of cash. If the entity has an obligation to repurchase its equity shares (or an obligation indexed to such an obligation), the instrument is a liability under ASC 480-10-25-8.

This form of settlement involves the entity **issuing** shares, not repurchasing them. However, further analysis under Section 2.6 may be necessary.

See Section 2.7.4 for application examples.

As discussed in Section 2.5.3, for ASC 480-10-25-8 to apply, the financial instrument either must require or may require the entity (issuer) to transfer cash or other assets. An instrument that requires the entity to issue another instrument that ultimately requires or may require settlement by transfer of assets also meets this condition, for example, an instrument the entity settles by issuing:

- A note payable in cash
- Mandatorily redeemable shares
- Shares that are puttable outside the entity's control (see Section 2.5.3.2).

CONSIDERATIONS RELATED TO PREPAID FORWARD CONTRACTS

If an entity prepays an obligation to repurchase its equity shares (or an obligation indexed to such an obligation), the instrument is not a liability under ASC 480 if the entity has no remaining obligations to transfer cash or other assets or to issue equity shares. The following are example instruments (from the issuer, prepaying party perspective) that are not under ASC 480:

- Prepaid physically settled forward purchase contracts on an entity's equity shares
- Prepaid written put options on an entity's equity share.

The conclusion that those instruments are not liabilities under ASC 480 is consistent with the definition of an obligation under that topic, which is a conditional or unconditional duty or responsibility to **transfer assets** or **issue shares**. In the above examples, the entity (issuer) is required or may be required to repurchase (rather than issue) its equity shares, and that obligation has been prepaid.

However, other prepaid obligations may be classified as liabilities under ASC 480-10-25-14 if specific conditions are met, such as a prepaid physically settled forward **sale** contract to issue a variable number of shares (see Section 2.6).

If a prepaid obligation is not under ASC 480, an entity considers other relevant U.S. GAAP to account for the instrument, including the guidance in ASC 815-40 on contracts in an entity's own stock (see Chapter 4).

2.5.3.2 Unconditional or Conditional Obligation to Transfer Assets

FASB REFERENCES

ASC 480-10-25-9, ASC 480-10-25-11, and ASC 480-10-55-32 through 55-33

ASC 480-10-25-8 encompasses financial instruments that either unconditionally or conditionally obligate the entity to transfer assets.

- An entity has an unconditional obligation to transfer assets if it must perform regardless of future events or conditions. For example, a noncontingent physically settled forward contract to purchase shares unconditionally requires an entity to repurchase its equity shares on a specified date.
- An entity has a conditional obligation to transfer assets if it does not have to perform unless any specified conditions are met. An instrument embodies a conditional obligation if the entity's obligation to transfer assets is based on the occurrence (or nonoccurrence) of events outside the entity's control.

The table illustrates how some common conditions affect whether an instrument embodies a conditional obligation or does not embody an obligation (whether unconditional or conditional) to transfer assets.

CONDITIONS	EMBODIES A CONDITIONAL OBLIGATION TO TRANSFER ASSETS IF BASED ON	DOES NOT EMBODY AN OBLIGATION (UNCONDITIONAL OR CONDITIONAL) TO TRANSFER ASSETS IF BASED ON
Contingent events	Events that are outside the issuer's control (for example, a change in control, completing an IPO, or meeting a stock price target).	Events that are within the issuer's control (for example, issuing debt or equity and the holder does not control the issuer's decisions).
Exercise of an option	Holder exercising a put option.	Issuer exercising a call option and the holder does not control the issuer's decisions.
Choice of settlement form	Holder electing the form of settlement and can choose physical or net cash settlement. Also, a contract that must or may (at the holder's option) be net cash settled embodies a conditional obligation because transferring assets is contingent on the possibility that the contract will be in a loss position from the issuer's perspective (that is, the issuer will transfer assets to the counterparty in a gain position).	Issuer electing the form of settlement and can choose net share settlement. Also, a contract does not embody an obligation to transfer assets if it requires only net share settlement. However, the instrument may need to be further assessed under ASC 480-10-25-14 (see Section 2.6.3).

CHOICE OF SETTLEMENT FORM MAY AFFECT THE NATURE OF AN ENTITY'S OBLIGATION

If the holder can choose the form of settlement (for example, physical, net cash, or net share), the instrument embodies an obligation under ASC 480-10-25-8 because the entity has no discretion to avoid the potential future transfer of assets. Whether the monetary values of the different settlement alternatives (cash or shares) have the potential to differ is irrelevant, so the obligation is under ASC 480-10-25-8.

On the other hand, if the instrument allows or requires an entity to settle the instrument in its own shares, it does not require the entity to transfer assets and therefore is not a liability under ASC 480-10-25-8 because an entity's own shares are not its assets. For example, an entity can avoid transferring assets under a forward purchase contract on its equity shares if the contract gives it the option to either net cash or net share settle that instrument. However, while the instrument is outside the scope of ASC 480-10-25-8, the entity must further assess it under ASC 480-10-25-14 (see Section 2.6.3).

If the obligation to transfer assets is conditional, the **number of conditions** leading up to the ultimate transfer of assets **is irrelevant**.

For instance, warrants for redeemable shares embody an entity's obligation to repurchase its equity shares and are liabilities **regardless of the redemption price or timing of exercising** the put feature because the underlying instruments are obligations to ultimately transfer assets. That is true even if the redemption feature is contingent as long as the condition is outside the entity's control.

The table illustrates the concept.

EXAMPLES	CONDITIONS LEADING TO ENTITY'S OBLIGATION TO REPURCHASE ITS EQUITY SHARES	CLASSIFICATION UNDER ASC 480-10-25-8
Warrants to purchase preferred shares at $10 per share. The preferred shares are mandatorily redeemable at $12 per share after five years.	▶ CONDITION 1: The holder exercises the warrants. (There are no additional conditions because the preferred shares are mandatorily redeemable.)	Liability classified
Warrants to purchase preferred shares at $10 per share. The preferred shares are puttable at the holder's option for $12 cash immediately after exercising the warrant.	▶ CONDITION 1: The holder exercises the warrants. ▶ CONDITION 2: The holder elects the option to put the preferred shares back to the entity.	Liability classified
Warrants to purchase preferred shares at $10 per share. The preferred shares are puttable for $12 per share upon a change in control.	▶ CONDITION 1: The holder exercises the warrants. ▶ CONDITION 2: There is a change in control. ▶ CONDITION 3: The holder elects the option to put the preferred shares back to the entity upon the change in control.	Liability classified

BDO INSIGHTS — DEEMED LIQUIDATION EVENTS AND FUNDAMENTAL TRANSACTION CLAUSES

Provisions in a warrant agreement regarding specific events, such as mergers, consolidations, changes in control, or sales of substantially all the entity's assets, often affect how an entity classifies a warrant. Those events are commonly referred to as "deemed liquidation" or "fundamental transaction" events.

For example:

- A warrant is exercisable for contingently redeemable preferred shares. The preferred shares are redeemable for cash when a deemed liquidation event or fundamental transaction outside the entity's control occurs.
- A warrant is exercisable for nonredeemable shares but the warrant itself is puttable or redeemable for cash upon a deemed liquidation event or fundamental transaction that is outside the entity's control.

By analogy to the limited exception in ASC 480-10-S99-3A-3(f), we believe the deemed liquidation or fundamental transaction clause in those examples does not cause liability accounting for the warrants if all holders of equally and more subordinated equity instruments of the entity would always be entitled to receive the same form of consideration the warrant holders would receive (see Section 5.4.1).

2.5.4 Financial Instruments Composed of More Than One Option or Forward

FASB REFERENCES

ASC 480-10-15-3, ASC 480-10-15-5, ASC 480-10-25-12, ASC 480-10-55-18 through 55-19, and ASC 480-10-55-29 through 55-30

A freestanding financial instrument may consist of more than one option or forward contract. In those cases, an entity applies ASC 480 to the entire instrument (see Section 2.3.3). That means that if the freestanding financial instrument includes a written put option to repurchase the entity's equity shares and another option, the instrument is typically classified as a liability under ASC 480. Consider the following examples:

- Combination of written put option and written call option — If a freestanding financial instrument, such as a warrant, is composed of a written put option (allowing the holder to put the warrant back to the entity for a fixed amount in cash) and a written call option (allowing the holder to receive a fixed number of the entity's equity shares at a fixed price), the written call option's existence does not affect the classification. The fact that at least one component embodies an obligation to repurchase the entity's equity shares is sufficient to scope the entire instrument under ASC 480-20-25-8. The instrument is classified as a liability even if the put feature is contingent, as long as the contingency is outside the entity's control. An entity cannot evaluate predominance among obligations or contingencies (which is different from the evaluation under ASC 480-10-25-14 (see Section 2.6 and Example 2-8)).
- Combination of written put option and purchased call option — If a freestanding financial instrument, such as an equity collar, is composed of a written put option (allowing the holder to put equity shares back to the entity at a specified date if the stock price is below a set price) and a purchased call option (allowing the entity to purchase its equity shares at a specified date if the stock price exceeds a set price), the contract is analyzed as one unit of account (a combination of a written put option and a purchased call option). That freestanding financial instrument is a liability under either ASC 480-10-25-8 or ASC 480-10-25-14, depending on the form of settlement (see Examples 2-23 and 2-25).

Further, some financial instruments that embody obligations under ASC 480-10-25-8 also may have characteristics of assets (see Section 2.7.3). For example, the equity collar discussed above may be in a net asset position if the fair value of the purchased call exceeds that of the written put. Those financial instruments are presented as either assets or liabilities, depending on the instruments' fair value at the reporting date (see Example 2-25).

2.5.5 Initial Measurement for Obligations to Repurchase Shares (or Obligations Indexed to Such Obligations)

FASB REFERENCES

ASC 480-10-30-7

All financial instruments accounted for under ASC 480-10-25-8 must be measured initially at fair value, except for some physically settled forward purchase contracts (see Section 2.5.5.1). Further, if the entity issued the financial instruments in a basket transaction, it must allocate the proceeds received among the instruments issued (see Section 2.8).

2.5.5.1 Initial Measurement for Some Physically Settled Forward Purchase Contracts

FASB REFERENCES

ASC 480-10-30-3 through 30-6, ASC 480-10-55-14 through 55-15, and ASC 480-10-55-17

Forward contracts that require physical settlement by repurchase of a fixed number of the entity's equity shares in exchange for cash are akin to financing a stock purchase using borrowed funds (that is, similar to a treasury stock transaction)[1] rather than a derivative instrument. They must be measured initially at the fair value of the shares at inception, adjusted for any unstated rights or privileges, using **either** of the following approaches:

- Discount the settlement amount at the rate implicit at inception (after taking into account any expected dividends to the holder and any consideration or unstated rights or privileges that may have affected the transactions' terms). This present value approach may be appropriate when both the settlement amount and date are fixed.
- Determine the cash the entity would pay under the conditions specified in the contract if the entity repurchased the shares immediately (after taking into account any expected dividends and any consideration or unstated rights or privileges that may have affected the transactions' terms)[2]. This settlement value approach may be appropriate when either the settlement amount or date varies (or both do).

An entity recognizes the physically settled forward purchase contract as a liability and reduces equity by an amount equal to the shares' fair value at inception.

Cash, as discussed above, includes foreign currency. Accordingly, forward purchase contracts physically settled for cash in foreign currency are first measured using the guidance above and then remeasured in accordance with ASC 830, *Foreign Currency Matters*.

FORWARD PURCHASE CONTRACTS THAT ARE INITIALLY MEASURED AT FAIR VALUE

Only **physically settled** forward purchase contracts for a **fixed number of shares** in exchange for **cash** are initially measured in the manner discussed above. Forward purchase contracts that require or allow net settlement (cash or share) or require physical settlement in exchange for specified quantities of assets other than cash (for example, gold) are measured initially at fair value (see Section 2.5.5) and classified as assets or liabilities, depending on the contracts' fair value at inception. That is because, in substance, those transactions are different than treasury stock transactions.

EXAMPLE 2-9 (ADAPTED FROM ASC 480-10-55-14: PHYSICALLY SETTLED FORWARD PURCHASE CONTRACT WITH NO UNSTATED RIGHTS OR PRIVILEGES

FACTS

An entity enters a forward contract with the following terms:

- The entity must repurchase 1 million shares of its common stock from another party in two years.
- The forward contract price per share (that is, the price at which the entity must repurchase the common stock) is $30.
- The common stock's current price is $25 per share.

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[1] Statement of Financial Accounting Standards (FAS) No. 150, *Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity,* Basis for Conclusions (BC), BC27 and BC80.
[2] *Id.* at BC61.

- The contract must be settled in cash for $30 million.
- There are no unstated rights or privileges affecting the transaction's terms.
- The entity does not expect to pay dividends.

CONCLUSION AND ANALYSIS

Because the contract is a financial instrument (other than an outstanding share) that embodies an obligation to repurchase shares by transferring assets, it is classified as a liability. The entity:

- Discounts the settlement amount ($30 million) at the rate implicit at inception after taking into account any consideration or unstated rights or privileges that may have affected the transaction's terms — $25 million (which also is the fair value of the shares at inception).
- Recognizes a liability and reduces equity by an amount equal to the shares' fair value at inception — $25 million.

The implicit rate for a contract with an initial value of $25 million (fair value of the shares at inception) and settlement amount of $30 million payable after two years is 9.54%, assuming no other consideration or unstated rights or privileges.

The entity accrues interest during the two-year contract period at the implied discount rate of 9.54%, increasing the liability to $30 million at the repayment date. Amounts accrued are recognized as interest cost.

If the underlying common stock is expected to pay dividends before the repurchase date and is reflected in the rate implicit at inception, the present value of the liability and subsequent accrual reflects that implicit rate.

EXAMPLE 2-10 (ADAPTED FROM ASC 480-10-55-15): PHYSICALLY SETTLED FORWARD PURCHASE CONTRACT WITH UNSTATED RIGHT OR PRIVILEGE

FACTS

An entity enters a forward contract with the following terms:

- The entity must repurchase 1 million shares of its common stock from another party in two years.
- The forward contract price per share is $30.
- The common stock's current price is $30 per share.
- The contract must be settled in cash for $30 million.
- The entity, at the same time as entering the forward contract, sold a product to the counterparty at a $5 million discount.
- The entity does not expect to pay dividends.

CONCLUSION AND ANALYSIS

As in Example 2-9, because the contract is a financial instrument (other than an outstanding share) that embodies an obligation to repurchase shares by transferring assets, it is classified as a liability.

However, unlike the forward contract in Example 2-9, this transaction includes an unstated right or privilege (the $5 million discount on the product the entity sold to the counterparty). That unstated right or privilege is considered in computing the appropriate implied discount rate, instead of having a 0% implied rate ($30 million due in two years compared to $30 million at inception).

Accordingly, the implicit rate for a contract with an initial value of $25 million ($30 million fair value of the shares at inception adjusted for unstated rights of $5 million sales discount) and settlement amount of $30 million payable after two years is 9.54%. The entity recognizes a liability of $25 million, reduces equity by $30 million (fair value of the shares at inception), and increases product revenue by $5 million.

The entity then accrues interest during the two-year contract period at the implied discount rate of 9.54%, increasing the liability to $30 million at the repayment date. Amounts accrued are recognized as interest cost.

Comparing this example to Example 2-9, the liability and interest cost recognized for the forward purchase contract over the two-year contract term are the same because the transaction is adjusted for the unstated right or privilege. The $5 million discount on product sale affects the amounts reported in equity and product revenue.

EXAMPLE 2-11 (ADAPTED FROM ASC 480-10-55-15): PHYSICALLY SETTLED FORWARD PURCHASE CONTRACT WITH PAYMENT RECEIVED AT INCEPTION

FACTS

An entity enters a forward contract with the following terms:

- The entity must repurchase 1 million shares of its common stock from another party in two years.
- The forward contract price per share is $30.
- The common stock's current price is $20 per share.
- The contract must be settled in cash for $30 million.
- The entity, at the same time as entering the forward contract, received a $5 million payment from the counterparty.
- The entity does not expect to pay dividends.

CONCLUSION AND ANALYSIS

As in Examples 2-9 and 2-10, because the contract is a financial instrument (other than an outstanding share) that embodies an obligation to repurchase shares by transferring assets, it is classified as a liability.

However, unlike Examples 2-9 and 2-10, this transaction includes a contract payment at inception (the $5 million payment the entity received). That payment is considered in computing the appropriate implied discount rate, instead of having a 22.47% implied rate ($30 million due in two years compared to $20 million at inception).

Accordingly, the implicit rate for a contract with an initial value of $25 million ($20 million fair value of the shares at inception plus $5 million received at inception) and settlement amount of $30 million payable after two years is 9.54%. The entity recognizes a liability of $25 million, reduces equity by $20 million (fair value of the shares at inception), and debits cash for $5 million.

The entity accrues interest during the two-year contract period at the implied discount rate of 9.54%, increasing the liability to $30 million at the repayment date. Amounts accrued are recognized as interest cost.

Comparing this example to Examples 2-9 and 2-10, the liability and interest cost recognized for the forward purchase contract over the two-year contract term are the same because the transaction is adjusted for any other consideration and unstated right or privilege. The $5 million discount on product sale (Example 2-10) and $5 million payment received at inception (this example) affect the amounts reported in equity and other accounts (product revenue or cash).

2.5.6 Subsequent Measurement for Obligations to Repurchase Shares (or Obligations Indexed to Such Obligations)

FASB REFERENCES

ASC 480-10-35-1 and ASC 480-10-35-5

Contracts that embody an entity's obligation to repurchase its equity shares, other than some physically settled forward purchase contracts (see Section 2.5.6.1), are subsequently measured at fair value with changes in fair value recognized in earnings.

Further, financial instruments that meet the definition of a derivative instrument under ASC 815-10-15-83 (see Appendix A) and do not qualify for a derivative scope exception (see Section 3.2.3) are generally also initially and subsequently measured at fair value through earnings (see Section 2.10).

2.5.6.1 Subsequent Measurement for Some Physically Settled Forward Purchase Contracts

FASB REFERENCES

ASC 480-10-35-3 through 35-4, ASC 480-10-45-3, and ASC 480-10-55-16 through 55-17

Forward contracts that require physical settlement by repurchase of a fixed number of the entity's equity shares in exchange for cash are subsequently measured in one of the following two ways, with changes recognized as interest costs:

If both the repurchase amount and date are fixed…	…measure at the present value of the amount payable at settlement, accruing interest cost using the rate implicit at inception (that is, using the effective interest method). Examples 2-9 through 2-11 illustrate this concept.
If either (or both) the repurchase amount or date is not fixed…	…measure at the amount of cash that would be paid under the conditions specified in the contract if settlement occurred as of the reporting date, recognizing the resulting change in that amount from the previous reporting date as interest cost. For example, this method applies to a variable-rate forward contract in which the contract price is not fixed at inception but based on changes in a specific index (for example, prime rate) during the contract term.

Also, cash, as discussed above, includes foreign currency. Accordingly, forward purchase contracts physically settled for cash in foreign currency are first measured using the guidance above and then remeasured in accordance with ASC 830.

FORWARD PURCHASE CONTRACTS THAT ARE REMEASURED AT FAIR VALUE

Only **physically settled** forward purchase contracts for a **fixed number of shares** in exchange for **cash** are subsequently measured in the manner discussed above. Forward purchase contracts that require or allow net settlement (cash or share) or require physical settlement in exchange for specified quantities of assets other than cash (for example, gold) are measured subsequently at fair value (see Section 2.5.6) and classified as assets or liabilities depending on the contracts' fair value on the reporting date. That is because, in substance, those transactions are different than treasury stock transactions.

2.5.7 Contract Reassessment for Obligations to Repurchase Shares (or Obligations Indexed to Such Obligations)

FASB REFERENCES

ASC 480-10-25-8 and ASC 480-10-55-63

As discussed in Section 2.5, ASC 480-10-25-8 requires an entity to classify a financial instrument (other than an outstanding share) as a liability (or an asset in some cases) if, at inception, the instrument embodies an obligation of the entity to repurchase its equity shares (or is indexed to such an obligation) by transferring assets.

BDO INSIGHTS — CONTRACT REASSESSMENT AS A POLICY ELECTION

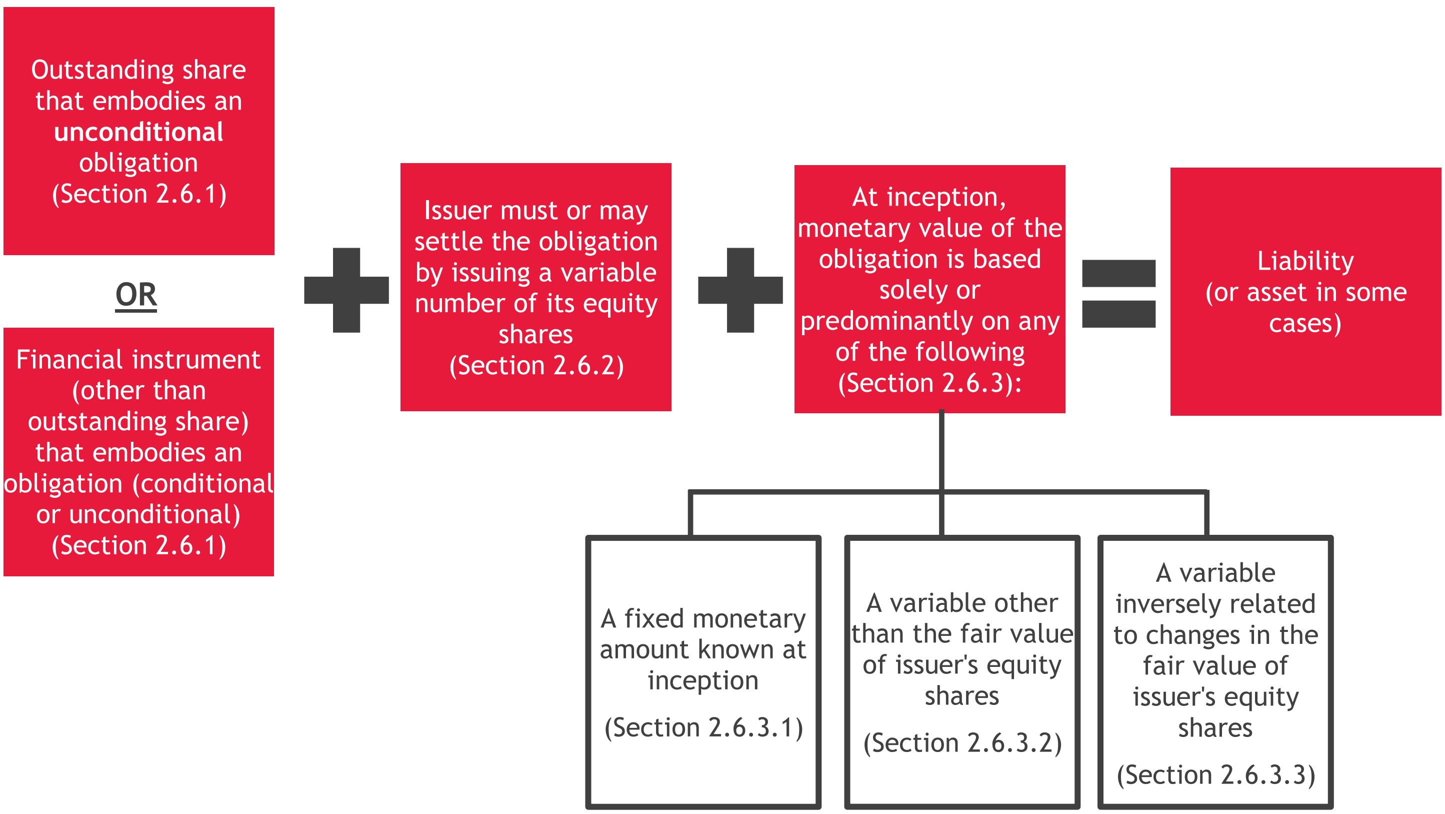
Sometimes, a contract that is liability classified under ASC 480 no longer embodies a future obligation to transfer assets (for example, because a redemption feature expires or a contingency is resolved). We believe an entity should typically reassess the classification of the financial instrument consistent with ASC 480-10-55-63, which requires a classification reassessment of specified instruments at each reporting period. However, because ASC 480-10-25-8 explicitly scopes in instruments that embody an obligation at **inception**, we believe that as an accounting policy, an entity may elect not to reassess the classification of the instrument except when the instrument is modified. That election must be applied consistently to all financial instruments accounted for under ASC 480-10-25-8.

2.6 SOME VARIABLE SHARE-SETTLED OBLIGATIONS

FASB REFERENCES

ASC 480-10-15-3, ASC 480-10-25-1, ASC 480-10-25-12, ASC 480-10-25-14, ASC 480-10-30-7, and ASC 480-10-35-5

ASC 480-10-25-14 requires entities to classify the following instruments as liabilities (or assets in some cases):



The instruments described above do not expose the counterparty to risks and rewards similar to those of an owner of the entity’s equity shares and thus do not create a shareholder relationship. For example, a financial instrument that is payable for a fixed amount and requires settlement by issuing a variable number of the entity’s equity shares creates a relationship more akin to a debtor-creditor relationship than to a share ownership. Further, the holder of a financial instrument with a monetary value that varies based on something other than the fair value of the entity’s equity shares is indifferent to the fair value movement of those shares. Lastly, a financial instrument with a monetary value that varies inversely with changes in the fair value of the entity’s equity shares creates the opposite of a shareholder relationship (that is, the entity conveys value to the holder that increases as the value of shareholder interests decreases).

Those financial instruments include instruments comprising a single option or forward, as well as freestanding instruments that comprise more than one option or forward — in which case, the entity must apply ASC 480 to each freestanding instrument in its entirety (see Section 2.7.2). The financial instruments could also represent an asset in some cases (see Section 2.7.3).

Further, when applying ASC 480, an entity must disregard the financial instrument's nonsubstantive or minimal features (see Section 2.7.1).

An entity initially and subsequently measures financial instruments under ASC 480-10-25-14 at fair value, with changes in fair value recognized in earnings, unless other U.S. GAAP specifies another measurement attribute.

2.6.1 Conditional vs. Unconditional Obligations

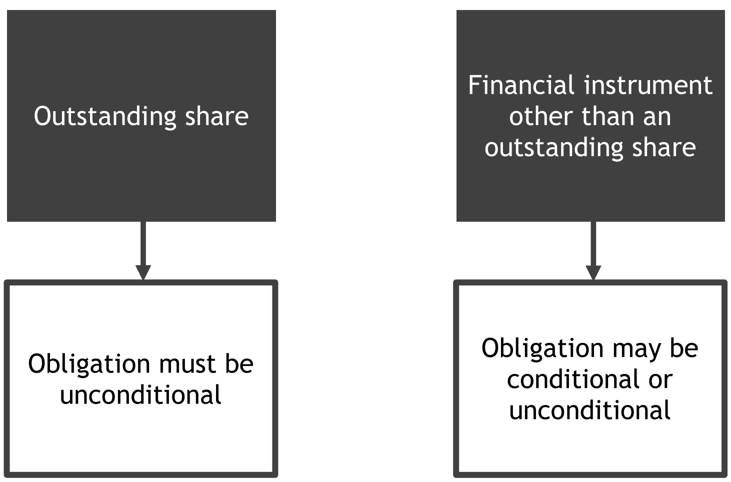
FASB REFERENCES

ASC 480-10-25-14 and 480-10-55-27 through 55-28

As illustrated in the graphic in Section 2.6, a first important consideration is whether the freestanding financial instrument is an outstanding share because that dictates the nature of obligations that may fall under this guidance.

For ASC 480-10-25-14 to apply to a financial instrument issued in the form of shares, the obligation must be unconditional (for example, the guidance applies to mandatorily convertible preferred shares that must be converted into a variable number of common shares at a specified date). Consequently, outstanding shares that embody conditional obligations to issue a variable number of shares are not subject to this guidance.

For financial instruments other than shares, the obligation to issue a variable number of shares can be conditional or unconditional for ASC 480-10-25-14 to apply.



An obligation is unconditional if the entity must perform regardless of future events or conditions (for example, based on only the passage of time). An obligation is conditional when the entity does not have to perform unless a specified condition is met.

Some financial instruments embody an unconditional obligation that allows an entity to settle the obligation's monetary value in cash or a variable number of shares at its discretion. Those financial instruments are assessed under ASC 480-10-25-14 even if the entity has discretion to avoid cash settlement because the entity does not have complete discretion to avoid the transfer of assets or shares (that is, the instruments embody an **unconditional** obligation that **may** be settled by issuing a variable number of shares). For example, a share that unconditionally obligates an entity to redeem by transferring assets or issuing a variable number of shares is an unconditional obligation even if the entity has a choice in the form of settlement (that is, either cash or shares). Consequently, the entity must account for the share as a liability under ASC 480-10-25-14.

EXAMPLE 2-12 (ADAPTED FROM ASC 480-10-55-28): UNCONDITIONAL OBLIGATION TO REDEEM AN INSTRUMENT FOR CASH OR SHARES

FACTS

An entity issues 1 million shares of cumulative preferred stock for cash equal to the stock's liquidation preference of $25 per share. The preferred stock includes the following terms:

- The entity must redeem the shares on the fifth anniversary of issuance for cash at the shares' issuance price ($25 per share) plus any accrued but unpaid dividends.
- The entity has the option to issue a variable number of its common shares worth $25 per share instead of paying cash at redemption.
- Dividends are mandatory, payable quarterly at an annual rate of 6% (that is, annual dividends of $1.50 per share). The dividends are cumulative and payable in cash or in additional preferred shares based on the liquidation preference of $25 per share.

CONCLUSION

The preferred stock embodies an unconditional obligation that the entity may settle by issuing a variable number of its equity shares with a monetary value that is fixed and known at inception. Therefore, the entity accounts for the preferred stock in accordance with ASC 480-10-25-14.

ANALYSIS

The entity evaluates the preferred stock as follows:

- The preferred stock is an outstanding share; however, it does not embody an unconditional obligation to transfer assets because redemption may be in the form of common shares. Therefore, the preferred stock is not a mandatorily redeemable stock under ASC 480-10-25-4.
- Because the preferred stock is an outstanding share, it is not under ASC 480-10-25-8.
- The preferred stock embodies an unconditional obligation under ASC 480 because the entity does not have complete discretion to avoid the transfer of assets or shares. Therefore, the preferred stock embodies an unconditional obligation that the entity may settle by issuing a variable number of its equity shares with a monetary value that is fixed and known at inception and is under ASC 480-10-25-14.

Because the preferred stock is a liability under ASC 480, the entity accounts for payments to holders as interest cost and accounts for the accrued but unpaid payments as part of the liability for the shares.

2.6.2 Must or May Settle by Issuing a Variable Number of Shares

FASB REFERENCES

ASC 480-10-25-14 and ASC 480-10-55-44

As illustrated in the graphic in Section 2.6, a second important consideration when the freestanding financial instrument embodies an obligation is whether it must or may be settled by issuing a variable number of equity shares.

Unlike the first two types of instruments under ASC 480-10-25-4 (see Section 2.4) and ASC 480-10-25-8 (see Section 2.5), which must involve a transfer of assets at settlement, a financial instrument that the entity must or may settle by issuing a variable number of its equity shares may be classified as a liability (or an asset in some cases) under ASC 480-10-25-14. That is the case even if the instrument's settlement does not involve the transfer of cash or other assets as long as the obligation's monetary value is based solely or predominantly on a fixed amount or a variable other than (or inversely related to changes in) the fair value of the entity's equity shares at inception. Such variable share-settled obligations do not expose the instrument's holder to a shareholder's risks and benefits, so they have different economic and risk exposure than an equity instrument. As such, they are classified as liabilities (or assets in some cases), even if they do not involve the future transfer of assets.[2]

Some financial instruments have more than one component or settlement outcome. For example, a financial instrument may allow the entity to settle the contract in cash or in a fixed or variable number of shares. The entity must evaluate the instrument at inception and consider all possible outcomes to determine whether settlement in a variable number of shares is the contract's predominant characteristic (see Section 2.6.3.4).

If the number of shares under an instrument's variable-share settlement is not capped, an entity must determine how that affects the classification of its other share-settled obligations. Depending on its reclassification policy, the entity may need to reclass some or all of those contracts to liability or bifurcate their share-settled embedded features (see Section 4.8.1).

2.6.3 Monetary Value of an Obligation Based Solely or Predominantly on Specific Conditions

FASB REFERENCES

ASC 480-10-05-4 through 05-5, ASC 480-10-20: Monetary Value, ASC 480-10-25-14, and ASC 480-10-55-2

As illustrated in the graphic in Section 2.6, the last important consideration is whether, at inception, the obligation's **monetary value** is based **solely or predominantly** on **any** of the following three conditions:

- A fixed monetary amount known at inception (for example, a payable settleable with a variable number of the entity's equity shares with a value equal to the payable's par amount)
- A variable other than the fair value of the entity's equity shares (for example, a financial instrument indexed to the S&P 500 and settleable with a variable number of the entity's equity shares)
- A variable inversely related to changes in the fair value of the entity's equity shares (for example, a net-share-settled written put option).

ASC 480 defines monetary value as the settlement date fair value of the cash, shares, or other instruments under specified market conditions that the entity (issuer) must pay the holder at settlement.

For variable share-settled obligations, ASC 480 requires an entity to consider whether the obligation's monetary value would remain fixed or would vary in response to changes in market conditions. In other words, because the number of shares the entity must or may issue to settle the obligation is variable, the entity must evaluate whether the variability is directly related to changes in fair value of its shares or caused by something else. The entity must evaluate the nature of the arrangement and how settlement, including form, affects the instrument's monetary value.

The following summary, adapted from ASC 480-10-55-2, illustrates some scenarios in which the monetary value does not vary in response to changes in the market conditions related to the entity's equity shares. In the scenarios, the holder is not exposed to the risks or benefits from changes in the fair value of the entity's equity shares, so the instruments would generally fall within the scope of ASC 480.

FORM OF SETTLEMENT	MONETARY VALUE	DOES THE MONETARY VALUE VARY IN RESPONSE TO CHANGES IN FAIR VALUE OF THE ENTITY'S EQUITY SHARES?
The entity must settle the obligation by either transferring $100,000 cash or issuing a number of its equity shares worth $100,000.	The monetary value is fixed at $100,000.	No. The monetary value is fixed at $100,000 even if the entity's equity share price changes; the obligation is therefore within ASC 480-10-25-14(a).

[2] *Id.* at B31 and B36.

FORM OF SETTLEMENT	MONETARY VALUE	DOES THE MONETARY VALUE VARY IN RESPONSE TO CHANGES IN FAIR VALUE OF THE ENTITY'S EQUITY SHARES?
The entity must settle the obligation by issuing a variable number of shares based on changes in the price of a variable other than the entity's equity shares — for example, a net share-settled obligation that the entity must settle by issuing a number of shares equal in value at settlement to the change in fair value of 100 ounces of gold.	The monetary value is based on variations in something other than the fair value of the entity's equity shares.	No. The monetary value varies based on changes in the price of gold, a variable other than the entity's equity share price; the obligation is therefore within ASC 480-10-25-14(b).
The entity must net share settle the obligation by issuing a variable number of its shares based on the change in fair value of a fixed number of its equity shares. For example, a net-share-settled written put option allows the holder to put 10,000 equity shares back to the entity for $11. If the entity's share price decreases from $13 to $10 on the exercise date, the written option's monetary value increases from $0 to $10,000 ((10,000 x $11) - (10,000 x $10)). The entity must issue a number of shares worth $10,000.	The monetary value is based on the fair value of a variable number of equity shares that the entity must issue at settlement. In this example, as the entity's share price decreases, the monetary value of the obligation increases.	While the monetary value varies as the entity's equity share price changes, it varies inversely; the obligation is therefore within ASC 480-10-25-14(c).

If, at inception, the instrument's monetary value is based solely or predominantly on a fixed amount or a variable other than (or inversely related to changes in) the fair value of the entity's equity shares, the entity classifies the instrument as a liability (or an asset in some cases) under ASC 480 (see Sections 2.6.3.1 through 2.6.3.4).

WARRANTS WITH SHARE-SETTLED FEATURES

Warrants to purchase an entity's shares often have a cashless exercise feature that requires an entity to issue a number of shares computed based on the difference between the entity's stock price and exercise price (a common form of net share settlement). While the number of shares issuable under that exercise provision is variable, the obligation's monetary value moves in the same direction as the fair value of the entity's shares. In other words, the higher the stock price, the higher the number and monetary value of the underlying shares issued.

That provision alone does not cause the warrant to be under ASC 480.

However, if that same warrant allowed the holder to require the entity to reacquire the warrant at a fixed date for shares equal to a fixed monetary amount known at inception, the holder's choice would depend on the entity's share price at the settlement date. The entity would therefore have to apply the predominance guidance discussed in Section 2.6.3.4 to determine whether the warrant is under ASC 480-10-25-14 (see Example 2-17).

2.6.3.1 Based on a Fixed Monetary Amount Known at Inception

FASB REFERENCES

ASC 480-10-25-14(a) and ASC 480-10-55-22

If, at inception, an entity's obligation to issue a variable number of shares has a monetary value that is based solely or predominantly on a fixed monetary amount known at inception, the entity classifies the instrument as a liability (or an asset in some cases) in accordance with ASC 480-10-25-14(a).

EXAMPLE 2-13: SHARE-SETTLED DEBT

FACTS

On January 1, 20X4, Issuer A issues a debt instrument for $475,000 that requires it to redeem the instrument on December 31, 20X4 in a variable number of shares of its common stock with a total fair value equal to $500,000.

CONCLUSION

The debt instrument is classified as a liability in accordance with ASC 480-10-25-14.

ANALYSIS

The instrument embodies an obligation that the entity must settle by issuing a variable number of shares, and at inception, the obligation's monetary value is based solely on a fixed monetary amount known at inception.

The monetary value is fixed at inception because the holder receives a value at settlement equal to $500,000, regardless of the entity's common stock price at the time of settlement. Therefore, the holder is not exposed to the risks and rewards of equity ownership. The table illustrates this concept using three stock price scenarios.

COMMON STOCK PRICE	NUMBER OF SHARES REQUIRED	MONETARY VALUE
$20	25,000 = ($500,000 / $20)	$500,000 = ($20 x 25,000 shares)
$15	33,333 = ($500,000 / $15)	$500,000 = ($15 x 33,333 shares)
$10	50,000 = ($500,000 / $10)	$500,000 = ($10 x 50,000 shares)

VARIABLE NUMBER OF SHARES COMPUTED BASED ON AVERAGE STOCK PRICE

Some share-settled obligations — that an entity may or must settle in a variable number of shares with a monetary value based solely or predominantly on a fixed monetary amount known at inception — compute the number of shares based on an average share price during a period (such as 30 days before settlement) instead of the share price on the settlement date. Therefore, if the average share price differs from the share price on the settlement date, the obligation's monetary value is not entirely fixed at inception and is based in small part on variations in the fair value of the entity's equity shares. In that case, the obligation's monetary value is not solely but predominantly based on a fixed monetary amount known at inception, and the entity must classify the obligation as a liability (or an asset in some cases) under ASC 480-10-25-14(a). Upon issuing the shares at settlement, the entity increases equity by the amount of the liability and does not recognize any gain or loss for the difference in the average and ending stock prices.

2.6.3.2 Based on a Variable Other Than the Fair Value of the Entity's Equity Shares

FASB REFERENCES

ASC 480-10-25-14(b) and ASC 480-10-55-25

A financial instrument may have a monetary value that partly or fully fluctuates in response to changes in a variable other than the changes in the fair value of the entity's equity shares and which an entity must or may settle with a variable number of shares. Examples of variables other than the fair value of the entity's shares include:

- S&P 500
- The price of gold
- The entity's revenues or earnings before interest, tax, depreciation, and amortization (EBITDA)
- The value of another entity's asset, liability, or equity security.

In accordance with ASC 480-10-25-14(b), an entity must classify such financial instrument as a liability (or an asset in some cases) if, at inception, the monetary value is based solely or predominantly on some factor other than the fair value of the entity's shares.

EXAMPLE 2-14: CONTINGENT CONSIDERATION AN ENTITY MAY SETTLE FOR A VARIABLE NUMBER OF SHARES

FACTS

On January 1, 20X4, Issuer A acquires Company X in a business combination. As part of the acquisition, Issuer A agrees to pay to the former owners of Company X additional consideration equal to 10% of Company X's positive EBITDA for the 12-month period post-acquisition. Instead of paying cash, Issuer A can pay the additional consideration in its equity shares worth the same amount.

CONCLUSION

Issuer A must classify the contingent consideration as a liability in accordance with ASC 480-10-25-14(b), initially and subsequently measured at fair value in accordance with ASC 805.

ANALYSIS

The contingent consideration is a financial instrument other than an outstanding share that embodies a conditional obligation that Issuer A may settle by issuing a variable number of its equity shares. The obligation's monetary value is based solely on Company X's EBITDA, a variable other than the changes in fair value of Issuer A's equity shares. Therefore, Issuer A must classify the contingent consideration as a liability in accordance with ASC 480-10-25-14(b).

ASC 480-10 DOES NOT APPLY TO DUAL-INDEXED OBLIGATIONS

Some variable share-settled obligations have a monetary value based on the fair value of the entity's equity shares and another variable. In those cases, an entity must assess whether the obligation's monetary value is based predominantly on the other variable rather than the fair value of the entity's equity shares (see Section 2.6.3.4).

- If based predominantly on the other variable, the instrument is classified as a liability (or an asset in some cases) under ASC 480-10-25-14(b).
- If not based predominantly on the other variable (that is, the obligation's monetary value is based in part on the entity's equity shares and **in part, but not predominantly**, on another variable, commonly referred to as a "dual-indexed obligation"), the instrument is not under ASC 480. The entity must further assess the instrument under other U.S. GAAP, such as ASC 815 (see Chapter 3).

For example, a derivative instrument that requires delivery of a variable number of the entity's equity shares with a monetary value equal to the product of changes in the price of a fixed number of the entity's equity shares and the Euro/U.S. dollar exchange rate would be outside the scope of ASC 480. That is because the obligation's monetary value varies based on both the fair value of the entity's equity shares and the foreign exchange rate. However, the instrument would be accounted for as a derivative asset or liability under ASC 815-10-15-75(b).

2.6.3.3 Based on a Variable Inversely Related to Changes in the Fair Value of the Entity's Equity Shares

FASB REFERENCES

ASC 480-10-25-14(c) and ASC 480-10-55-26

Some contracts that must or may be net share settled are liabilities (or assets in some cases) under ASC 480-10-25-14(c) because the monetary value of the obligation to deliver a variable number of shares varies inversely in relation to changes in the fair value of the entity's equity shares. In other words, as the entity's share price decreases, the entity's obligation under those contracts increases. Those kinds of instruments include freestanding forward purchase contracts, written put options, and net written options (combination of written put option and purchased call option) that are net share settled. Examples 2-15 and 2-25 through 2-27 illustrate the concepts. Freestanding purchased call options are not under ASC 480 because they do not embody an obligation for the entity.

EXAMPLE 2-15: NET-SHARE-SETTLED WRITTEN PUT OPTION

FACTS

On January 1, 20X4, Issuer A issues a put option with the following terms:

- The option entitles the holder to put back 100 shares of Issuer A for $20 per share.
- The option contract expires in two years.
- At its discretion, Issuer A can settle the option in either cash or shares upon exercise.

CONCLUSION

Issuer A must account for the net-share-settled written put option as a liability in accordance with ASC 480-10-25-14(c).

ANALYSIS

The written put option is a financial instrument other than an outstanding share that embodies a conditional obligation that Issuer A may settle by issuing a variable number of its equity shares with a monetary value that is based solely on variations inversely related to changes in the fair value of Issuer A's equity shares. Therefore, the written put option is a liability in accordance with ASC 480-10-25-14(c).

The table uses three stock price scenarios to illustrate how the instrument's monetary value varies inversely to changes in Issuer A's stock price.

COMMON STOCK PRICE	NUMBER OF SHARES REQUIRED UNDER NET SHARE SETTLEMENT	MONETARY VALUE
$15	33.33 = (($20 - $15) x 100 / $15)	$500 = ($15 x 33.33 shares)
$12	66.67 = (($20 - $12) x 100 / $12)	$800 = ($12 x 66.67 shares)
$10	100 = (($20 - $10) x 100 / $10)	$1,000 = ($10 x 100 shares)

Because Issuer A can settle the option in shares and avoid transferring assets, the instrument is not under ASC 480-10-25-8 (see Section 2.5). However, Issuer A must account for the written put option as a liability under ASC 480-10-25-14(c).

2.6.3.4 Assessing Predominance

FASB REFERENCES

ASC 480-10-25-14 and ASC 480-10-55-42 through 55-51

If, at inception, the monetary value of a financial instrument that must or may be settled in a variable number of shares is based **solely** on a fixed monetary amount known at inception, a variable other than (or inversely related to changes in) the fair value of the entity's shares (the three conditions described in Section 2.6.3), the entity classifies the instrument as a liability (or an asset in some cases) under ASC 480.

Some financial instruments, such as those composed of more than one option or forward contract (for example, puttable warrants) embody multiple obligations. Others have multiple settlement outcomes (for example, variable share forwards). If any of the component obligations or settlement outcomes meet any of the three conditions described in Section 2.6.3, the entity must determine whether those component obligations or settlement outcomes are **predominant** relative to the instrument's other obligations or settlement outcomes.

The graphic illustrates the analysis for financial instruments with multiple component obligations.

Step 1: Identify any component obligations that if freestanding would be liabilities under ASC 480-10-25-14.

Step 2: Identify the financial instrument's other component obligations.

Step 3: Assess whether the monetary value of any obligations in Step 1 is (collectively) predominant over the (collective) monetary value of other obligations identified in Step 2.

- If so, account for the entire instrument as a liability (or asset) under ASC 480-10-25-14.
- If not, the financial instrument is not under ASC 480-10-25-14.

In performing steps 1 and 2, it is important for the entity to understand the terms of the financial instrument and the nature of the component obligations. For example, some share-settled financial instruments are referred to as convertible instruments but are convertible or settleable into a variable number of shares with a fixed monetary value known at inception (see Example 2-16). While the variable share-settled feature may be called a conversion feature in the agreement, in substance, the entity is using its own shares as currency to settle an obligation that has a fixed monetary value. That arrangement does not expose the instrument's holder to changes in the entity's share price, so the conversion feature is assessed based on its substance as a redemption feature. That is an example of a component obligation included in Step 1 above.

However, if the instrument also includes a "true conversion feature" at the holder's option (that is, a conversion feature for a fixed number of shares), the monetary value of that component obligation varies directly with changes in the entity's share price and if freestanding would not be within the scope of ASC 480-10-25-14. That is an example of a component obligation included in Step 2 above.

In performing Step 3, an entity must determine whether the monetary value of any obligations included in Step 1 is collectively predominant over the collective monetary value of other obligations included in Step 2. For example, if the "conversion" into a variable number of shares is the predominant component, the instrument is classified as a liability under ASC 480-10-25-14(a). Conversely, if the true conversion feature is the predominant obligation, the instrument is outside the scope of ASC 480. Generally, determining which component obligation(s) is (are collectively) predominant is based on the likelihood that the contract will settle in accordance with the obligation(s) included in Step 1 when compared to the likelihood of settling in accordance with the obligation(s) included in Step 2.

Similarly, when an instrument has multiple settlement outcomes (for example, the variable share forward described in Example 2-19), determining whether settlement in a variable number of shares that meet any of the conditions in ASC 480-10-25-14 is predominant is based on the likelihood of that settlement outcome.

If an instrument's settlement into a fixed or variable number of shares is contingent on both the entity's share price and the occurrence or nonoccurrence of a specified event, the entity must consider all possibilities and analyze the instrument in accordance with ASC 480-10-55-43 (the three steps discussed above).

BDO INSIGHTS — PREDOMINANCE CONCEPT NOT DEFINED

ASC 480 does not define the concept of predominance, which is not straightforward. ASC 480-10-55-44 states that the entity must analyze the instrument at inception and consider all possible outcomes to determine which obligation is predominant. The entity must consider all relevant information, including current stock price, stock volatility, exercise price, and instrument term. While the guidance discusses information and factors to consider, it does not provide a probability threshold to use. Accordingly, some entities interpret the word "predominant" as any outcome with a likelihood over 50%, while others believe it means a higher probability, such as 70%, 80%, or 90%. Because of the lack of guidance, we believe an entity may apply a threshold between 51% and 90% as an accounting policy election, which must be consistently applied.

Regardless of the selected accounting policy, assessing predominance requires the application of professional judgment based on the facts and circumstances.

EXAMPLE 2-16: DEBT THAT IS CONTINGENTLY SETTLEABLE IN A VARIABLE NUMBER OF SHARES

FACTS

Issuer A issues a debt instrument for $1 million that is payable one year after issuance. The coupon interest rate is 8% per year, payable at maturity. Further, it includes the following settlement features:

- If a qualified equity financing occurs, the debt's principal and accrued interest automatically convert to the same type of shares issued in the qualified equity financing at a conversion price of 80% of the share price issued in that financing. That means that if a qualified equity financing occurs, Issuer A would issue a variable number of shares worth $1.25 million (the debt would settle at a premium of 25% ((100% - 80%) / (80%)).
- The holder may elect to convert the principal and accrued interest at maturity at a conversion price equal to $50 million divided by Issuer A's fully diluted shares at the time of conversion.
- The debt is redeemable at 150% of principal if Issuer A undergoes a change in control.

CONCLUSION

The debt instrument is not under ASC 480.

ANALYSIS

Issuer A performs the three steps to determine the debt instrument's predominant obligation:

- **Step 1: Identify any component obligations that if freestanding would be liabilities under ASC 480-10-25-14.** For conversion upon qualified equity financing, the potential settlement in a variable number of shares worth $1.25 million has a monetary value that is based on a fixed monetary amount known at inception. However, that settlement feature generally does not embody an obligation to issue shares because initiating a qualified equity financing is within Issuer A's control. In that case, it would not be classified as a liability under ASC 480-10-25-14 if it were freestanding. Determining whether an instrument or component of an instrument embodies an obligation requires the use of professional judgment based on the facts and circumstances.
- **Step 2: Identify the financial instrument's other component obligations.**
  - The conversion at maturity is a component obligation that involves issuing a variable number of shares (it is intended to give the holder an option to convert to a fixed percentage of Issuer A's diluted equity). However, the monetary value of that obligation is not based on a fixed amount (it changes based on at least the fair value of Issuer A's shares) or on a variable other than (or inversely related to changes in) the fair value of Issuer A's shares (as Issuer A's share price increases, so does the monetary value of the component obligation). That component obligation would therefore not be classified as a liability under ASC 480-10-25-14 if it were freestanding.
  - The redemption for cash equal to 150% of the principal upon a change in control or 100% of the principal at maturity date does not embody an obligation to issue a variable number of shares. Those component obligations would therefore not be classified as liabilities under ASC 480-10-25-14 if they were freestanding.

- **Step 3: Assess predominance.** Because there is no component obligation to issue a variable number of shares that if freestanding would be a liability under ASC 480-10-25-14, Step 3 is not applicable. Consequently, Issuer A determines that the debt instrument is not under ASC 480 and must assess the instrument for bifurcation of embedded derivatives (see Chapter 3).

EXAMPLE 2-17 (ADAPTED FROM ASC 480-10-55-45 THROUGH 55-46): WARRANT WITH SHARE-SETTLEABLE PUT

FACTS

Entity C issues a puttable warrant to a holder.

- The warrant allows the holder to purchase one equity share at an exercise price of $10 on a specified date (a written call component).
- The warrant also allows the holder to put the warrant back to Entity C on the specified date for $2, settleable in fractional shares (a share-settleable written put feature with a monetary value based on a fixed amount).
- The warrant has a short life.
- Entity C's share price is well below the warrant's $10 exercise price at inception.
- Entity C's stock is determined to have very low volatility.

CONCLUSION AND ANALYSIS

Entity C performs the three steps to determine the warrant's predominant obligation:

- **Step 1: Identify any component obligations that if freestanding would be liabilities under ASC 480-10-25-14.** If the share price on the settlement date is equal to or less than $12, the holder is expected to put the warrant back to Entity C, and Entity C would issue a variable number of shares with a fixed monetary amount known at inception ($2). Accordingly, that component obligation would be classified as a liability under ASC 480-10-25-14(a) if it were freestanding.
- **Step 2: Identify the financial instrument's other component obligations.** If the share price on the settlement date is greater than $12, the holder is expected to exercise the warrant and pay Entity C a fixed amount of cash ($10), and Entity C would issue a fixed number of shares (one share worth more than $12). In this case, the monetary value of the share varies directly with changes in the share price above $12 (the higher the share price above $12, the higher the component's monetary value). Therefore, the component obligation would not be classified as a liability under ASC 480-10-25-14 if it were freestanding.
- **Step 3: Assess predominance.** Entity C considers the facts and circumstances to determine whether, at inception, the monetary value of the component obligation identified in Step 1 is predominant over the monetary value of the component obligation identified in Step 2. The written call component of the warrant identified in Step 2 is deeply out-of-the-money, Entity C's stock has very low volatility, and the warrant has a short life. If Entity C determines that the share-settleable put feature identified in Step 1 (a component obligation with a monetary value based on a fixed amount) is the warrant's predominant component, it accounts for the warrant as a liability under ASC 480-10-25-14(a).

A freestanding instrument composed of more than one option or forward contract may include an obligation to issue a fixed number of shares on a specified date and once those shares are issued, to potentially issue a variable number of additional shares. That type of instrument must also be assessed to determine whether, at inception, the possibility of issuing a variable number of shares in which the monetary value of the obligation that meets any of the conditions in ASC 480-10-25-14 is predominant.

EXAMPLE 2-18 (ADAPTED FROM ASC 480-10-55-47 THROUGH 55-48): WARRANT WITH SHARE-SETTLEABLE MAKE-WHOLE PUT

FACTS

Entity E issues a warrant to a holder.

- The warrant allows the holder to purchase one equity share at an exercise price of $10.
- The warrant has an embedded liquidity make-whole put that entitles the holder to receive from Entity E the net difference between the share price on the date the holder exercises the warrant and the sales price the holder receives when it later sells the share. That make-whole feature is not legally detachable.
- Entity E has the option to settle the make-whole put by issuing a variable number of shares. For example, if the holder exercises the warrant when the share price is $15, and the share price decreases to $12 when the holder sells the shares, the entity may issue a variable number of shares worth $3 (instead of paying cash) to settle the make-whole put.

CONCLUSION AND ANALYSIS

Entity E performs the three steps to determine the warrant’s predominant obligation:

- **Step 1: Identify any component obligations that if freestanding would be liabilities under ASC 480-10-25-14.** The potential settlement in a variable number of shares to settle the make-whole put (that is, if the share price declines between the dates the holder exercises the warrant and sells the shares) embodies a conditional obligation with a monetary value that is inversely related to changes in Entity E’s share price. Accordingly, the component obligation would be classified as a liability under ASC 480-10-25-14(c) if it were freestanding.
- **Step 2: Identify the financial instrument’s other component obligations.** The settlement in a fixed number of shares when the holder exercises the warrant (that is, the liquidity make-whole is not triggered and no additional shares are issuable under the make-whole put) embodies an obligation with a monetary value that varies directly with changes in Entity E’s share price. Therefore, the component obligation would not be classified as a liability under ASC 480-10-25-14 if it were freestanding.
- **Step 3: Assess predominance.** Entity E considers the facts and circumstances (including its stock volatility) to determine whether, at inception, the monetary value of the component obligation identified in Step 1 is predominant over the monetary value of the component obligation identified in Step 2. If so, the warrant is a liability under ASC 480-10-25-14(c). In contrast, if Entity E determines that at inception, the component obligation identified in Step 2 is predominant (in other words, the share-settleable make-whole put feature — a component obligation with a monetary value inversely related to changes in Entity E’s share price — is not the warrant’s predominant component obligation), the warrant is not a liability under ASC 480-10-25-14(c). In that case, Entity E must evaluate the warrant under ASC 815-40.

Some contracts have settlement that generally moves in the same direction as the fair value of the entity’s equity shares. However, that relationship should not be assumed without analyzing the contractual terms and features. For instance, while a forward sale contract typically has a monetary value that moves directly with changes in the entity’s share price, it may include terms that require issuing variable number of shares with a monetary value that meets one of the conditions in ASC 480-10-25-14 and is predominant.

EXAMPLE 2-19 (ADAPTED FROM ASC 480-10-55-50): VARIABLE SHARE FORWARD SALES CONTRACT

FACTS

Entity D enters a forward contract to issue its equity shares in exchange for $50 in six months. The contract requires Entity D to issue a variable number of shares at settlement as follows:

IF ENTITY D'S STOCK PRICE ON SETTLEMENT DATE IS:	ENTITY D MUST ISSUE AT SETTLEMENT:
Greater than $60	83.33 shares
Greater than $50 but less than or equal to $60	Variable number of shares worth $50
Less than or equal to $50	One share

Entity D's share price is $53 at inception.

CONCLUSION AND ANALYSIS

Entity D has an obligation to issue a variable number of shares with a range of potential outcomes. It must consider the facts and circumstances (including stock price at inception, stock volatility, and duration of the contract) to determine whether, at inception, the monetary value of that obligation is predominantly based on a fixed monetary amount known at inception (that is, $50) based on the likelihood that Entity D's share price will be greater than $50 but less than or equal to $60 at the contract's settlement. If so, Entity D accounts for the forward sale contract as a liability under ASC 480-10-25-14(a).

Some instruments have a monetary value that is based on both the entity's share price and another variable (for example, contingent consideration that requires an entity to issue a variable number of shares based on the entity's revenues (see Example 2-3)). The entity must assess whether the instrument's monetary value is based predominantly on the achievement of the performance target rather than predominantly on the share price. See Section 5.4.5.2 of our Blueprint, Business Combinations Under ASC 805, for more guidance on classification of contingent consideration.

2.6.4 Initial Measurement for Some Variable Share-Settled Obligations

FASB REFERENCES

ASC 480-10-30-7

All financial instruments accounted for under ASC 480-10-25-14 must be measured initially at fair value. However, if the instruments are issued in a basket transaction, the entity must allocate the proceeds received among the instruments issued. The method of allocation depends on how the instruments are subsequently measured (see Section 2.8). The amount of proceeds allocated to the financial instrument is its initial carrying amount. If the instrument has a bifurcated embedded derivative, the entity further reduces the initial carrying amount by the embedded derivative's fair value (see Section 3.7.1).

2.6.5 Subsequent Measurement for Some Variable Share-Settled Obligations

FASB REFERENCES

ASC 480-10-35-1 and ASC 480-10-35-5

Financial instruments accounted for under ASC 480-10-25-14 are subsequently measured at fair value, with changes in fair value recognized in earnings unless other U.S. GAAP specifies another measurement attribute. For example, a share-settled obligation for a fixed amount payable in shares functions like a debt instrument the entity will settle using shares as currency. For that instrument, the entity must determine whether a different measurement attribute other than fair value better reflects the instrument's economics (for example, amortized cost using the interest method under ASC 835-30-35).

Some entities elect the fair value option under ASC 825 for eligible instruments. In those cases, the instrument is subsequently measured at fair value, regardless of whether a different measurement attribute other than fair value may otherwise apply.

Further, financial instruments that meet the definition of a derivative instrument under ASC 815-10-15-83 (see Appendix A) and do not qualify for a derivative scope exception (see Section 3.2.3) are generally also initially and subsequently measured at fair value through earnings (see Section 2.10).

2.6.6 Contract Reassessment for Some Variable Share-Settled Obligations

ASC 480-10-25-14 requires an assessment of the nature of the entity's obligation at inception. Therefore, an entity does not reassess financial instruments under ASC 480-10-25-14 unless the instruments' terms are modified.

2.7 ADDITIONAL CONSIDERATIONS WHEN EVALUATING FINANCIAL INSTRUMENTS UNDER ASC 480

When evaluating financial instruments under ASC 480, an entity must also consider all the following in its analysis:

- Whether an instrument includes nonsubstantive or minimal features and how they affect the nature and substance of the instrument.
- How to apply ASC 480 to the units of account and to instruments with multiple components.
- How to evaluate instruments that also have characteristics of an asset.
- How the instrument's form of settlement affects the nature of the entity's obligation.

2.7.1 Nonsubstantive or Minimal Features

FASB REFERENCES

ASC 480-10-25-1, ASC 480-10-55-12, and ASC 480-10-55-41

When applying ASC 480, an entity disregards the financial instrument's nonsubstantive or minimal features. That requires an entity to use professional judgment and to consider all the instrument's terms and any other relevant facts and circumstances when distinguishing substantive features from nonsubstantive or minimal features.

EXAMPLE 2-20 (ADAPTED FROM ASC 480-10-55-12): REDEEMABLE PREFERRED STOCK WITH NONSUBSTANTIVE CONVERSION OPTION

FACTS

An entity issues preferred stock with the following features:

- Has a stated redemption date of 10 years after issuance
- Convertible at the holder's option during the first five years for a fixed number of the entity's common stock.

The conversion price is extremely high compared to the current share price of common stock at issuance date.

CONCLUSION

The preferred stock is mandatorily redeemable and classified as a liability under ASC 480 (see Section 2.4).

ANALYSIS

Because the conversion price is extremely high compared to the current share price at issuance date, the conversion option is disregarded (that is, considered nonsubstantive) under ASC 480-10-25-1. Because the preferred stock is mandatorily redeemable with the passage of time, the instrument is classified as a liability.

There is no subsequent reassessment of the nonsubstantive feature (the conversion option).

EXAMPLE 2-21 (ADAPTED FROM ASC 480-10-55-41): WRITTEN PUT WITH A MINIMAL PREFERRED STOCK HOST

FACTS

An entity issues one unit of preferred stock with the following features:

- Par value of $100
- Pays a small dividend
- Embedded in the stock is a put option that allows the holder to put the preferred stock and 100,000 shares of the entity's common stock (with a current price of $50) for a fixed price of $45 per share in cash.

CONCLUSION

The instrument is considered a written put option that is classified as a liability and initially and subsequently measured at fair value under ASC 480 (see Section 2.5).

ANALYSIS

The preferred stock host is considered nonsubstantive because it has a minimal par value and a small dividend compared to the put option's notional and obligation to repurchase the entity's equity shares. Therefore, the preferred stock host is disregarded under ASC 480-10-25-1. Said differently, the terms of the preferred stock instrument and the facts and circumstances indicate that the substance of the transaction is that the parties entered into an arrangement on the entity's common stock, not to issue preferred stock. The entity therefore evaluates the instrument as a freestanding written put, which it classifies as a liability under either ASC 480-10-25-8 or ASC 480-10-25-14(c), depending on the settlement form (see Section 2.7.4). That classification and measurement are also consistent with the table in ASC 480-10-55-63.

2.7.2 Applying ASC 480 to the Units of Account (Including Instruments With Multiple Components)

FASB REFERENCES

ASC 480-10-25-1, ASC 480-10-55-12, and ASC 480-10-55-34 through 55-40

An entity may issue multiple freestanding financial instruments to the same counterparty or may issue a freestanding financial instrument with more than one option or forward contract. As discussed in Section 2.3.1, an entity must first determine the unit(s) of account (that is, all the freestanding financial instruments and whether any of them must be combined). The entity then applies ASC 480 to each freestanding financial instrument (unit of account) in its entirety.

Examples 2-22 through 2-24 illustrate the concept and emphasize that the conclusions under ASC 480 may differ depending on the freestanding financial instruments identified.

EXAMPLE 2-22 (ADAPTED FROM ASC 480-10-55-34 THROUGH 55-35): THREE FREESTANDING FINANCIAL INSTRUMENTS

FACTS

An entity issues the following three freestanding financial instruments contemporaneously to the same counterparty:

- A written put option on its equity shares
- A purchased call option on its equity shares
- Outstanding shares of stock.

The separate financial instruments do not meet the criteria for contract combination in accordance with ASC 815.

CONCLUSION

The entity accounts for the written put option as a liability in accordance with ASC 480-10-25-8. The purchased call option and outstanding shares of stock are outside the scope of ASC 480, so the entity must account for them in accordance with other U.S. GAAP.

ANALYSIS

The entity evaluates the three freestanding financial instruments separately as follows:

- The written put option gives the counterparty the right to require the entity to buy the equity shares. Therefore, the written put option embodies an obligation of the entity to repurchase its equity shares and is under ASC 480-10-25-8 (see Section 2.5).
- The purchased call option gives the entity the right, but not the obligation, to buy its equity shares, so the option is outside the scope of ASC 480 (see Section 2.2.3). The entity must evaluate the instrument under other U.S. GAAP (for example, ASC 815-40).
- The outstanding stock does not embody an obligation, so it is outside the scope of ASC 480 (see Section 2.2.3). The entity must evaluate the instrument under other U.S. GAAP (for example, ASC 505).

In accordance with ASC 480-10-25-15, the entity must not combine a freestanding financial instrument accounted for under ASC 480 (in this case, the written put option) with another freestanding financial instrument (the purchased call option or the outstanding shares of stock) unless required by ASC 815. If ASC 815 required the entity to combine the written put option and the purchased call option as one unit of account, the entity would account for the combined unit as an equity collar under ASC 480 (in its entirety) because it includes a component that embodies an obligation of the entity to repurchase shares. An entity must apply judgment to determine whether it is appropriate to combine multiple freestanding financial instruments as one unit of account (see Section 2.3.2).

EXAMPLE 2-23 (ADAPTED FROM ASC 480-10-55-36 THROUGH 55-37): TWO FREESTANDING FINANCIAL INSTRUMENTS

FACTS

An entity issues the following two freestanding financial instruments contemporaneously to the same counterparty:

- A combination of a written put option at one exercise price and a purchased call option at a different exercise price on its equity shares (issued as one freestanding instrument)
- Outstanding shares of stock.

Assume the separate financial instruments do not meet the criteria for contract combination in accordance with ASC 815.

CONCLUSION

The entity accounts for the combined written put option and purchased call option as a liability in accordance with ASC 480. The outstanding shares of stock are outside the scope of ASC 480, so the entity must account for them in accordance with other U.S. GAAP.

ANALYSIS

The entity evaluates the two freestanding financial instruments separately as follows:

- The entity applies ASC 480 to the entire freestanding financial instrument that comprises a put option and a call option. The combined written put and purchased call option (an equity collar) is reported as a liability (or asset) under either ASC 480-10-25-8 (see Section 2.5) or ASC 480-10-25-14(c) (see Section 2.6) depending on the instrument's form of settlement. In other words, the instrument is accounted for under ASC 480 (either within ASC 480-10-25-8 or ASC 480-10-25-14(c)) regardless of the form of settlement and regardless of whether at current prices it is a net written, net purchased, or zero-cost collar option.
- The outstanding stock does not embody an obligation, so it is outside the scope of ASC 480 (see Section 2.2.3). The entity must evaluate the instrument under other U.S. GAAP (for example, ASC 505).

In accordance with ASC 480-10-25-15, the entity must not combine a freestanding financial instrument accounted for under ASC 480 (in this case, the equity collar) with another freestanding financial instrument (the outstanding shares of stock) unless required by ASC 815.

EXAMPLE 2-24 (ASC 480-10-55-38 THROUGH 55-40): ONE FREESTANDING FINANCIAL INSTRUMENT

FACTS

An entity issues a share of stock with a written put option and a purchased call option embedded in the share as follows:

- The written put option allows the holder to put the share back to the entity any time after five years or upon a change in control.
- The purchased call option allows the entity to purchase the share from the holder any time after five years.

CONCLUSION

The share is outside the scope of ASC 480, so the entity must account for it in accordance with other U.S. GAAP.

ANALYSIS

The entity evaluates the redeemable share as follows:

- The share is not mandatorily redeemable because redemption is optional. The combination of a written put option and purchased call option with the same terms is not an embedded forward purchase contract under ASC 480. That is because the options could expire at the money unexercised. Therefore, the share is outside the scope of ASC 480-10-25-4 (see Section 2.4) — but see Section 2.9 for similar features embedded in NCI, for which the analysis differs.
- Because the instrument is an outstanding share, it is outside the scope of ASC 480-10-25-8 (see Section 2.5), and because it embodies a conditional obligation, it is also outside the scope of ASC 480-10-25-14 (see Section 2.6).
- ASC 480 does not apply to embedded features. The entity evaluates the embedded options under ASC 815-15. If the embedded options meet the scope exception under ASC 815-10-15-74(a), they are not separated from the share. Had the entity issued the written put option as a freestanding financial instrument, that option would be a liability under ASC 480 (see Example 2-22).

2.7.3 Application Example — Instruments With Characteristics of Assets

FASB REFERENCES

ASC 480-10-25-12 and ASC 480-10-55-18 through 55-20

As discussed in Section 2.3.3, some financial instruments that embody obligations and are under ASC 480-10-25-8 (see Section 2.5) or ASC 480-10-25-14 (see Section 2.6) may have characteristics of assets (in addition to having characteristics of liabilities and equity). In contrast, ASC 480 does not apply to financial instruments that have only characteristics of assets.

Each freestanding financial instrument within the scope of ASC 480 must be classified as an asset or a liability in its entirety, initially and subsequently, depending on its fair value on the reporting date. Examples of those instruments include:

- Net-cash-settled or net-share-settled forward purchase contracts
  - For example, an entity may be obligated under a forward contract to purchase its equity shares at a future date under net cash settlement. Depending on the market price for the entity's equity shares at the reporting date, that obligation may result in a liability or an asset accounted for under ASC 480 (see Section 2.7.4). Example 2-27 illustrates the concept.
- Some combined options to repurchase the entity's shares
  - For example, an equity collar, which is a combination of a written put option (an obligation of the entity) and a purchased call option (a right for the entity), may be in a net asset position if the fair value of the purchased call exceeds the fair value of the written put. That financial instrument is presented as either an asset or a liability, depending on the instrument's fair value at the reporting date. Example 2-25 illustrates the concept.

EXAMPLE 2-25 (ADAPTED FROM ASC 480-10-55-18 THROUGH 55-20): EQUITY COLLAR

FACTS

An entity enters one freestanding contract (an equity collar) with the following terms:

- If at the end of Year 1, its share price falls below $20, the entity must purchase 100 shares of its own stock for $20 (a written put).
- If at the end of Year 1, its share price is greater than $21, the entity has a right to purchase 100 shares of its own stock for $21 (a purchased call).

CONCLUSION

The equity collar is under ASC 480 (either ASC 480-10-25-8 or ASC 480-10-25-14(c), depending on the contract's form of settlement).

ANALYSIS

The entity evaluates the freestanding contract in its entirety as a combination of a written put option and a purchased call option (not as a forward contract) as follows:

- If the entity must physically settle the contract, the contract embodies an obligation of the entity to repurchase its equity shares by transferring assets, so the entity accounts for it as a liability in accordance with ASC 480-10-25-8 (see Section 2.5).
- If the entity must or may net cash settle the contract, the contract embodies an obligation of the entity that is indexed to an obligation to repurchase its equity shares by transferring assets, so the entity accounts for it as a liability in accordance with ASC 480-10-25-8 (see Section 2.5).
- If the entity must or may net share settle the contract, the contract embodies an obligation of the entity to issue a variable number of shares with a monetary value that varies inversely in relation to changes in the fair value of

the entity's equity shares, so the entity accounts for it as a liability in accordance with ASC 480-10-25-14(c) (see Section 2.6).

Accordingly, the contract is under ASC 480 (either ASC 480-10-25-8 or ASC 480-10-25-14(c), depending on the contract's form of settlement).

- If at issuance, the written put option's fair value exceeds the fair value of the purchased call option, the contract is a net written option and is initially presented as a liability.
- If the purchased call option's fair value exceeds the fair value of the written put option, the contract is a net purchased option and is initially presented as an asset.
- If the fair values of the two options are equal and opposite, the contract's initial fair value is zero (commonly called a zero-cost collar).

Subsequently, as the financial instrument's fair value changes, the entity performs a similar analysis to remeasure and classify the instrument as an asset or liability.

2.7.4 Application Examples — Forms of Settlement

FASB REFERENCES

ASC 480-10-20: Physical Settlement, Net Cash Settlement, and Net Share Settlement

Evaluating financial instruments includes understanding how their settlement terms affect the entity's obligation to transfer assets or issue a variable number of its equity shares.

The different forms of contract settlement (assuming the entity (issuer) is the party with a potential obligation to repurchase its equity shares) are:

Physical Settlement

The issuer delivers the full stated amount of cash or other financial instruments to the holder.

The holder delivers the full stated number of shares of stock to the issuer.

Net Cash Settlement

The party with a loss (which could be the issuer) delivers to the party with a gain cash equal to the gain.

Net Share Settlement

The party with a loss (which could be the issuer) delivers to the party with a gain shares of stock with a current fair value equal to the gain.

These two forms of settlement represent delivery of cash. If the entity has an obligation to repurchase its equity shares (or an obligation indexed to such an obligation), the instrument is a liability under ASC 480-10-25-8.

This form of settlement involves the entity **issuing** shares, not repurchasing them. The instrument may be a liability under ASC 480-10-25-14.

A contract's settlement terms may affect the nature of the entity's obligation and how the contract should be accounted for. For example, a physically settled forward purchase contract for a fixed number of shares and a net-cash-settled forward purchase contract are both under ASC 480-10-25-8 but are measured in a different manner (see Sections 2.5.5.1 and 2.5.6.1).

Also, depending on the form of settlement, an instrument may be under ASC 480-10-25-8 (embodies an obligation to transfer assets) or ASC 480-10-25-14 (embodies an obligation to issue a variable number of shares).

EXAMPLE 2-26: ANALYSIS OF FORMS OF SETTLEMENT FOR A WRITTEN PUT OPTION

The example illustrates different forms of settlement for a freestanding written put option and why it is within the scope of ASC 480. The instrument embodies either an entity's obligation (or an obligation indexed to an obligation) to repurchase its equity's shares by transferring assets under ASC 480-10-25-8 or an obligation to issue a variable number of shares under ASC 480-10-25-14. In scenarios presented, the instrument's exercise or settlement is not based on any contingent events.

FACTS

Issuer A issues a freestanding written put option that allows the holder to require Issuer A to purchase 100 of its common shares held by the holder at $20 per share.

Because the contract is a put option, it is in a gain position from the holder's perspective when the exercise price ($20) is higher than the share price at settlement.

Assume the following three scenarios about the fair value of Issuer A's common shares (share price):

- Scenario 1: $5 per share
- Scenario 2: $10 per share
- Scenario 3: $15 per share

CONCLUSION AND ANALYSIS

Physical Settlement

If the contract requires (or allows at the holder's discretion) physical exercise, Issuer A is (or may be) obligated to transfer cash. Issuer A pays the $2,000 exercise price in cash and receives 100 shares (and the written put option is settled).

Issuer A's obligation to transfer assets is an obligation to repurchase its equity shares. Therefore, the written put option is a liability under ASC 480-10-25-8 (see Section 2.5).

Net Cash Settlement

If the contract requires (or allows at the holder's discretion) net cash settlement, Issuer A is required (or may be required) to pay cash equal to the gain in the contract:

- Scenario 1: $1,500 (($20 - $5) x 100 shares)
- Scenario 2: $1,000 (($20 - $10) x 100 shares)
- Scenario 3: $500 (($20 - $15) x 100 shares)

Issuer A (the party with a loss) pays cash to the holder (the party with a gain). Issuer A does not receive shares (and the written put option is settled).

Net Share Settlement

If the contract requires or allows net share settlement, Issuer A (the party with a loss) will deliver a variable number of shares to the holder (the party with a gain). The value of the shares delivered is equal to the gain in the contract (which varies under the three scenarios) as follows:

- Scenario 1: 300 shares (($20 - $5) x 100 shares / $5 share price) with a monetary value of $1,500
- Scenario 2: 100 shares (($20 - $10) x 100 shares / $10 share price) with a monetary value of $1,000

CONCLUSION AND ANALYSIS

	Net Cash Settlement	Net Share Settlement
	As illustrated herein, as the share price decreases, the value of the obligation to repurchase shares increases. The obligation to transfer assets is indexed to Issuer A’s obligation to repurchase its equity shares (the value of the obligation to transfer assets increases as the share price decreases). Therefore, the written put option is a liability under ASC 480-10-25-8 (see Section 2.5).	▶ Scenario 3: 33.33 shares (($20 - $15) x 100 shares / $15 share price) with a monetary value of $500 As illustrated herein, the obligation’s monetary value changes inversely with changes in Issuer A’s share price (the lower Issuer A’s share price, the higher the monetary value). Issuer A’s obligation to issue a variable number of shares has a monetary value that varies inversely with changes in its share price. Therefore, the contract is a liability under ASC 480-10-25-14(c) (see Section 2.6). If the contract also gives Issuer A the option to elect net cash settlement, the written put option is not a liability under ASC 480-10-25-8 because Issuer A can avoid transferring assets by issuing shares. However, it is a liability under ASC 480-10-25-14 (see Section 2.6).

EXAMPLE 2-27: ANALYSIS OF FORMS OF SETTLEMENT FOR A FORWARD PURCHASE CONTRACT

The example illustrates different forms of settlement for a freestanding forward purchase contract and why it is within the scope of ASC 480. The instrument embodies either an entity’s obligation (or an obligation indexed to an obligation) to repurchase its equity’s shares by transferring assets under ASC 480-10-25-8 or an obligation to issue a variable number of shares under ASC 480-10-25-14. In scenarios presented, the instrument’s exercise or settlement is not based on any contingent events.

FACTS

Issuer A enters a freestanding forward purchase contract that requires it to purchase 100 of its common shares from the counterparty at $20 per share. Assume the following two scenarios about Issuer A’s share price at settlement:

- Scenario 1: $15 per share
- Scenario 2: $25 per share

Because the contract is a purchase contract, from the counterparty's perspective the contract is in a gain position when the exercise price ($20) is higher than the share price (Scenario 1) and in a loss position when the exercise price ($20) is lower than the share price (Scenario 2).

CONCLUSION AND ANALYSIS

Physical Settlement

If the contract requires (or allows at the counterparty's discretion) physical exercise, Issuer A is (or may be) obligated to transfer cash. Issuer A pays the $2,000 exercise price in cash and receives 100 shares (and the forward purchase contract is settled).

Issuer A's obligation to transfer assets is an obligation to repurchase its equity shares. Therefore, the forward purchase contract is a liability under ASC 480-10-25-8 (see Section 2.5).

Net Cash Settlement

If the contract requires (or allows at the counterparty's discretion) net cash settlement, Issuer A (the party with a loss) is required (or may be required) to pay the counterparty (the party with a gain) cash equal to the gain in the contract:

- Scenario 1: $500 (($20 - $15) x 100 shares)

However, under Scenario 2, Issuer A (the party with a gain) will receive cash from the counterparty (the party with a loss) equal to the gain in the contract:

- Scenario 2: $500 (($25 - $20) x 100 shares)

Issuer A either pays or receives cash equal to the loss or gain and does not receive shares (and the forward purchase contract is settled).

As illustrated herein, as the share price decreases, the value of the obligation to repurchase shares increases. The obligation to transfer assets is indexed to Issuer A's obligation to repurchase its equity shares (the value of the obligation to transfer assets increases as the share price decreases). Therefore, the forward purchase contract is under ASC 480-10-25-8. Depending on Issuer A's share price at the reporting date, the forward contract may be a liability (such as in Scenario 1) or an asset (such as in Scenario 2) (see Section 2.5).

Net Share Settlement

If the contract requires or allows net share settlement, under Scenario 1, Issuer A (the party with a loss) will deliver a variable number of shares to the counterparty (the party with a gain). The value of the shares delivered is equal to the gain in the contract.

- Scenario 1: 33.33 shares (($20 - $15) x 100 shares / $15 share price) with a monetary value of $500

However, under Scenario 2, Issuer A (the party with a gain) will receive a variable number of shares from the counterparty (the party with a loss). The value of the shares delivered is equal to the gain in the contract.

- Scenario 2: 20 shares (($25 - $20) x 100 shares / $25 share price). Because Issuer A is not required to issue shares under this scenario, the monetary value of Issuer A's obligation is zero. Instead, Issuer A has a right to receive shares (an asset).

As illustrated herein, the obligation's monetary value changes inversely with changes in Issuer A's share price (the lower Issuer A's share price, the higher the monetary value when the contract is in a loss position for Issuer A).

CONCLUSION AND ANALYSIS

Net Share Settlement

Issuer A's obligation to issue a variable number of shares has a monetary value that varies inversely with changes in its share price. Therefore, the contract is an asset or a liability under ASC 480-10-25-14(c) (see Section 2.6).

If the contract also gives Issuer A the option to elect net cash settlement, the forward purchase contract is not under ASC 480-10-25-8 because Issuer A can avoid transferring assets by issuing shares. However, it is an asset or a liability under ASC 480-10-25-14 (see Section 2.6).

ENTITIES MUST EVALUATE SETTLEMENT TERMS TO DETERMINE THE NATURE OF ITS OBLIGATION

As illustrated in ASC 480-10-55-63, freestanding written put options and forward purchase contracts that embody an entity's obligation are within the scope of ASC 480 regardless of the instrument's required settlement method and regardless of who (the issuer or the holder) has the choice of settlement method.

On the other hand, depending on their terms, written call options and forward sale contracts may be within the scope of ASC 480. While the settlement of written call options and forward sale contracts that are settled in shares generally moves in the same direction as the fair value of the underlying shares, an entity must not assume that relationship without analyzing the contractual terms and features.

For example, a forward sale contract may be under ASC 480 if it embodies an obligation that the entity must or may settle by issuing a variable number of shares with a monetary value predominantly based on a fixed amount, as in the case of the variable share forward sale contract illustrated in Example 2-19.

Similarly, if a written call option (such as a warrant) could require the entity to reacquire the warrant for shares with a total value equal to a fixed monetary amount known at inception, the entity must apply the predominance guidance discussed in Section 2.6.3.4 to determine whether the warrant is under ASC 480-10-25-14 (see Example 2-17).

2.8 ALLOCATION OF PROCEEDS AND ISSUANCE COSTS

If the financial instruments are issued in a basket transaction, the entity must allocate the proceeds received among the instruments issued. The method of allocation depends on how the instruments are subsequently measured.

2.8.1 Measurement Models for ASC 480 Financial Instruments

In summary, financial instruments accounted for under ASC 480 are measured as shown in the table (assuming the entity does not elect the fair value option and the financial instrument is not issued in a basket transaction, which may change initial measurement (see Section 2.8.2)).

TYPE OF INSTRUMENT	INITIAL MEASUREMENT	INSTRUMENT'S SETTLEMENT TERMS	SUBSEQUENT MEASUREMENT
Mandatorily redeemable financial instruments	Fair value (see Section 2.4.4)	Settlement date and amount are fixed	At the present value of the amount payable at settlement using the rate implicit at inception (see Section 2.4.5)
		Settlement date and (or) amount varies	At the amount of cash that would be paid if settlement occurred as of the reporting date (see Section 2.4.5)
Physically settled forward purchase contracts in exchange for cash	Fair value of shares at inception, adjusted for any consideration for unstated rights or obligations (see Section 2.5.5.1)	Repurchase date and amount are fixed	At the present value of the amount payable at settlement using the rate implicit at inception (see Section 2.5.6.1)
		Repurchase date and (or) amount varies	At the amount of cash that would be paid if settlement occurred as of the reporting date (see Section 2.5.6.1)
Obligations to issue a variable number of shares in exchange for a fixed monetary amount	Fair value (see Section 2.6.4)	Fixed monetary amount	Fair value unless other U.S. GAAP specifies another measurement attribute — for example, amortized cost (see Section 2.6.5)
All other freestanding financial instruments	Fair value (see Sections 2.4.4, 2.5.5, and 2.6.4)		Fair value (see Sections 2.4.5, 2.5.6, and 2.6.5)

2.8.2 Allocation of Proceeds

In financing transactions, entities commonly issue more than one financial instrument. In those cases, the entity must allocate the transaction proceeds among the financial instruments issued in the transaction.

BDO INSIGHTS — ALLOCATING PROCEEDS TO MULTIPLE INSTRUMENTS

ASC 480 does not specify how an entity must allocate transaction proceeds. However, entities generally analogize to the allocation methods described in ASC 815-15-30-2 for bifurcated embedded derivatives (see Section 3.7.1.2) and ASC 470-20-25-2 for debt issued with detachable warrants (see Section 6.2.1.3).

Under that approach, the entity must first identify the subsequent measurement for each financial instrument (fair value or other than fair value) because that determines the allocation approach the entity uses.

The allocation approach is summarized in the following steps:

Step 1: Determine the subsequent measurement model for each financial instrument issued. → Step 2: Recognize at fair value financial instruments that must be remeasured at fair value. → Step 3: Allocate the remaining proceeds to any remaining instruments on a residual or relative fair value basis.

The allocations described in Steps 2 and 3 above are further described as follows:

- Instruments recognized at **fair value**
  - For any financial instrument that must be remeasured at fair value, the entity allocates a portion of the proceeds equal to that instrument's fair value (Step 2). Those instruments include assets and liabilities remeasured at fair value under ASC 480 (see Section 2.8.1), derivative instruments accounted for under ASC 815, and instruments for which the entity elected the fair value option under ASC 825. That avoids recognizing an immediate gain or loss that would otherwise be recognized if those financial instruments were initially recorded at an amount other than fair value.
- **Residual** and **relative fair value** allocation
  - The entity allocates the remaining proceeds (after allocating proceeds to financial instruments remeasured at fair value under Step 2) to the remaining instrument(s) that are **not** remeasured at fair value (Step 3).
  - If there is only one remaining instrument, the entity allocates the entire residual proceeds to that instrument (see Example 2-28).
  - If there is more than one remaining instrument, the entity allocates the remaining proceeds among the remaining instruments on a relative fair value basis.
  - If the entity did not issue any financial instruments remeasured at fair value, it skips Step 2 and allocates the entire proceeds to the financial instruments on a relative fair value basis (see Example 2-29).

Although not explicitly addressed in U.S. GAAP, if the financial instruments' fair value in Step 2 exceeds the proceeds received, entities must reassess the valuation techniques used to develop the estimates of fair value to confirm that the fair values determined are appropriate. If after doing so an excess still remains, an entity must determine whether:

- The transaction was at arm's length and whether the parties are related parties.
- There are other elements that should be recognized (for example, other rights or privileges in the transaction that meet the definition of an asset under other U.S. GAAP or, in some cases, deemed dividends).

If the transaction is at arm's length and has no other elements that require recognition, the difference is recognized as a loss in earnings (see Example 2-30).

The SEC staff speech excerpted below addresses those concepts.

SEC STAFF GUIDANCE

[Remarks before the 2014 AICPA Conference on Current SEC and PCAOB Developments]

Hillary H. Salo, Professional Accounting Fellow, Office of the Chief Accountant

> *A question we have received involving the allocation of proceeds when a reporting entity issues a hybrid instrument and the fair value of the financial liabilities required to be measured at fair value exceeds the net proceeds received…*
>
> *You wouldn’t expect a party to an arm’s length transaction to accept proceeds that are less than the fair value of the financial instruments being exchanged. However, the staff understands that there are substantive reasons reporting entities may enter into these types of arrangements, including circumstances in which alignment with a particular investor is viewed as beneficial to the reporting entity or because a reporting entity is in financial distress and requires financing. For example, assume a reporting entity that wants to align itself with a specific investor issues $10 million of convertible debt at par and is required to bifurcate an in the money conversion option with a fair value of $12 million. In this case, the fair value of the financial liability required to be measured at fair value (that is, the embedded derivative) exceeds the net proceeds received under the transaction.*
>
> *US GAAP provides allocation guidance for certain types of transactions. For instance, Topic 815 requires reporting entities to record an embedded derivative at fair value and assign the remainder of the proceeds to the carrying value of the host contract. In addition, Topic 470 requires that proceeds from the sale of a debt instrument with equity-classified detachable warrants be allocated between the two elements based on their relative fair values. However, for those transactions where the hybrid instrument is not issued at fair value, and the financial liabilities required to be measured at fair value exceed the net proceeds received, the staff acknowledges that judgment is required to determine the allocation of proceeds.*
>
> *When reporting entities analyze these types of unique fact patterns, they should first, and most importantly, verify that the fair values of the financial liabilities required to be measured at fair value are appropriate under Topic 820. If appropriate, then the reporting entity should evaluate whether the transaction was conducted on an arm’s length basis, including an assessment as to whether the parties involved are related parties under Topic 850. Lastly, if at arm’s length between unrelated parties, a reporting entity should evaluate all elements of the transaction to determine if there are any other rights or privileges received that meet the definition of an asset under other applicable guidance.*
>
> *If no other rights or privileges that require separate accounting recognition as an asset could be identified, the financial liabilities that are required to be measured at fair value (for example, embedded derivatives) should be recorded at fair value with the excess of the fair value over the net proceeds received recognized as a loss in earnings. Furthermore, given the unique nature of these transactions, we would expect reporting entities to provide clear and robust disclosure of the nature of the transaction, including reasons why the entity entered into the transaction and the benefits received.*
>
> *Additionally, some people may wonder whether the staff would reach a similar conclusion if a transaction was not at arm’s length or was entered into with a related party. We believe those fact patterns require significant judgment; therefore, we would encourage consultation with OCA in those circumstances.*
>
> [Footnotes omitted]

EXAMPLE 2-28: LIABILITY-CLASSIFIED WARRANTS AND DEBT AT AMORTIZED COST

FACTS

Issuer A issues $1,000 of share-settled debt that must be settled in a variable number of shares worth $1,100 and 1,000 detachable warrants to purchase its stock for overall proceeds of $1,000. The share-settled debt is within the scope of ASC 480, has no embedded features that must be bifurcated, and is measured at amortized cost. Also, the warrants are classified as liabilities under ASC 480 and have a fair value of $200. (Transaction costs and taxes have been ignored for simplicity.)

CONCLUSION AND ANALYSIS

- Step 1: Determine the subsequent measurement model for each financial instrument issued.
  - The subsequent measurement model for the debt is amortized cost because it must be settled in a variable number of shares based on a fixed amount (see Section 2.6.5).
  - The subsequent measurement model for the warrants is fair value (see Section 2.8.1).
- Step 2: Recognize at fair value financial instruments that must be remeasured at fair value.
  - Because the warrants are subsequently measured at fair value, they are initially recognized at their fair value of $200.
- Step 3: Allocate the remaining proceeds to any remaining instruments.
  - There is only one remaining instrument, so all the residual proceeds are allocated to that instrument.
  - The residual proceeds of $800 ($1,000 - $200) are allocated to the share-settled debt by recognizing an offsetting discount on the debt as a contra-liability account (subsequently, the debt is accreted to its redemption amount of $1,100 through interest cost using the effective interest method under ASC 835-30-35).

Issuer A records the following journal entry on the issuance date:

Debit	Cash	$	1,000		
Debit	Discount on debt		200		
Credit	Debt			$	1,000
Credit	Warrant liability				200

EXAMPLE 2-29: EQUITY-CLASSIFIED WARRANTS AND DEBT AT AMORTIZED COST

FACTS

Assume the same facts as in Example 2-28, except the warrants are outside the scope of ASC 480, are classified as equity under ASC 815-40, and have a fair value of $200. The debt has a fair value of $900.

CONCLUSION AND ANALYSIS

- Step 1: Determine the subsequent measurement model for each financial instrument issued.
  - The proceeds are $1,000 in cash.
  - The subsequent measurement model for the debt is amortized cost because it must be settled in a variable number of shares based on a fixed amount (see Section 2.6.5).
  - The warrants are classified in equity and are therefore not remeasured at fair value.
- Step 2: Recognize at fair value financial instruments that must be remeasured at fair value.
  - None of the issued financial instruments are remeasured at fair value.
- Step 3: Allocate the remaining proceeds to any remaining instruments.

- The proceeds of $1,000 are allocated to the debt and warrants on a relative fair value basis as follows:

INSTRUMENT	FAIR VALUE	% OF TOTAL	ALLOCATED AMOUNT
Debt	$ 900	81.8%	$ 818
Warrants	200	18.2%	182
Total	$ 1,100	100%	$ 1,000

- Issuer A recognizes an offsetting discount on the debt as a contra-liability account (subsequently, the debt is accreted to its redemption amount of $1,100 through interest cost using the effective interest method under ASC 835-30-35).

Issuer A records the following journal entry on the issuance date:

Debit	Cash	$ 1,000	
Debit	Discount on debt	182	
Credit	Debt		$ 1,000
Credit	APIC (warrants)		182

EXAMPLE 2-30: FAIR VALUE OF LIABILITY-CLASSIFIED WARRANTS EXCEEDS PROCEEDS

FACTS

Assume the same facts as in Example 2-28, except the warrants' fair value at issuance is $1,200.

CONCLUSION AND ANALYSIS

- Step 1: Determine the subsequent measurement model for each financial instrument issued.
  - The proceeds are $1,000 in cash.
  - The subsequent measurement model for the debt is amortized cost because it must be settled in a variable number of shares based on a fixed amount (see Section 2.6.5).
  - The subsequent measurement model for the warrants is fair value (see Section 2.8.1).
- Step 2: Recognize at fair value financial instruments that must be remeasured at fair value.
  - Because the warrants are subsequently measured at fair value, they are initially recognized at their fair value.
- Step 3: Allocate the remaining proceeds to any remaining instruments.
  - The warrants' fair value of $1,200 exceeds the proceeds of $1,000. Issuer A further assesses the transaction to determine whether the excess is attributable to any unstated rights and privileges that meet the definition of an asset under other U.S. GAAP. Issuer A determines the transaction does not include any unstated rights and privileges that could be recognized as an asset and the valuation of the warrants is appropriate (the transaction is also at arm's length and the two parties to the transaction are not related parties). It therefore recognizes the difference as an expense.
  - Issuer A recognizes an offsetting discount on the debt as a contra-liability account (subsequently, the debt is accreted to its redemption amount of $1,100 through interest cost using an appropriate method).

Issuer A records the following journal entry on the issuance date:

Debit	Cash	$	1,000		
Debit	Expense		200		
Debit	Debt discount		1,000		
Credit	Debt			$	1,000
Credit	Warrant liability				1,200

Issuer A must also provide clear and robust disclosure of the nature of the transaction, including why it entered the transaction and the benefits received.

2.8.3 Allocation of Issuance Costs

Entities often incur issuance costs for their financing transactions. Issuance costs are specific incremental costs directly attributable to the financial instrument's issuance (for example, legal and professional fees and other costs related to document preparation). ASC 480 does not specifically address the accounting for issuance costs.

BDO INSIGHTS — ALLOCATION APPROACH FOR ISSUANCE COSTS

We believe issuance costs should be allocated to the instruments issued in the transaction based on a systematic and rational method, which should be applied consistently. We believe either of the following approaches is acceptable:

In proportion to allocated proceeds	• Allocate the issuance costs based on the percentage of proceeds allocated to the instrument to the total proceeds
On relative fair value basis	• Allocate the issuance costs using the relative fair values of the instruments issued, regardless of how the proceeds were allocated

Any issuance costs allocated to financial instruments that are remeasured at fair value should be expensed as incurred. Issuance costs allocated to financial instruments that are not remeasured at fair value reduce the instruments' initial carrying amount.

2.9 ASC 480 APPLICATION TO INSTRUMENTS INDEXED TO NONCONTROLLING INTERESTS

FASB REFERENCES

ASC 480-10-55-53 through 55-62

ASC 480 also includes guidance on specific transactions entered by a parent on shares of its consolidated subsidiary.

EXAMPLE 2-31 (ADAPTED FROM ASC 480-10-55-53 THROUGH 55-62): PARENT'S ACCOUNTING FOR TRANSACTIONS IN THE SHARES OF CONSOLIDATED SUBSIDIARY ISSUED WITH DERIVATIVE INSTRUMENTS INDEXED TO THOSE SHARES

FACTS

A parent entity and an unrelated party (noncontrolling interest holder) own 80% and 20% equity interests, respectively, in a subsidiary the parent consolidates. Contemporaneously with the noncontrolling interest acquisition, the parent and noncontrolling interest holder enter a derivative instrument indexed to the subsidiary's equity shares. The table illustrates the analysis for separate scenarios for different types of derivative instruments issued with that 20% interest.

INSTRUMENTS' TERMS	CONCLUSION AND ANALYSIS
▶ Forward purchase contract • The parent has a fixed-price forward contract to buy the 20% interest at a stated future date in exchange for cash. The forward purchase contract requires physical settlement.	▶ Effectively, the parent has entered an arrangement to finance its purchase of the 20% interest (that is, it finances the purchase of 20% of its subsidiary shares using borrowed funds). ▶ The parent accounts for the forward purchase contract as a liability and initially recognizes it at the present value of the contract amount and correspondingly reduces the noncontrolling interest (see Section 2.5.5.1). The parent subsequently accretes the contract amount and any amounts paid or to be paid to the 20% interest holder as interest cost (see Section 2.5.6.1). ▶ Because the parent accounts for the transaction as a financing of its purchase of the 20% interest, it consolidates 100% of the subsidiary and does not record a noncontrolling interest in its books.
▶ Purchased call and written put options issued as one freestanding financial instrument • The parent has a call option to buy the 20% interest at a fixed price at a stated future date and the holder has a put option to sell the 20% interest to the parent under those same terms (that is, the fixed price of the call option is equal to the fixed price of the put option).	▶ Because the purchased call and written put are issued as a single freestanding financial instrument, the parent accounts for the combined options as one instrument under ASC 480 (see Section 2.7.2) as a liability (or an asset in some cases) and initially and subsequently measures it at fair value. ▶ The parent does not combine the freestanding financial instrument under ASC 480 (that is, the combined options) with another freestanding instrument (that is, the 20% interest) unless required by ASC 815 (see Section 2.3.2). Therefore, the parent accounts for the 20% interest separately in accordance with other U.S. GAAP (that is, the parent consolidates the subsidiary and accounts for the 20% interest owned by the holder as noncontrolling interest under ASC 810).

INSTRUMENTS' TERMS	CONCLUSION AND ANALYSIS
▶ Purchased call and written put options issued as two separate freestanding financial instruments • The parent has a call option to buy the 20% interest at a fixed price at a stated future date. • The holder has a put option to sell the 20% interest to the parent under the same terms as the parent's call option (that is, the fixed price of the call option is equal to the fixed price of the put option).	▶ Because the purchased call and written put are two separate freestanding instruments, the parent assesses each freestanding instrument in its entirety under ASC 480. • The purchased call option does not embody an obligation for the parent to purchase the shares of its consolidated subsidiary from the holder. Therefore, the purchased call option is not under ASC 480 and the parent accounts for it in accordance with other U.S. GAAP (for example, ASC 815-40). • The written put option embodies an obligation for the parent to purchase equity shares of its consolidated subsidiary from the holder, so the parent accounts for it as a liability under ASC 480-10-25-8 (see Section 2.5) and initially and subsequently measures it at fair value. ▶ The parent does not combine the freestanding financial instrument under ASC 480 (that is, the written put option) with another freestanding instrument (that is, the purchased call option or the 20% interest) unless required by ASC 815 (see Section 2.3.2). Therefore, the parent accounts for the 20% interest separately in accordance with other U.S. GAAP (that is, the parent consolidates the subsidiary and accounts for the 20% interest owned by the holder as noncontrolling interest under ASC 810).
▶ Purchased call and written put options are embedded in the 20% interest • The parent has a call option to buy the 20% interest at a fixed price at a stated future date and the holder has a put option to sell the 20% interest to the parent under those same terms (that is, the fixed price of the call option is equal to the fixed price of the put option). • The 20% interest is not otherwise accounted for as a liability under ASC 480 (for example, under ASC 480-10-25-4).	▶ Because the purchased call and written put options are embedded in the 20% interest, the parent accounts for that interest with embedded options as one freestanding financial instrument. ▶ The parent retains the risks and rewards of owning the 20% interest during the instrument's term (even though the 20% interest holder legally owns the subsidiary shares). By issuing that instrument, the parent has effectively entered an arrangement to finance its purchase of the shares of its consolidated subsidiary using borrowed funds. The parent accounts for the transaction as follows: • The parent initially recognizes a financing liability. It does not recognize any gain or loss on the sale of the 20% interest at inception. • The parent recognizes the accretion to the option's exercise price over the period until settlement as interest cost.

INSTRUMENTS' TERMS	CONCLUSION AND ANALYSIS
	• Because the parent accounts for the transaction as a financing of its purchase of the 20% interest, it consolidates 100% of the subsidiary and does not record a noncontrolling interest in its books. That accounting applies even if the exercise prices of the put and call options are not equal as long as those exercise prices are not significantly different.
▶ Total return swap • The parent will pay the counterparty (initially the 20% interest holder) an amount based on a referenced rate plus an agreed spread and, at the termination date, any net depreciation in the fair value of the 20% interest since the swap's inception. • The counterparty will pay the parent an amount equal to dividends paid on the 20% interest plus at the termination date any net appreciation in the fair value of the 20% interest since the swap's inception. • At the termination date, the net change in the fair value of the 20% interest is determined through an appraisal or sale of the stock.	▶ The parent accounts for the total return swap as a liability (or asset in some cases) in accordance with ASC 480 because that instrument is indexed to an obligation to repurchase the 20% interest and may require the parent to settle by transferring assets. The parent initially and subsequently measures the instrument at fair value (see Section 2.5). ▶ The parent separately accounts for the 20% interest in accordance with other U.S. GAAP (that is, the parent consolidates the subsidiary and accounts for the 20% interest owned by the holder as noncontrolling interest under ASC 810).

The guidance in this example is limited to the instruments described herein and when the parent owns a majority of the subsidiary's outstanding common stock and consolidates the subsidiary at inception of the instruments.

2.10 ASC 480 INTERACTION WITH ASC 815

FASB REFERENCES

ASC 815-10-15-74, ASC 815-10-15-83, and ASC 815-10-S99-4

Instruments under ASC 480 that also meet the definition of derivative instruments under ASC 815-10-15-83 (see Chapter 3) are within the scope of both ASC 480 and ASC 815-10 unless a derivative scope exception applies.

Financial instruments within the scope of ASC 815-10 are generally initially and subsequently measured at fair value through earnings (unless the instrument qualifies and is designated as a hedging instrument, in which case some or all of the changes in fair value are recognized in other comprehensive income). Financial instruments under ASC 480 that do not have to be remeasured at fair value typically are not derivative instruments in their entirety under ASC 815-10 because (1) they require a significant initial net investment — so ASC 815-10-15-83(b) is not met (for example, mandatorily redeemable preferred stock and variable share-settled debt based on a fixed amount) — or (2) because they qualify for a derivative scope exception (for example, physically settled forward purchase contracts for a fixed number of shares). Therefore, the instruments within the scope of ASC 480 that may also be derivatives under ASC 815-10 are generally already required to be remeasured at fair value under ASC 480. Often, the practical consequence of a financial instrument being subject to both ASC 480 and ASC 815-10 is that the entity must include the required disclosures under both ASC topics.

However, if a financial instrument under ASC 480 is a hybrid instrument that is not subsequently remeasured at fair value, the entity must evaluate it under ASC 815-15 to determine whether any embedded derivatives require bifurcation. For example, mandatorily redeemable shares and some share-settled obligations based on a fixed amount may include other embedded features the entity must evaluate for potential bifurcation (see Chapter 3).

BDO INSIGHTS — SHARE-SETTLED OBLIGATIONS WITH MULTIPLE SETTLEMENT FEATURES

Often, an instrument that can be settled with a variable number of shares for a fixed monetary amount also includes other settlement features, such as conversion at the holder's option on the maturity date or a redemption for cash at a premium upon a change of control. If the instrument is under ASC 480 because the variable share-settlement feature is the predominant component obligation (see Section 2.6.3.4), we believe such feature is a characteristic of the host contract and **not** an embedded feature that should be evaluated for potential bifurcation (see Section 3.4.1.1). The instrument is predominantly a variable share-settled host contract that includes embedded features (such as a conversion option and change of control redemption feature) that must be assessed for bifurcation if the instrument is not accounted for at fair value (see Chapter 3).

Reaching a conclusion about the nature of the host contract requires the application of professional judgment based on the facts and circumstances.

If the financial instrument is an equity-linked instrument and is outside the scope of ASC 480, the entity must assess it under ASC 815-40 (see Chapter 4).

Chapter 3 — Hybrid Instruments and Embedded Derivatives

3.1 OVERVIEW

ASC 815 requires entities to account for financial instruments that are derivatives in their entirety as derivative assets or liabilities measured at fair value. Financial instruments are accounted for as derivatives in their entirety if they meet the definition of a derivative instrument in accordance with ASC 815-10 (see Appendix A) and do not qualify for any derivative scope exceptions (see Section 3.2.3).

Conversely, financial instruments are not accounted for as derivatives in their entirety under ASC 815 if they do not meet the definition of a derivative instrument or if a derivative scope exception applies. However, they may contain embedded derivatives (terms embedded in a host contract that would be derivative instruments if they were freestanding), in which case they are referred to as "hybrid instruments," consisting of a host contract and an embedded derivative, as shown in the graphic below.

Embedding a derivative instrument in a host contract modifies some or all of the host contract's cash flows or other exchanges based on changes in one or more underlyings. ASC 815-15 requires entities to account for an embedded derivative separately from the host contract if it meets the criteria for bifurcation.

Often, hybrid instruments contain more than one embedded feature, in which case an entity must identify all the embedded features in the hybrid instrument and determine the unit of account for bifurcation analysis of embedded derivatives using a consistent and rational approach (see Section 3.3).

An embedded derivative is bifurcated from the hybrid instrument if **all** the following criteria are met (see Section 3.4):

- The host contract and embedded derivative have economic characteristics and risks that are **not** clearly and closely related (see Section 3.4.1).
- The hybrid instrument is **not** remeasured at fair value through earnings (see Section 3.4.2).
- The embedded derivative would be considered a derivative instrument under ASC 815-10 if it were freestanding (see Section 3.4.3). When evaluating this criterion, an entity considers both the definition of a derivative instrument in ASC 815-10 and the scope exceptions from derivative accounting (see Section 3.2.3).

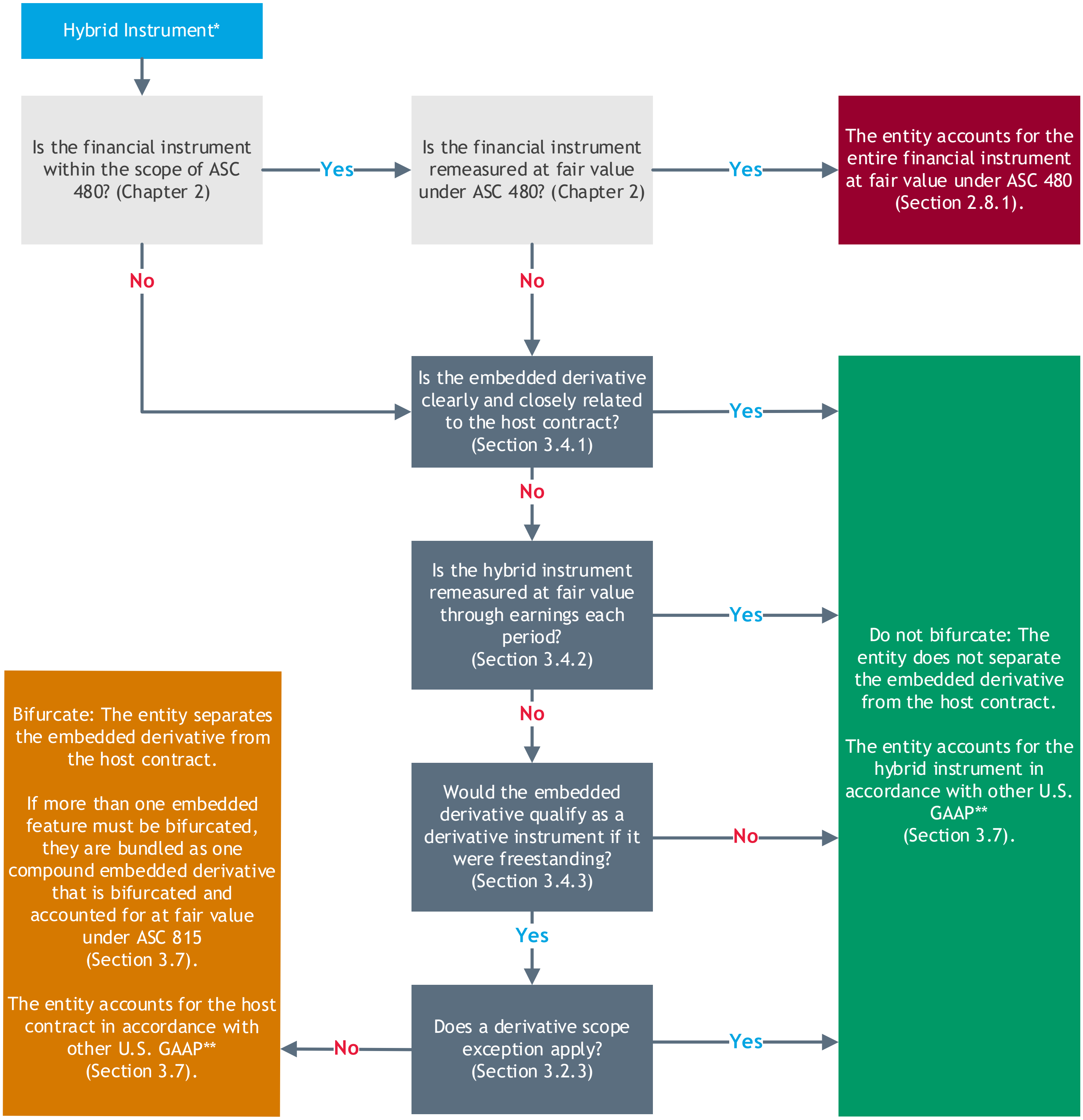
If a hybrid instrument has more than one embedded feature that must be bifurcated, the embedded features are bundled as a single, compound embedded derivative that is then bifurcated and accounted for separately from the host contract (see Section 3.7.1.1).

The bifurcated embedded derivative is recognized as a derivative asset or liability and is initially measured at fair value (see Section 3.7.1.1). The initial carrying amount of the host contract (the instrument that remains after bifurcation) is recognized as the difference between the proceeds allocated to the hybrid instrument and the embedded derivative's initial fair value (see Section 3.7.1.2).

Subsequently, the bifurcated embedded derivative is remeasured at fair value, while the host contract is accounted for under other U.S. GAAP (for example, ASC 470, ASC 480, ASC 480-10-S99-3A, or ASC 505 (see Section 3.7.2)).

If the entity elects the fair value option for an eligible instrument, the embedded derivative is not bifurcated, and the entire hybrid instrument is accounted for at fair value (see Section 3.7.2).

The flowchart illustrates an analysis of a hybrid instrument.



*This flowchart does not apply to instruments that are derivatives in their entirety (see Appendix A).

**If the instrument is a convertible instrument (1) with a nonbifurcated conversion option, (2) is in the scope of ASC 470-20, and (3) is not remeasured at fair value, the entity evaluates whether it includes a substantial premium that must be recognized in APIC (see Section 3.6.1.2).

3.2 SCOPE

Entities apply ASC 815-15 to determine whether to separate an embedded derivative from the host contract. ASC 815-15 applies to all entities (see Section 3.2.1) and only to hybrid instruments (instruments that are not derivatives in their entirety but include embedded derivatives (see Section 3.2.2)).

3.2.1 Entities

FASB REFERENCES

ASC 815-10-15-1, ASC 815-10-15-98, ASC 815-15-15-1, and ASC Master Glossary: Issuer

ASC 815 applies to all entities and includes guidance for both the issuer and investor (or holder) of the financial instrument. However, the issuer and investor may have different accounting for the same financial instrument. For example, even if an instrument meets the definition of a derivative for both parties, an available scope exception might apply only to the issuer (such as for contracts involving an entity's own equity).

This chapter discusses the accounting for financial instruments (generally issued in financing transactions) only from the issuer entity's perspective. An issuer is the entity that issued a financial instrument or may be required under the financial instrument's terms to issue its shares. This chapter uses the terms "issuer" and "entity" interchangeably.

3.2.2 Hybrid Instruments

FASB REFERENCES

ASC 815-15-05-1, ASC 815-15-15-2, and ASC 815-15-20: Hybrid Instrument, Embedded Derivative, and Underlying

ASC 815-15 applies to contracts that are not derivative instruments in their entirety. See Appendix A for more guidance on how to assess whether a financial instrument is a derivative in its entirety.

Nonderivative instruments that contain embedded derivatives are referred to as "hybrid instruments," consisting of a **host contract** and an **embedded derivative**. Embedding a derivative instrument in a host contract alters some or all of the cash flows or other exchanges that otherwise would be required by the host contract, whether unconditional or contingent on a specified event based on one or more underlyings. ASC 815-15 requires entities to account for an embedded derivative separately from the host contract if it meets the criteria for bifurcation (see Section 3.4). That prevents entities from circumventing the recognition and measurement requirements in ASC 815 merely by embedding derivative instruments in nonderivative contracts.

For instance, debt instruments generally are not derivative instruments in their entirety because they typically lack the initial net investment characteristic of a derivative instrument (see Appendix A, Section A.1.2). However, debt instruments often include one or more embedded derivatives that would be accounted for as derivative instruments under ASC 815 if issued separately as freestanding instruments. Therefore, an entity must assess whether those embedded derivatives must be bifurcated from the debt instrument (a nonderivative host contract).

Unlike Chapter 2, which discusses only contracts that involve an entity's shares, this chapter also discusses hybrid financial instruments with an underlying other than those related to an entity's shares.

ASC 815-15 includes the following key definitions:

Hybrid instrument	*A contract that embodies both an embedded derivative and a host contract.*
Embedded derivative	*Implicit or explicit terms that affect some or all of the cash flows or the value of other exchanges required by a contract in a manner similar to a derivative instrument.*
Underlying	*A specified interest rate, security price, commodity price, foreign exchange rate, index of prices or rates, or other variable (including the occurrence or nonoccurrence of a specified event such as a scheduled payment under a contract). An underlying may be a price or rate of an asset or liability but is not the asset or liability itself. An underlying is a variable that, along with either a notional amount or a payment provision, determines the settlement of a derivative instrument.*

BDO INSIGHTS — HYBRID AND EQUITY-LINKED INSTRUMENTS

Freestanding financial instruments that do not meet the definition of a derivative instrument in their entirety or that qualify for a derivative scope exception are not accounted for as derivative instruments under ASC 815. If those instruments include embedded derivatives, they are subject to the hybrid instrument model discussed in this chapter.

In practice, financial instruments in the form of debt or shares issued in financing transactions typically do not meet the definition of a derivative instrument in their entirety because they lack the initial net investment characteristic (see Appendix A, Section A.1.2). Those financial instruments are often hybrid instruments with embedded derivatives that an entity must assess for bifurcation.

Similarly, some equity-linked contracts (see Chapter 4) also lack the initial net investment characteristic and are therefore not derivatives in their entirety. For example, a prepaid forward contract to repurchase an entity's outstanding shares is a hybrid financial instrument that contains a loan to the counterparty represented by the prepaid amount and an embedded forward contract on the entity's shares. An entity must assess the embedded forward for bifurcation and, based on the facts and circumstances, may need to account for the prepayment on the entity's shares (a receivable by the entity) in equity in accordance with ASC 505-10-45-2.

Accounting for equity-linked contracts as hybrid instruments requires the application of professional judgment based on the facts and circumstances.

3.2.3 Scope Exceptions to ASC 815-10 and ASC 815-15

FASB REFERENCES

ASC 815-10-15-59 through 15-60, ASC 815-10-15-69, ASC 815-10-15-74, and ASC 815-10-15-82

ASC 815-10 includes numerous exceptions to derivative accounting (as shown in the flowchart in ASC 815-10-55-2); however, only a few of those exceptions typically apply to an issuer of a financial instrument. An entity must consider the scope exceptions that may apply in evaluating whether a freestanding financial instrument must be accounted for as a derivative instrument in its entirety (see Appendix A) and whether an embedded derivative requires bifurcation (see Section 3.4.3). The table summarizes some of the common exceptions to derivative accounting for issuers of financial instruments.

TYPE OF CONTRACT	DESCRIPTION
Contracts involving an entity's own equity	Contracts that are: ▶ Indexed to the reporting entity's own stock and classified in stockholders' equity (see Section 3.2.3.1) ▶ In the scope of ASC 718 ▶ Between an acquirer and a seller to enter a business combination (including contracts to enter an acquisition by a not-for-profit (NFP) entity and contracts between one or more NFPs to enter a merger of NFP entities) ▶ Physically settled forward contracts in the scope of ASC 480
Loan commitments	▶ For holders of loan commitments (that is, the potential borrower) to originate a loan (see Section 3.2.3.2)
Contracts not traded on an exchange	If the underlying on which the settlement is based is **any** of the following: ▶ A climatic or geological variable or other physical variable (for example, number of inches of rainfall or snow, severity of an earthquake) ▶ The price or value of a nonfinancial asset that is: • Unique • Owned by the party to the contract that would not benefit from an increase in the asset's fair value under the contract • Not readily convertible to cash ▶ The fair value of a nonfinancial liability that does not require delivery of an asset that is readily convertible to cash ▶ Specified volumes of sales or service revenues of one party to the contract If a contract has multiple underlyings and some, but not all, of them qualify for a scope exception, an entity must determine the contract's predominant characteristics.
Registration payment arrangements	Registration payment arrangements in the scope of ASC 825-20 (see Section 3.2.3.3)

Section 3.2.3.4 also discusses a scope exception from ASC 815-15 that may apply to some foreign currency transactions.

3.2.3.1 Indexed to an Entity's Own Stock and Classified in Stockholders' Equity

FASB REFERENCES

ASC 815-10-15-74(a), ASC 815-10-15-75(b), and ASC 815-10-15-75A through 15-76

Contracts (freestanding financial instruments or embedded features) involving an entity's own equity meet the derivative scope exception in ASC 815-10-15-74(a) if they are **both**:

- Indexed to the entity's own stock in accordance with ASC 815-40-15 (see Section 4.5)
- Classified in the entity's stockholders' equity in accordance with ASC 815-40-25 (see Section 4.6).

If both criteria are met, the financial instrument is classified as equity (if freestanding) or is not separated from the host contract (if embedded).

When evaluating whether a financial instrument is indexed to an entity's own stock, an entity excludes a down round feature in its consideration (see Section 4.5.2.3). Further, temporary equity is considered stockholders' equity even if it must be displayed outside the permanent equity section.

See Chapter 4 for more guidance on the indexation and equity classification assessments in accordance with ASC 815-40.

APPLICATION OF ASC 815-10-15-74(a) EXCEPTION TO DUAL-INDEXED INSTRUMENTS

The scope exception in ASC 815-10-15-74(a) does not apply to contracts that are indexed in part or in full to something other than an entity's own stock even though the entity can settle the contract by issuing its own equity. For example, a forward contract that is indexed to both an entity's own stock and currency exchange rates does not qualify for that exception because it is indexed in part to something other than the entity's own stock (the currency exchange rates). Therefore, an entity must account for that contract as a derivative asset or liability in accordance with ASC 815.

3.2.3.2 Loan Commitments

FASB REFERENCES

ASC 815-10-15-69 and ASC 815-10-S99-4

An entity may enter a debt arrangement giving it access to funds by issuing debt on future date(s) (for example, a line of credit, a delayed draw facility, or a tranche debt issuance).

A revolving or nonrevolving loan commitment that allows a potential borrower to originate a loan is excluded from the scope of derivative accounting in accordance with ASC 815-10. That exception applies even if the borrower's right to borrow debt is conditional (for example, upon achieving specified milestones). If the exception applies, the borrower accounts for the loan when it is issued.

EXAMPLE 3-1: TRANCHE DEBT ISSUANCE

FACTS

Issuer A (the reporting entity) enters a loan agreement with Lender X with the following terms:

- Tranche I term loan: Issuer A borrows $10 million (it issues debt) on the agreement date with a two-year maturity date.
- Tranche II term loan commitment: Issuer A can borrow an additional $5 million from Lender X at any time in the 12 months after the Tranche I term loan is issued. The Tranche II term loan matures two years after issuance.

Issuer A determines that the Tranche I term loan and the Tranche II term commitment are two freestanding financial instruments because they are legally detachable and separately exercisable (see Section 3.3).

CONCLUSION

The Tranche II term loan commitment is outside the scope of derivative accounting in accordance with ASC 815-10-15-69. Therefore, Issuer A accounts for the Tranche II term loan when issued.

ANALYSIS

Issuer A determines the unit of account on the date it enters the loan agreement.

- Issuer A accounts for the Tranche I term loan as debt and evaluates whether it must account for any embedded derivatives separately from the loan (see Section 3.4).
- Issuer A determines that the Tranche II term loan commitment is outside the scope of derivative accounting in accordance with ASC 815-10-15-69. It accounts for the Tranche II term loan and evaluates whether it must bifurcate any embedded derivatives (see Section 3.4) when it issues that loan.

BDO INSIGHTS — WRITTEN OPTION TO ISSUE ADDITIONAL DEBT

The derivative scope exception for loan commitments does not apply if the lender can require the entity (borrower) to issue debt, such as in written options (that is, the entity has an obligation, not a right, to issue debt). Further, the entity must evaluate whether a freestanding written option must be accounted for in accordance with other U.S. GAAP (for example, under ASC 480 if the entity has an obligation to issue debt that is convertible into redeemable shares).

However, irrespective of whether a freestanding written option to issue debt is a derivative, we believe the entity should account for the option at fair value with changes in fair value recognized in earnings. That is consistent with the SEC staff's longstanding position (as stated in ASC 815-10-S99-4) that written options that do not qualify for equity classification must be initially and subsequently measured at fair value.

3.2.3.3 Registration Payment Arrangements

FASB REFERENCES

ASC 815-10-15-82, ASC 825-20-20 Registration Payment Arrangement, and ASC 825-20-25-1 through 25-3

Convertible debt, convertible preferred stock, and warrants are often accompanied by a registration payment arrangement that entitles the instrument holder to require the entity to either (or both):

- File a registration statement for the resale of the instrument's underlying shares and endeavor to have the registration statement declared effective by the SEC within a specified grace period
- Keep the registration statement effective for a specified period of time (or in perpetuity).

Further, the registration payment arrangement requires the entity to pay consideration to the holder if the entity fails to have the registration statement declared effective or to maintain its effectiveness. The consideration may be a lump sum or periodic payments, and its form may vary (for example, cash; equity instruments; or adjustments to the instrument's terms, such as an increased interest rate on a debt instrument).

For example, a typical registration rights agreement in a private placement requires an entity to use its best efforts to register the shares underlying the conversion option or warrant by a specified date or else pay a penalty (sometimes referred to as "liquidated damages"). In that instance, the agreement might specify that "the company will use its best efforts to cause the shares to be included in an effective registration statement, but in no event later than 180 days from the closing."

That registration payment arrangement is outside the scope of ASC 815-10. Instead, an entity accounts for it under ASC 825-20 as a separate unit of account from the financial instruments subject to that arrangement. That is, the entity accounts for the liquidated damages in accordance with ASC 825-20 and measures it in accordance with ASC 450, *Contingencies* (see Section 6.4.1). The entity accounts for the financial instruments subject to the registration payment arrangement in accordance with other U.S. GAAP (for example, ASC 815-10, ASC 815-40, or ASC 835-30) exclusive of the contingent obligation to transfer consideration under the registration payment arrangement.

3.2.3.4 Foreign Currency Derivatives

FASB REFERENCES

ASC 815-15-15-5 and ASC 815-15-55-112 through 55-113

In addition to derivative scope exceptions in ASC 815-10, ASC 815-15 includes some exceptions, including one that applies to hybrid financial instruments: embedded foreign currency derivatives are excluded from the scope of ASC 815-15 if the financial instrument meets **all** the following criteria:

- Is a monetary item
- Has its principal payments, interest payments, or both denominated in a foreign currency
- Is subject to the requirement in ASC 830-20 to recognize any foreign currency transaction gain or loss in earnings.

For example, a mandatorily redeemable preferred stock that is classified as a liability under ASC 480 and **requires** the entity to pay the redemption price, dividends, or both in a stipulated amount of a specified foreign currency meets the embedded foreign currency scope exception, and no foreign currency derivative is bifurcated (because the instrument does not include a foreign currency option). The entity instead applies ASC 830 to the foreign currency denominated instrument.

In contrast, a mandatorily redeemable preferred stock for which the redemption price, dividends, or both **may be** settled (at either the holder or the entity's option) in a stipulated amount in either U.S. dollars or a specified currency contains an embedded foreign currency option that must be evaluated for bifurcation in accordance with ASC 815-15.

3.3 DETERMINING THE UNIT OF ACCOUNT

As discussed in Section 2.3, in evaluating financial instruments, an entity must first determine the unit of account to which it must apply the accounting guidance. Generally, before evaluating an embedded derivative for bifurcation, an entity must assess whether the hybrid instrument is under ASC 480. That assessment requires the entity to identify each freestanding financial instrument issued as part of the same transaction. Each freestanding financial instrument is evaluated separately unless required to be combined with other freestanding financial instruments under ASC 815 (see Section 2.3.2).

The entity evaluates each freestanding hybrid instrument that is not remeasured at fair value (regardless of whether the instrument is accounted for under ASC 480) to determine whether it has an embedded derivative that must be bifurcated. That requires identifying the hybrid instrument's embedded features and determining the unit of analysis for those features.

3.3.1 Identifying the Hybrid Instrument's Embedded Features

FASB REFERENCES

ASC 815-10-15-5 through 15-7 and ASC 815-15-25-2

An entity must evaluate whether the features in a hybrid instrument are freestanding or embedded by determining whether they are legally detachable and separately exercisable.

- While U.S. GAAP does not define the term "legally detachable," an instrument that can be separated and transferred to another party generally is considered legally detachable (see Section 2.3.1.2.1).
- Typically, a feature is considered separately exercisable if it can be exercised without terminating another item. If exercising the feature results in terminating the instrument, such as through redemption or conversion, the feature is embedded and not freestanding. Conversely, if the feature can be exercised while the instrument remains outstanding and is legally detachable, it is freestanding (see Section 2.3.1.2.2).

An embedded derivative refers only to terms within a single instrument, not to terms in separate instruments between different counterparties. Further, a feature that can be sold or traded separately from the contract in which those rights and obligations are included is an attached freestanding derivative instrument, rather than an embedded derivative, by both the writer and holder of the option. For example, an option feature in a debt instrument that is explicitly transferable independently of the debt instrument is potentially exercisable by a counterparty other than the issuer or the debt holder and therefore is freestanding, rather than embedded.

3.3.2 Determining the Unit of Analysis for Embedded Features

FASB REFERENCES

ASC 815-10-25-9A and ASC 815-10-25-10 through 25-13

Often, hybrid instruments contain more than one embedded feature. For example, a preferred stock may contain a conversion option and a redemption option. Further, the conversion or redemption option may include more than one exercise trigger (for example, one based on the passage of time and one based on a change in control). An entity must identify all embedded features in an instrument and determine the appropriate unit of analysis using a consistent and rational approach.

BDO INSIGHTS — AGGREGATING AND DISAGGREGATING EMBEDDED FEATURES FOR ANALYSIS

Except for combining specific put and call options (as discussed in ASC 815-10-25-10 through 25-13), ASC 815-15 does not include guidance on how to aggregate or disaggregate embedded features when performing the bifurcation analysis. Therefore, an entity must use a rational approach and apply it consistently. For example, in practice, entities often aggregate or disaggregate embedded features for analysis by considering their similar and different characteristics, such as:

- Nature of the feature; for example, evaluating conversion features separately from redemption features
- Party holding the option; for example, evaluating options held by the entity separately from options held by the counterparty
- Nature, amount, and form of settlement
  - For example, an automatic settlement when a qualified financing occurs for the higher value of a fixed number of shares (a conversion feature) or a variable number of shares based on a fixed amount (a redemption feature) may be two separate units of analysis: the conversion feature and the redemption feature (see Section 3.6.3). That depends on the facts and circumstances, including the substance of the arrangement.
  - Conversely, two or more conversion features with multiple triggers but the same settlement amount may be aggregated into one unit.
- Settlement contingencies; for example, evaluating contingent options separate from noncontingent options.

We believe an entity generally should not disaggregate a component of a settlement amount as a separate feature for analysis. For example, if a conversion feature requires a make-whole payment if it is triggered, the make-whole payment is part of the conversion feature, not a separate unit.

Determining the unit of analysis for evaluating embedded features requires the application of professional judgment based on the facts and circumstances.

COMBINATIONS OF TWO EMBEDDED OPTIONS

ASC 815-10 addresses how an entity should view a combination of options when applying ASC 815.

Specifically, it provides guidance on an embedded purchased call (put) option and an embedded written put (call) option combined in a single hybrid instrument having **all** the following characteristics:

- The options are entered contemporaneously with the same counterparty
- The options are nontransferable
- The options have the same strike price and notional amount
- The options have the same exercise date (before the contract's maturity date)
- The options have the same underlying.

The table illustrates how an entity evaluates that combination of options different scenarios.

SCENARIO	ANALYSIS
Neither party is required to exercise its option	The embedded options are in substance an embedded forward contract. Even though neither party is required to exercise its option, the hybrid instrument will likely be redeemed at a point earlier than the stated maturity. That is expected regardless of the contract's form (two separate options versus a single forward). The hybrid instrument therefore conveys rights and obligations equivalent to an embedded forward contract from an economic and risk perspective, which the entity assesses under ASC 815-15.
Either party is required to exercise its option	The instrument is not viewed as containing embedded derivatives. In substance, the issuer and investor have agreed to accelerate the instrument's stated maturity date (that is, the exercise date is the instrument's actual maturity date, which is a characteristic of the instrument, so there is no embedded derivative to assess).

In contrast, a combination of a purchased call (put) option and a written put (call) option should be considered separate option contracts if at least one of the options is freestanding. That is so even if the options have the same terms and underlying and are entered with the same counterparty at inception.

Also, a share of stock that is puttable by the holder and callable by the issuer under the same terms is not considered mandatorily redeemable under ASC 480 because the options may expire unexercised (see Section 2.4.2).

See also Section 2.9 for a discussion of a parent's accounting for a similar transaction on the shares of a subsidiary, which the parent accounts for as a financing of its purchase of NCI.

3.4 CRITERIA FOR BIFURCATING EMBEDDED DERIVATIVES

FASB REFERENCES

ASC 815-10-25-1, ASC 815-10-30-1, ASC 815-10-35-1, and ASC 815-15-25-1

An entity must evaluate a hybrid instrument to determine whether it has an embedded derivative that must be bifurcated and accounted for separately as a derivative asset or liability.

The entity determines the unit of analysis for the embedded features (see Section 3.3.2) and evaluates them against the following three criteria for bifurcation:

Not clearly and closely related	Not remeasured at fair value	Qualify as a derivative instrument if freestanding
The host contract and embedded derivative have economic characteristics and risks that are not clearly and closely related (see Section 3.4.1).	The hybrid instrument is not remeasured at fair value through earnings each period (see Section 3.4.2).	The embedded derivative would be a derivative instrument under ASC 815-10 if it were freestanding (see Section 3.4.3) and no derivative scope exception applies (see Section 3.2.3).

If the embedded derivative meets **all** three criteria for bifurcation and no derivative scope exception applies, the entity bifurcates the embedded derivative from the hybrid instrument and accounts for it separately as a derivative asset or liability. The bifurcated embedded derivative is recognized at fair value and remeasured at fair value through earnings.

If the embedded derivative fails **any** criteria for bifurcation or meets all three criteria but a derivative scope exception applies, it is not separated from the host contract. The entity accounts for the entire hybrid instrument under other applicable U.S. GAAP (for example, ASC 470, ASC 480, ASC 480-10-S99-3A, or ASC 505).

3.4.1 Not Clearly and Closely Related

FASB REFERENCES

ASC 815-15-25-1(a) and ASC 815-15-25-16 through 25-17

The first criterion for bifurcating an embedded derivative is that it has economic characteristics and risks that are **not** clearly and closely related to the economic characteristics and risks of the host contract. In other words, an embedded derivative that **is** clearly and closely related to the host contract is not bifurcated.

For instance, a host contract that encompasses a residual interest in an entity is considered to have economic characteristics and risks of an equity instrument. For an embedded derivative to be considered clearly and closely related to that equity host contract, it must possess principally equity characteristics related to the entity. In contrast, an embedded derivative that has characteristics and risks related to changes in fair value of an equity interest is not clearly and closely related to a debt host contract that has economic characteristics and risks that are principally related to interest rates and credit risk.

In evaluating the first criterion for bifurcation, an entity performs two steps:

1. Identify the nature of the host (see Section 3.4.1.1).
2. Determine whether the host and embedded derivative are clearly and closely related (see Section 3.4.1.2).

First, an entity determines the nature of the host contract: equity or debt. While legal form debt is always considered a debt host, the same is not always true for an instrument in the form of a share. Evaluating an equity instrument as equity-like or debt-like for this purpose involves considering the instrument's relevant features and other factors in the arrangement. The analysis often requires judgment and may be challenging. An entity must not automatically conclude that the nature of a share is equity-like based solely on its legal form but instead must consider all the facts and circumstances (see Section 3.4.1.1).

In thinking about the nature of an instrument issued as a share, it is helpful to remember the characteristics or features typically associated with equity and debt instruments.

Equity	Debt
Exposes holder to residual economic risk and is typically subordinated to debt instruments in liquidation	Exposes holder to credit risk and is typically senior to equity instruments in liquidation
Returns vary with entity's performance (including the fair value of the entity's shares)	Returns are fixed or vary based on interest rate
Votes in matters that affect the entity's operations or strategy	Has limited or no voting rights
Exit includes conversion to residual equity	Exit includes redemption

Second, an entity identifies the nature of the embedded derivative; specifically, its underlying and how it affects the instrument's settlement. For example:

- A conversion option for a fixed number of shares has a share price underlying that causes the settlement to vary based on the movement in the entity's share price. Therefore, the conversion option has equity characteristics.
- An interest rate reset feature has an interest rate underlying that causes the instrument's cash flows to vary based on the movement in interest rates. Therefore, the interest rate reset feature has debt characteristics.

After identifying the nature of the host contract and embedded derivative, the entity determines whether they are clearly and closely related. Embedded derivatives with equity-like economic characteristics and risks are clearly and closely related to an equity-like host (the equity host contract) and, conversely, are not clearly and closely related to a debt-like host (the debt host contract). Embedded derivatives with debt-like economic characteristics and risks are generally clearly and closely related to a debt host contract and, conversely, are not clearly and closely related to an equity host contract.

PUTS AND CALLS AND INTEREST FEATURES ARE NOT ALWAYS CLEARLY AND CLOSELY RELATED TO A DEBT HOST CONTRACT

As explained above, a conversion feature typically is considered clearly and closely related to an equity host contract. However, the same is not always true for a call or put (redemption feature) or an interest-rate-related feature in a debt host contract. ASC 815-15 requires additional analysis to determine whether those embedded features and the debt host contract are clearly and closely related. For example, an embedded interest-rate-related feature with a leverage factor (see Section 3.6.2) or a redemption feature with a substantial premium or discount (see Section 3.6.3) might not be clearly and closely related to a debt host contract.

If an embedded derivative is **not** clearly and closely related to the host contract, to determine whether to bifurcate the embedded derivative from the hybrid instrument, an entity evaluates whether:

- The hybrid instrument is not remeasured at fair value (see Section 3.4.2)
- The embedded derivative would meet the definition of a derivative instrument if it were freestanding and, if so, whether no derivative scope exception applies (see Section 3.4.3).

3.4.1.1 Identify the Nature of the Host Contract

FASB REFERENCES

ASC 815-15-25-17A and ASC 815-15-25-17C through 25-17D

As discussed in Section 3.4.1, the first step in evaluating an embedded derivative for bifurcation is to determine the nature of the host contract. In some cases, the analysis is clear; for example, a convertible preferred stock instrument with no debt-like features, such as redemption and fixed cumulative dividend rights. In other cases, the nature of the host contract might not be readily apparent, such as for a preferred stock instrument with conversion and redemption rights, so more analysis is needed. An entity considers not only the relevant terms and features of the hybrid instrument but also the substance (relative strength) of those terms, which requires judgment.

FORMS OF HYBRID INSTRUMENTS

A hybrid instrument that is a **legal form debt** contains a debt host contract. In other words, an entity does not evaluate whether the debt instrument could contain an equity host contract.

A hybrid instrument **other than a legal form equity** (for example, prepaid forward contracts) typically has a debt host contract because it often lacks any existing or potential residual interests (that is, the rights and risks of ownership present in an equity instrument).

If a hybrid instrument is in **legal form equity** (such as an outstanding share), more analysis is needed to determine whether it has an equity host or debt host contract. The nature of the host (equity or debt) affects whether an entity must bifurcate an embedded derivative in the hybrid instrument. However, it does not affect how an entity accounts for the outstanding share (whether equity or liability). For example, even if an entity determines that a redeemable preferred stock is a debt host contract, it does not mean the entity must account for the redeemable preferred stock as a liability unless it is a liability under other U.S. GAAP (for example, mandatorily redeemable in the scope of ASC 480 (see Chapter 2)).

In some cases, an entity must apply judgment in determining an instrument's legal form based on the parties' contractual, legal, and economic rights and obligations. The name of the contract does not determine the contract's legal form.

If the hybrid instrument is in the form of an **outstanding share**, an entity must determine the nature of the host contract using the following steps:

Step 1: Identify all the stated and implied substantive terms and features of the share.

Step 2: Determine whether those terms and features are debt-like or equity-like.

Step 3: Weigh those terms and features based on the relevant facts and circumstances.

In determining the nature of a share, an entity considers the economic characteristics and risks of the **entire** hybrid instrument, including the embedded derivative it is evaluating for bifurcation, which is often referred to as the "whole instrument approach." Including or omitting any single term or feature does not necessarily determine the nature of the host contract. Rather, an entity uses judgment when weighing the individual term or feature based on the facts and circumstances. For example, an entity does not presume that a fixed price, noncontingent redemption option held by the holder in and of itself determines whether the nature of the host contract is more akin to debt than equity. Rather, the entity evaluates the hybrid instrument in its entirety.

When performing the whole instrument approach, an entity considers not only whether the relevant terms and features are debt-like or equity-like but also the substance of those terms and features (that is, the relative strength of each feature, given the facts and circumstances). An entity may consider the following when performing Step 3:

CONSIDERATIONS	ATTRIBUTES
The characteristics of the relevant terms and features	▶ Is the exercise of the feature contingent or noncontingent? ▶ Is the feature in-the-money or out-of-the-money?
The circumstances under which the hybrid financial instrument was issued	▶ Is the issuer thinly capitalized or profitable and well-capitalized? ▶ Is the feature based on a contingent event (for example, a financing or a change in control) that the entity is contemplating or is in the process of completing at inception?
The potential outcomes of the instrument	What is the most likely settlement for the instrument? ▶ Settled by issuing a fixed number of shares (that is, conversion)? ▶ Settled by transferring cash or a variable number of shares (that is, redemption)? ▶ Remain legal-form equity? This assessment may be qualitative in nature.

Further, ASC 815-15-25-17D provides examples of common hybrid instrument terms and features that an entity evaluates when determining the nature of the host contract. The table lists example factors and how they might affect the weighting of the share's specific terms and features. The examples are illustrative only, not determinative, and reaching a conclusion depends on the facts and circumstances.

STEP 1: IDENTIFY THE FEATURES	STEP 2: DETERMINE WHETHER THE FEATURE IS DEBT-LIKE OR EQUITY-LIKE	STEP 3: WEIGH THE TERMS AND FEATURES	
		FACTORS FOR HEAVIER WEIGHTING	FACTORS FOR LESS WEIGHTING
Redemption rights	The issuer or investor's ability to redeem a hybrid instrument in the form of a share at a fixed or determinable price is generally viewed as a **debt-like** characteristic. But not all redemption rights have the same importance (weight).	Mandatory	Optional (however, not all options are equal, as noted below)
		Optional	
		Noncontingent (for example, based on passage of time) or contingent (and contingent event is likely to occur)	Contingent (and contingent event is not likely to occur)
		In-the-money (deeply in-the-money options are weighted more heavily than slightly in-the-money options)	Out-of-the-money (deeply out-of-the-money options are weighted less heavily than slightly out-of-the-money options)
		Who holds the option (for example, an in-the-money option held by the investor is more likely to be exercised and therefore given more weight. If the option is held by the issuer, its wherewithal could affect the analysis of whether it will likely exercise an in-the-money option).	Who holds the option (for example, an out-of-the-money option held by the investor is less likely to be exercised and therefore given less weight. If the option is held by the issuer, economic compulsion could affect the analysis of whether it will likely exercise an out-of-the-money option; for example, if the instrument is an increasing-rate preferred stock).
		Redemption price is more favorable than the conversion price of any conversion right	Redemption price is less favorable than the conversion price of any conversion right
		Redemption is senior to other classes of stock and is substantive	Redemption is subordinated to other classes of stock and may not be substantive
		No laws restrict redemption	Laws restrict exercise of the redemption right (for example,

STEP 1: IDENTIFY THE FEATURES	STEP 2: DETERMINE WHETHER THE FEATURE IS DEBT-LIKE OR EQUITY-LIKE	STEP 3: WEIGH THE TERMS AND FEATURES	
		FACTORS FOR HEAVIER WEIGHTING	FACTORS FOR LESS WEIGHTING
			if redemption would make the issuer insolvent)
		Circumstances of the Issuer	
		Issuer is well-capitalized and profitable	The share is effectively the residual interest in the issuer (because the issuer is thinly capitalized or the issuer's common equity has already incurred losses)
Conversion rights	The investor's ability to convert (for example, a preferred share into a fixed number of common shares) is generally viewed as an **equity-like** characteristic. But not all conversion rights have the same importance (weight). Also, some conversion features are in substance redemption features, in which case they are analyzed as redemption features.	Mandatory	Optional (however, not all options are equal, see below)
		Optional	
		Noncontingent (for example, based on passage of time) or contingent (and contingent event is likely to occur)	Contingent (and contingent event is not likely to occur)
		In-the-money (deeply in-the-money options are weighted more heavily than slightly in-the-money options)	Out-of-the-money (deeply out-of-the-money options are weighted less heavily than slightly out-of-the-money options)
		Who holds the option (for example, an in-the-money option held by the investor is more likely to be exercised and therefore given more weight)	Who holds the option (for example, an out-of-the-money option held by the investor is less likely to be exercised and therefore given less weight)
		Conversion price is more favorable than the redemption price of any redemption right	Conversion price is less favorable than the redemption price of any redemption right
		Conversion is more likely to occur before redemption if there is a redemption right	Redemption is more likely to occur before conversion

STEP 1: IDENTIFY THE FEATURES	STEP 2: DETERMINE WHETHER THE FEATURE IS DEBT-LIKE OR EQUITY-LIKE	STEP 3: WEIGH THE TERMS AND FEATURES	
		FACTORS FOR HEAVIER WEIGHTING	FACTORS FOR LESS WEIGHTING
Voting rights	A shareholder's ability to exercise voting rights is generally viewed as an **equity-like** characteristic. But not all voting rights are of equal importance.	Vote on all significant matters	Vote on limited matters that are protective in nature
		Vote with common stock as a single class	Vote on matters based on its specific class of stock
		Investor class of stock with significant influence on vote	Investor class of stock with limited influence on vote
Dividend rights	Fixed (stated) dividends are generally viewed as a **debt-like** characteristic	Mandatory and cumulative dividends, whether declared or earned	Noncumulative stated dividends paid only if declared by the issuer
	Discretionary and participating dividends based on earnings are generally viewed as an **equity-like** characteristic	Issuer regularly pays dividends, or it is likely that the issuer will declare and pay dividends while the instrument is outstanding	Issuer historically has not paid dividends, or it is not likely that the issuer will declare and pay dividends while the instrument is outstanding
Protective covenants	Protective covenants are generally viewed as a **debt-like** characteristic. But not all protective rights are of equal importance.	Includes collateral requirements	Does not include collateral requirements
		Parent or other party guarantees issuer's performance (for example, investor redemption)	No party guarantees issuer's performance
		Includes rights akin to creditor rights (for example, right to force bankruptcy or a preference in liquidation)	Does not include rights akin to creditor rights

In practice, some entities analyze the nature of the host contract by assigning low, neutral, or high weighting to each relevant term and feature. The weighting is not based on looking at the term in isolation but rather on looking at it in relation to the other features and to the instrument as a whole. All equity-like features are then weighed against all debt-like features to determine which features have more substance in determining whether the host is more akin to equity or debt.

3.4.1.2 Determine if the Host Contract and Embedded Derivative Are Clearly and Closely Related

FASB REFERENCES

ASC 815-15-25-24 through 25-25 and ASC 815-15-55-117 through 55-118

Once an entity determines the nature of the host contract, it compares each embedded derivative (feature) to determine whether it has the same risks and economics as the host contract. For some features, that analysis is straightforward, but for others, it may be more complex and involve considering specific guidance in ASC 815-15.

In determining the characteristics of a debt host contract, an entity generally must consider the hybrid instrument's stated or implied substantive terms. In the absence of stated or implied terms, an entity considers the features of the hybrid instrument, the circumstances of the issuer, the market in which the instrument is issued, and other relevant factors.

EXAMPLE 3-2 (ADAPTED FROM ASC 815-15-55-117 THROUGH 55-118): DEBT INSTRUMENT WITH EMBEDDED EQUITY-BASED DERIVATIVE

FACTS

- Entity A issues a five-year debt instrument with a principal amount of $1 million.
- At maturity, Entity A must repay the principal amount plus any appreciation or minus any depreciation (since the debt's issuance date) in the fair value of 10,000 shares of Entity B (a publicly traded entity unrelated to Entity A and the debtholder).
- No interest is due.
- At issuance, Entity B's stock trades at $100 per share.

CONCLUSION

The debt instrument includes a debt host contract and an embedded equity-based derivative, so the debt host contract and embedded derivative are not clearly and closely related.

ANALYSIS

The debt instrument is not itself a derivative instrument because it requires an initial net investment equal to the notional amount (see Appendix A, Section A.1.2). Therefore, Entity A evaluates the embedded derivative for potential bifurcation.

First, Entity A determines the nature of the host contract. The hybrid instrument is in the form of a debt instrument, so it has a debt host contract (it has a stated maturity and has no shareholder rights; for example, voting or distribution rights).

Second, Entity A determines the nature of the embedded derivative, which is equity-like because its underlying is the fair value of Entity B's stock. Because the host instrument is a debt instrument, the embedded equity-based derivative is not clearly and closely related to the debt host contract.

Entity A must evaluate the embedded derivative for the other bifurcation criteria to determine whether it must be bifurcated (see Sections 3.4.2 and 3.4.3).

The table summarizes common embedded derivatives in equity and debt instruments and whether they are generally clearly and closely related to an equity or debt host contract.

TYPE OF EMBEDDED DERIVATIVE	NATURE OF HOST CONTRACT	GENERALLY CLEARLY AND CLOSELY RELATED TO HOST CONTRACT?	GUIDANCE
Conversion features	Equity	Clearly and closely related	Section 3.5.1
	Debt	Not clearly and closely related	Section 3.6.1
Redemption features (calls and puts)	Equity	Not clearly and closely related	Section 3.5.2
	Debt	Evaluate under the four-step test in accordance with ASC 815-15-25-42	Section 3.6.3
Rights or obligations to issue fixed number of shares of own equity	Equity	Clearly and closely related	Section 3.5.3
	Debt	Not clearly and closely related	Section 3.6.1
Interest-rate-related features	Debt	Evaluate in accordance with ASC 815-15-25-26	Section 3.6.2
Term-extending options	Debt	Evaluate in accordance with ASC 815-15-25-44 through 25-45	Section 3.6.4
Embedded loan commitments	Debt	Evaluate in accordance with ASC 815-10-15-69. If scope exception is not met, typically clearly and closely related; however, analysis must be performed.	Section 3.6.5
Credit-sensitive payments	Debt	Evaluate in accordance with ASC 815-15-25-46 through 25-47	Section 3.6.6
Equity-indexed payments	Debt	Not clearly and closely related	Section 3.6.7
Exchange features	Debt	Not clearly and closely related	Section 3.6.8
Inflation-indexed interest payments	Debt	Clearly and closely related unless there is leverage	Section 3.6.9
Foreign currency options	Debt	Not clearly and closely related	Section 3.6.10
Interest or principal payments indexed to other than credit risk or inflation (such as payments indexed to commodity price)	Debt	Not clearly and closely related	Section 3.6.11

3.4.2 Not Remeasured at Fair Value

FASB REFERENCES

ASC 815-15-25-1(b)

The second criterion for bifurcating an embedded derivative is that the hybrid instrument is not remeasured at fair value through earnings.

Financial instruments accounted for entirely in equity (for example, an outstanding share classified in permanent or temporary equity) are not remeasured at fair value through earnings, and issuers cannot elect the fair value option in ASC 815 or ASC 825 for those instruments. Also, debt instruments are generally not accounted for at fair value (however, issuers may elect the fair value option in ASC 815 or ASC 825 for those instruments if they do not have components recognized in equity (see Section 3.4.2.1)). If a hybrid instrument is **not** remeasured at fair value through earnings and the embedded derivative is **not** clearly and closely related to the host contract, an entity must determine whether the embedded derivative would meet the definition of a derivative instrument if it were freestanding and whether no derivative scope exception applies (see Section 3.4.3).

Conversely, embedded derivatives in hybrid instruments accounted for at fair value through earnings are **not** separated from the host contract. For instance, some hybrid instruments are remeasured at fair value under other U.S. GAAP that requires fair value accounting for those instruments (such as instruments that must be remeasured at fair value under ASC 480 (see Chapter 2)). Also, an entity may elect the fair value option for eligible instruments (see Section 3.4.2.1).

3.4.2.1 Electing the Fair Value Option

FASB REFERENCES

ASC 815-15-25-4 through 25-5, ASC 825-10-15-5(f), ASC 825-10-25-2 through 25-3, ASC 825-10-25-4(a), ASC 825-10-25-4(e), ASC 825-10-25-5(a), ASC 825-10-25-5(c), ASC 825-10-25-7(a), ASC 825-10-25-10 through 25-11, and 825-10-45-5

An entity may elect the fair value option for eligible instruments, including recognized financial assets and liabilities with some exceptions. For instance, an entity cannot elect the fair value option for financial instruments that it classifies, in whole or in part, as equity (including temporary equity). Therefore, an entity cannot elect the fair value option for the following instruments:

- Equity instruments (for example, common stock and preferred stock) classified in permanent or temporary equity
- NCI recognized in permanent or temporary equity
- Convertible debt with a substantial premium recognized in equity (see Section 3.6.1.2)
- Instruments indexed to an entity's own stock and classified in the entity's stockholders' equity (see Chapter 4).

TIMING FOR ELECTING THE FAIR VALUE OPTION

An entity elects the fair value option at an instrument's initial recognition, and that election is irrevocable. An entity may also elect the fair value option when a previously recognized financial instrument becomes subject to a remeasurement event (a new basis event), which requires remeasuring the instrument to its fair value at that date (but does not necessarily require subsequent remeasurement at fair value), such as a business combination under ASC 805. Similarly, when a debt instrument is amended or exchanged under ASC 470-50 and the transaction is accounted for as an extinguishment of the original debt and issuance of a new debt instrument, an entity may elect the fair value option for the 'new' debt instrument or may elect not to apply it (if the fair value option was previously elected for the original debt).[3]

We believe an entity generally cannot elect the fair value option for previously recognized financial instruments (for which the fair value option was not previously elected) in reissued financial statements; for example, if an entity issues restated financial statements.

An entity may apply the fair value option on an instrument-by-instrument basis; the fair value option generally does not need to be applied to all instruments issued or acquired in a single transaction. For example, in a syndicated loan arrangement with individual loans from different lenders, an entity may elect the fair value option for some loans but not others. However, if multiple advances are made from one lender in a single contract (such as a line of credit or a construction loan) and the individual advances lose their identity and become part of a larger loan balance, an entity must apply the fair value option to the larger balance rather than to each advance. Further, an entity cannot separate a legally single financial instrument into parts (such as into portions of that instrument, specific cash flows, or specified risks) when applying the fair value option.

An entity must document its fair value election concurrently or establish a policy for automatic election (such as establishing a policy to elect the fair value option for specific types of eligible instruments).

If an entity elects the fair value option, upfront costs and fees are recognized in earnings and not deferred.

BDO INSIGHTS — FAIR VALUE ELECTION FOR HYBRID FINANCIAL INSTRUMENTS

Electing the fair value option for a financial instrument in its entirety has its pros and cons. For instance, the fair value election allows entities to achieve consistent accounting and potentially offset the effect of the changes in the fair value of related financial instruments without having to apply complex hedge accounting requirements. For example, accounting for a hybrid debt instrument and related interest rate swap at fair value might be easier than electing hedge accounting for the interest rate swap.

Also, carrying debt at fair value may be less complex than bifurcating an embedded derivative from the debt instrument (further, bifurcating an embedded derivative adjusts the effective interest rate on the debt instrument). In either case, entities must develop a fair value estimate each period (the hybrid instrument as a whole or the bifurcated derivative). However, electing the fair value option eliminates the need to perform multiple detailed bifurcation assessments. In other words, separate assessments of conversion features, redemption features, and contingent interest features are required if the hybrid instrument is carried at amortized cost.

While ASC 815-15-25 indicates that an entity must evaluate a financial instrument to determine whether it has an embedded derivative requiring bifurcation before electing the fair value option, ASC 825-10-15 does not include a similar requirement. Therefore, we believe an entity may elect the fair value option for eligible hybrid instruments before analyzing those instruments for embedded derivatives (which would therefore make the evaluation for embedded derivatives unnecessary, as noted above) provided the requirements in ASC 825-10-15 are met (for example, the financial instrument is not recognized, in whole or in part, in equity).

However, under ASC 815-20-25-71(a)(3), if the entity elects the fair value option, it cannot designate the hybrid instrument as a hedging instrument. Further, for financial liabilities, the entity must recognize changes in fair value

[3] FAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*, BC15.

caused by instrument-specific credit risk separately in other comprehensive income. Once made, the fair value election is irrevocable and could reduce comparability with other entities.

Determining whether to elect the fair value option requires the application of professional judgment based on the facts and circumstances.

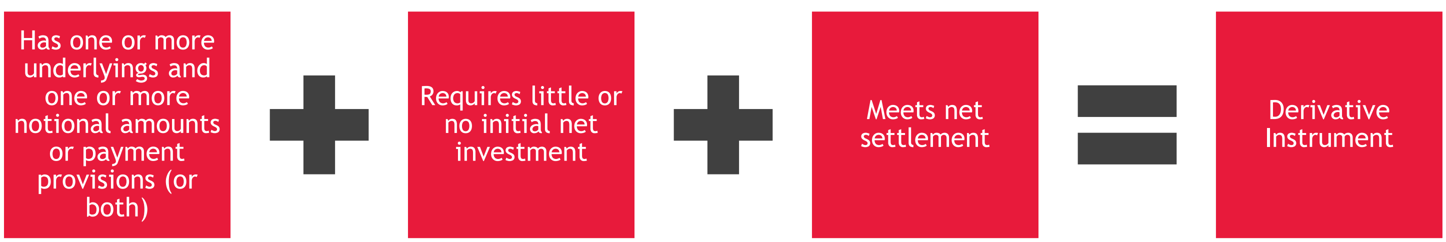
3.4.3 Qualify as a Derivative if Freestanding

FASB REFERENCES

ASC 815-15-25-1(c) and ASC 815-10-15-83

The third criterion for bifurcating an embedded derivative from a hybrid instrument is that the embedded derivative would meet the definition of a derivative instrument if it were freestanding and no exception from derivative accounting applies. Often the determination of whether to bifurcate an embedded derivative depends on this criterion.

ASC 815-10-15-83 defines a derivative instrument as a contract with the following characteristics:



See Appendix A for more guidance on how to evaluate whether a freestanding instrument meets the definition of a derivative instrument in its entirety. The next three sections provide additional considerations for evaluating whether embedded derivatives would meet the definition of a derivative instrument if they were freestanding.

3.4.3.1 Has an Underlying and Notional Amount or Payment Provision

FASB REFERENCES

ASC 815-10-15-83(a)

The first characteristic of a derivative instrument is that it includes an underlying accompanied by a notional amount, payment provision, or both. For example:

- For a conversion or put option in a preferred stock instrument, the stock price is an underlying and the number of shares issued upon conversion, or redeemed upon exercise of the put option, is the notional amount.
- For a redemption option in a debt instrument, the interest rate is an underlying and the par amount of the debt to be repaid is the notional amount.

Referring to those two elements (underlying and notional amount) enables the parties to compute the settlement amount. For some embedded derivatives, a contingency, such as the occurrence or nonoccurrence of a change in control, IPO, or event of default, may also be an underlying.

Also, instead of a notional amount, some embedded derivatives may have a payment provision. For example, an embedded feature that requires the entity to pay $1,000 if it does not maintain a specific credit rating has an underlying (the entity not maintaining its specific credit rating) and a payment provision ($1,000).

In practice, this derivative characteristic is frequently met.

3.4.3.2 Requires Little or No Initial Net Investment

FASB REFERENCES

ASC 815-10-15-83(b) and ASC 815-15-25-1(c)

An embedded derivative meets the second characteristic of a derivative instrument if it requires no initial investment or an initial net investment that is smaller than would be required for other types of contracts expected to respond similarly to changes in market factors.

In applying this requirement, ASC 815 says the initial net investment for the hybrid instrument is **not** considered the initial net investment for the embedded derivative (even though theoretically, the proceeds or consideration received relates to both the host contract and the embedded derivative).

For example, while the initial net investment in a convertible debt instrument represented by the loan proceeds theoretically relates to both the debt instrument and the conversion option, the embedded conversion option generally meets the second characteristic of a derivative in ASC 815-15-25-1(c). That is because the initial net investment for an embedded instrument is the amount that would be paid to acquire that instrument on a freestanding basis (separately from the host contract), which theoretically is the embedded instrument's fair value. The investor's initial net investment for the conversion option (the fair value of the conversion option) is generally less — by more than a nominal amount — than the initial net investment that would be required to buy the underlying shares (the aggregate fair value of the underlying shares).

In practice, this derivative characteristic is frequently met.

3.4.3.3 Meets Net Settlement

FASB REFERENCES

ASC 815-10-15-83(c), ASC 815-10-15-99, and ASC 815-10-15-107 through 15-108

An embedded derivative meets the third characteristic of a derivative instrument if it requires or allows net settlement. In applying that guidance, net settlement is determined based on whether one party to the contract is required to deliver an asset that meets both conditions:

- Is associated with the underlying
- Has a principal amount, stated amount, face value, number of shares, or other denomination that equals the notional amount (or the notional amount plus a premium or minus a discount).

This Blueprint refers to that asset as an "**asset associated with the underlying.**"

Net settlement can occur under the contract terms, through a market mechanism, or by delivery of an asset associated with the underlying that is itself a derivative instrument or readily convertible to cash (see Appendix A, Section A.1.3).

The table provides additional guidance for embedded derivatives.

Net settlement under contract terms	Net settlement through market mechanism	Net settlement by delivery of a derivative or asset readily convertible to cash
▶ Exists when neither party is required to deliver an asset associated with the underlying, such as when either party can elect net cash settlement or net share settlement, regardless of whether the shares are restricted for more than 31 days or are readily convertible to cash (see Appendix A, Section A.1.3.1). ▶ For a debt instrument, the potential settlement through exercise of an embedded call or put option (for example, a prepayment option) meets the net settlement characteristic because neither party is required to deliver an asset that is associated with the underlying (see Section 3.6.3.3).	▶ Exists when one of the parties must deliver an asset associated with the underlying but the instrument can readily be net settled by a means outside the contract (see Appendix A, Section A.1.3.2). ▶ Settlement of an embedded derivative generally does not occur by net settlement through a market mechanism because it is not legally detachable and separately exercisable from the hybrid financial instrument.	▶ Exists when one of the parties must deliver an asset associated with the underlying but that asset is readily convertible to cash or is itself a derivative instrument (see Appendix A, Section A.1.3.3). ▶ Generally, a conversion option on shares traded in a public market can be net settled because the shares are readily convertible to cash. However, when a public company's shares are thinly traded, entities must assess whether the shares converted could be sold rapidly without significantly affecting the stock price (see Section 3.6.1). ▶ Shares in private companies generally are not readily convertible to cash and therefore would not meet this form of net settlement.

ANALYSIS OF NET SETTLEMENT DIFFERS FOR AN EQUITY HOST CONTRACT AND DEBT HOST CONTRACT

In some cases, the net settlement conclusion for the same feature depends on whether the hybrid instrument has an equity host or debt host contract. For example, a redemption feature in a preferred stock that is not publicly traded would **not** meet the net settlement characteristic if the preferred stock is an equity host unless it includes contractual net share or net cash settlement. In contrast, the same redemption feature **would** meet the net settlement characteristic if the preferred stock is a debt host regardless of whether the preferred stock is publicly traded. Therefore, reaching a conclusion about the nature of the host contract is important (see Section 3.4.1.1) and requires the use of professional judgment based on the facts and circumstances.

3.4.3.4 No Scope Exception Applies

If an entity determines that an embedded derivative meets the definition of a derivative instrument, it evaluates whether any scope exceptions apply (see Section 3.2.3). For example, an embedded conversion feature that meets the definition of a derivative instrument is not bifurcated if it meets the exception for contracts involving an entity's own equity in ASC 815-10-15-74(a) (see Section 3.6.1.1 and Chapter 4). If any scope exceptions apply, the embedded derivative is not bifurcated from the hybrid instrument. If no exception applies and all the bifurcation criteria are met, the embedded derivative is bifurcated and accounted for separately from the host contract.

3.5 BIFURCATION EXAMPLES — EMBEDDED FEATURES IN AN EQUITY HOST CONTRACT

FASB REFERENCES

ASC 815-15-25-1

As discussed in Section 3.4, an entity must account for an embedded derivative separately from an equity host contract when **all** the following criteria are met:

Not clearly and closely related	Not remeasured at fair value	Qualify as a derivative instrument if freestanding
The host contract and the embedded derivative have economic characteristics and risks that are not clearly and closely related (see Section 3.4.1).	The hybrid instrument is not remeasured at fair value through earnings each period (see Section 3.4.2).	The embedded derivative would be a derivative instrument under ASC 815-10 if it were freestanding (see Section 3.4.3) and no derivative scope exception applies (see Section 3.2.3)

An equity host contract is often in the form of an outstanding share. Because an outstanding share is generally not remeasured at fair value, the bifurcation analysis typically focuses on whether the embedded derivative is clearly and closely related to the equity host contract and whether the embedded derivative would be accounted for as a derivative instrument under ASC 815-10 if it were freestanding.

ANALYSIS OF EMBEDDED FEATURES IN AN OUTSTANDING SHARE DIFFERS FOR AN EQUITY HOST CONTRACT AND A DEBT HOST CONTRACT

As discussed in Section 3.4.1.1, an outstanding share is not always an equity host contract. Also, the analysis of embedded derivatives differs depending on whether the outstanding share is an equity host or debt host. For example, the redemption of privately issued preferred stock meets the net settlement characteristic if the preferred stock is a debt host, while net settlement would typically not be met if the preferred stock is an equity host (see Section 3.4.3.3).

Section 3.5 discusses the analysis for embedded derivatives in an outstanding share that is an equity host contract. If the outstanding share is a debt host contract, the embedded derivatives must be evaluated using the guidance in Section 3.6.

3.5.1 Conversion Features in an Equity Host Contract

FASB REFERENCES

ASC 815-15-25-16

Often, an equity instrument includes conversion features (for example, preferred stock convertible into common shares). Generally, the value of equity instruments are affected by the price of the issuer's stock. To be considered clearly and closely related to an equity host contract, an embedded derivative must have economic characteristics and risks of an equity instrument (residual interest).

Accordingly, an embedded conversion feature for a fixed number of the issuer's shares has equity characteristics and **is** clearly and closely related to an equity host contract and is therefore not separated from the host contract. That is generally true regardless of whether the conversion feature is noncontingent (for example, exercisable at the holder's option) or contingent (for example, exercisable upon an IPO).

Because the conversion option does not meet the first criterion for bifurcation, it is not relevant whether the conversion option would qualify as a derivative instrument if it were freestanding. Therefore, whether the conversion feature's underlying share is publicly traded does not change the conclusion that the conversion option is not separated from an equity host contract.

3.5.2 Redemption Features in an Equity Host Contract

FASB REFERENCES

ASC 815-10-15-74(a) and ASC 815-15-25-20

A redemption feature that requires or may require an entity to reacquire its own shares for cash or other assets is not clearly and closely related to an equity host contract and would be bifurcated if it meets the other criteria for bifurcation and no derivative scope exception applies (see Section 3.4).

Redemption features typically meet the first two derivative characteristics because they have an underlying and notional amount (the stock price and the number of shares, or the liquidation amount) and they require little or no initial net investment (typically, the fair value of the redemption feature is substantially less than the fair value of the underlying shares).

Often, redemption features in an equity host contract do not meet the net settlement characteristic because the shares are not publicly traded and the redemption feature requires physical settlement (that is, the entity pays cash to reacquire the full stated number of shares from the holder at exercise). In that case, the entity does not bifurcate the redemption feature from the host contract.

On the other hand, if the redemption feature meets the net settlement characteristic (for example, because the shares are publicly traded or the contract requires or allows net settlement), the entity must evaluate the redemption feature for the scope exception in ASC 815-10-15-74(a) (see Chapter 4). An entity does not bifurcate a redemption feature that meets the scope exception.

An entity also must consider whether the shares should be presented in temporary equity under ASC 480-10-S99-3A (see Chapter 5).

DERIVATIVE SCOPE EXCEPTION FOR REDEMPTION FEATURES EMBEDDED IN AN EQUITY HOST CONTRACT

As discussed in Chapter 4, an embedded derivative qualifies for a scope exception in ASC 815-10-15-74(a) if it is indexed to the entity's own stock (the indexation guidance) and would be classified in the entity's stockholders' equity if it were freestanding (the equity classification guidance).

Under the indexation guidance, a redemption feature in an equity instrument (such as preferred stock) is indexed to the entity's own stock if the exercise contingencies (if any) are not based on an observable market or index other than those solely related to the entity and the settlement amount does not vary from a "fixed-for-fixed" settlement. Generally, a redemption feature that requires or may require an entity to reacquire a fixed number of its equity shares for a fixed redemption price (or an amount based on the fair value of the entity's shares) is indexed to an entity's own stock. However, the entity must analyze any terms that adjust the number of shares or the redemption price (see Section 4.5).

Under the equity classification guidance, assuming the instrument meets the additional conditions necessary for equity classification (see Section 4.6.2), it would be considered classified in equity (that is, it does not preclude the embedded derivative from meeting the scope exception) in **both** situations:

- Contract requires share settlement (physical or net share settlement)
- Contract gives the **issuer** the choice of net cash settlement or settlement in shares (physical or net share settlement).

Therefore, a redemption feature that an entity must or may settle through **physical settlement** could qualify for the scope exception even if the entity pays cash to settle the instrument (see Section 4.6).

In contrast, an instrument would not be considered classified in equity (that is, the scope exception is not met for the embedded derivative) in **both** situations:

- Contract requires net cash settlement
- Contract gives the **holder** the choice of net cash settlement or settlement in shares (physical or net share settlement).

3.5.3 Preferred Stock Tranche Issuance

Often, private companies sell preferred stock pursuant to an agreement that allows or requires the entity to issue more shares in the same series to the investor or allows or requires the investor to buy more shares in the same series from the entity within a short period. That is commonly referred to as a "preferred stock tranche issuance."

An entity must first determine whether the preferred stock tranche right or obligation is freestanding or embedded. Typically, the entity's right or obligation to issue more shares under the stock purchase agreement is freestanding if the investor can transfer the preferred stock it bought in the initial closing to another party without affecting its remaining rights and obligations in the agreement. If the feature is freestanding, it is evaluated under ASC 480:

- If the underlying preferred stock is redeemable outside the entity's control (including upon deemed liquidation events) and the preferred stock tranche represents an entity's obligation, it is accounted for under ASC 480 (see Chapter 2).
- If the underlying preferred stock is not redeemable or the preferred stock tranche does not represent an entity's obligation, it is outside the scope of ASC 480 and must be further assessed under ASC 815-40 (see Chapter 4).

If the preferred stock tranche right or obligation is embedded in the preferred stock issued in the initial closing, the entity evaluates it for bifurcation under ASC 815-15 (see Section 3.4). If the preferred stock is not publicly traded or the contract does not require or allow net settlement, the embedded feature does not meet the definition of a derivative instrument (see Section 3.4.3.3) and is not bifurcated. If the preferred stock is publicly traded, an entity evaluates whether the embedded feature meets the scope exception in ASC 815-10-15-74(a). If so, the embedded feature is not bifurcated.

3.6 BIFURCATION EXAMPLES — EMBEDDED FEATURES IN A DEBT HOST CONTRACT

FASB REFERENCES

ASC 815-15-25-1

As discussed in Section 3.4, an entity must account for an embedded derivative separately from a debt host contract when **all** the following criteria are met:

Not clearly and closely related	Not remeasured at fair value	Qualify as a derivative instrument if freestanding
The host contract and the embedded derivative have economic characteristics and risks that are not clearly and closely related (see Section 3.4.1).	The hybrid instrument is not remeasured at fair value through earnings each period (see Section 3.4.2).	The embedded derivative would be a derivative instrument under ASC 815-10 if it were freestanding (see Section 3.4.3) and no derivative scope exception applies (see Section 3.2.3).

Generally, a debt host contract has economic and risk characteristics that are based on an interest rate, credit risk, and inflation. Also, it typically has no shareholder rights (such as the ability to vote or receive dividends) or residual rights. However, not all those characteristics must be present for a hybrid instrument to have a debt host contract.

As a starting point, an embedded derivative must have economic characteristics and risks of a debt instrument to be clearly and closely related to a debt host contract. For some embedded derivatives, ASC 815-15 includes specific guidance in making that assessment (see Section 3.4.1.2).

Also, an entity generally does not remeasure debt instruments at fair value through earnings unless it elects the fair value option in ASC 815 or ASC 825. An entity cannot elect the fair value option for debt instruments that have components recognized in equity (see Section 3.4.2.1).

Finally, embedded derivatives in a debt instrument typically meet the first two characteristics of a derivative instrument (see Sections 3.4.3.1 and 3.4.3.2). Therefore, the factor that decides whether an embedded derivative would be a derivative instrument if it were freestanding often is whether it meets the net settlement characteristic (see Section 3.4.3.3). If the embedded derivative meets all the characteristics of a derivative instrument, an entity must assess whether it qualifies for any derivative scope exceptions (see Section 3.2.3).

3.6.1 Conversion Features in a Debt Host Contract

FASB REFERENCES

ASC 815-10-55-99 through 55-110, ASC 815-15-25-51, ASC 815-15-55-76A through 55-76B, and ASC 815-15-55-217 through 55-218

In a typical convertible debt arrangement, the host contract is a debt instrument that requires interest and principal payments. Generally, convertible debt bears a lower interest rate than nonconvertible debt. A typical embedded conversion option gives the holder the option to buy the entity's stock at a fixed price (a written call option). In that case, the conversion option has the economic characteristics and risks of an equity interest, while the host contract is a debt instrument.

The changes in fair value in an equity interest are not clearly and closely related to interest rates on a debt instrument. Therefore, unless the entity accounts for the debt instrument at fair value (see Section 3.4.2), it must evaluate whether the embedded conversion option would be a derivative instrument if it were freestanding and, if so, whether no derivative scope exception applies.

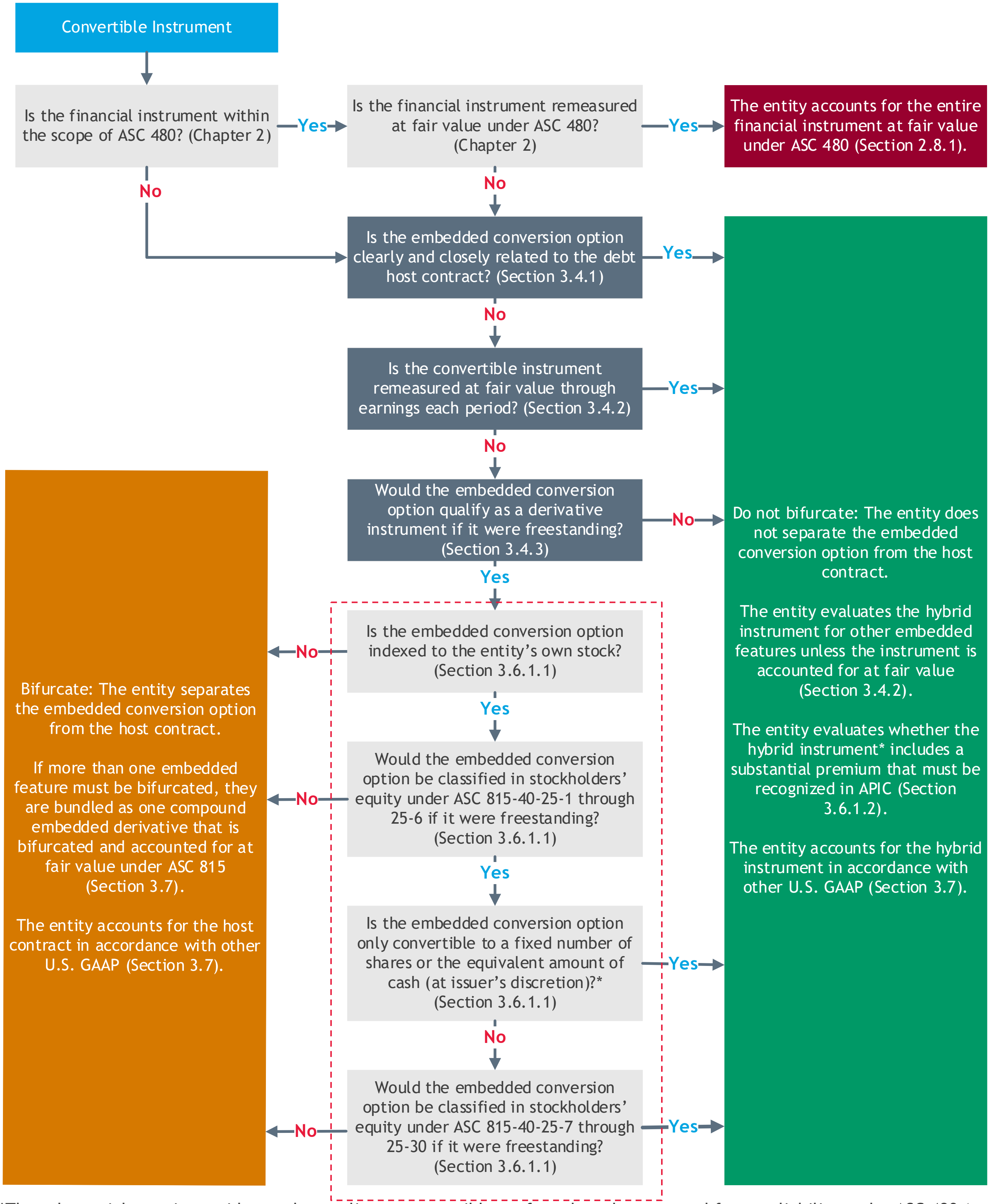
A conversion option qualifies for a derivative scope exception if it is indexed to the entity's own stock and would be classified in the entity's stockholders' equity if it were freestanding. In that case, the entity does not bifurcate the conversion option from the debt instrument. However, the entity must evaluate the debt instrument for other embedded derivatives that may require bifurcation, including whether the debt includes a substantial premium that must be recognized in equity (see Section 3.6.1.2). If no embedded derivatives require bifurcation, the entity accounts for the entire debt instrument as a liability under ASC 470-20 (see Section 6.2.4). If the host contract is preferred stock, the entity accounts for the convertible preferred stock (including the conversion option and any other embedded features not bifurcated) as equity under ASC 480-10-S99-3A, if applicable (see Chapter 5) or ASC 505-10 (see Section 6.3.3.4).

On the other hand, if all criteria for bifurcation are met and no exception applies, the entity bifurcates the conversion option and accounts for it as a derivative liability separate from the host contract (see Section 3.7).

EMBEDDED PURCHASED PUT OPTION IN A DEBT HOST CONTRACT

Similar to a written call option (conversion option), an entity must evaluate any purchased put option or forward sale contract (right or obligation to issue its own shares) embedded in a debt host contract for bifurcation. For example, an entity may issue preferred stock that is a debt host with an embedded purchased put option that gives the entity a right to sell additional shares of preferred stock to the holder. Often, that embedded feature would not be a derivative if it were freestanding (for example, because the preferred stock is not publicly traded and the contract does not allow or require net settlement). If so, the entity does not bifurcate the embedded feature from the preferred stock. However, if the embedded feature meets the definition of a derivative instrument (for example, because the preferred stock is publicly traded), the entity must evaluate whether that feature is clearly and closely related to the debt host contract or whether a derivative scope exception applies (such as ASC 815-10-15-74(a)).

Presented below is the flowchart discussed in Section 3.1 as applied to an analysis of an embedded conversion option, including the derivative scope exception in ASC 815-10-15-74(a). The flowchart also applies to convertible preferred stock.



*The substantial premium guidance also applies to convertible preferred stock accounted for as a liability under ASC 480 (see Sections 3.6.1.2 and 6.2.4.1). It does not apply to convertible preferred stock accounted for as equity.

The table illustrates how an entity generally applies the preceding flowchart in evaluating a conversion option for bifurcation. Entities must apply professional judgment based on the facts and circumstances.

BIFURCATION CRITERIA	ANALYSIS
Is the embedded conversion option not clearly and closely related to the debt host contract?	The changes in fair value of an equity interest and the interest rates on a debt instrument are not clearly and closely related. Therefore, if the debt is convertible into a specified number of shares of the entity's stock, the conversion option is **not** clearly and closely related to the debt host contract and thus meets the first of the three criteria for bifurcation.
Is the debt instrument not remeasured at fair value through earnings each period?	An entity generally does not remeasure debt instruments at fair value through earnings unless it elects the fair value option in ASC 815 or ASC 825. An entity cannot elect the fair value option for debt instruments that have components recognized in equity (see Section 3.4.2.1). If the debt instrument is not remeasured at fair value, the entity must analyze the third criterion for bifurcation.
Would the embedded conversion option qualify as a derivative instrument if it were freestanding?	Often, determining whether to bifurcate an embedded conversion option depends on whether a separate instrument with the same terms as the embedded conversion option would be a derivative instrument because the other criteria for bifurcation are typically met. Whether the conversion option has the characteristics of a derivative instrument is generally analyzed as shown below.
▶ Does it have one or more underlyings and either (or both) a notional amount or payment provision?	▶ In a typical conversion option, the price of the stock to be issued upon conversion is the underlying and the number of shares to be issued upon conversion is the notional amount. Therefore, an embedded conversion option meets the first characteristic of a derivative instrument (see Section 3.4.3.1).
▶ Does it require little or no initial net investment?	▶ Although the loan proceeds theoretically relate to the debt instrument and the conversion option, ASC 815-15-25-1(c) states that the initial net investment for the hybrid instrument is **not** the initial net investment for the embedded derivative (that is, the conversion option). Accordingly, an embedded conversion option typically meets the second characteristic of a derivative instrument because it has little or no initial net investment (see Section 3.4.3.2).
▶ Does it meet net settlement?	▶ Shares in private companies generally are not readily convertible to cash and typically would not meet the net settlement characteristic (see Section 3.4.3.3). On the other hand, a conversion option on shares that are traded in a public market generally possesses the net settlement characteristic because the shares are readily convertible to cash. Accordingly, for a public company, an embedded conversion option generally meets the third characteristic of a derivative instrument (unless the entity's shares are thinly traded — see below).
▶ Does a derivative scope exception apply?	▶ If the conversion option meets all the characteristics of a derivative instrument, the entity must assess whether it qualifies for a scope exception. An entity does not bifurcate a conversion option from the host contract if it is indexed to its own stock and would be classified in its stockholders' equity if it were freestanding (see Section 3.6.1.1).

As discussed in the preceding table, a conversion option on shares that publicly trade in an active market generally meets net settlement because the shares are readily convertible to cash. However, when a public entity's shares are thinly traded, the entity must assess whether the number of shares converted may be sold rapidly without significantly affecting the entity's share price (in which case, the shares are readily convertible to cash and the conversion option meets net settlement).

Examples 3-3 and 3-4 illustrate the relevance of daily transaction volumes in determining whether net settlement exists. They also show that separate contracts must be evaluated individually in determining whether net settlement exists (that is, the form of the financial instrument matters and individual instruments cannot be combined to circumvent the net settlement characteristic).

EXAMPLE 3-3 (ADAPTED FROM ASC 815-10-55-101 THROUGH 55-108): SINGLE BOND WITH MULTIPLE CONVERSION OPTIONS

FACTS

An entity issues a single convertible bond with the following characteristics:

- It has a face amount of $100 million and is not exchange-traded.
- It can be converted to up to 10 million shares of the entity's common stock. The common stock is publicly traded.
- It may be converted in full or in increments of $1,000 immediately or at any time during the next two years. If converted in a $1,000 increment, the bond holder would receive 100 shares of common stock.
- The market for the entity's stock can absorb 500,000 shares without significantly affecting the stock price.

CONCLUSION AND ANALYSIS

The $100 million bond is convertible in increments of $1,000 — it essentially contains 100,000 embedded conversion options, each with a notional amount of 100 shares. Each conversion option individually meets the net settlement characteristic because the 100 shares to be delivered are readily convertible to cash. Whether underlying shares of the entire bond (or a significant portion of the bond) could on conversion be sold without affecting the stock price does not affect the analysis. For instance, the fact that if the bond holder simultaneously converted the entire bond, or a significant portion thereof, the shares received could not be readily converted to cash without incurring a significant block discount is irrelevant. Thus, the conversion option meets the net settlement characteristic.

Because the conversion option also has an underlying and notional amount (the stock price and number of underlying shares) and requires little or no initial net investment, it has all the characteristics of a derivative instrument. The entity must therefore assess the conversion option for derivative scope exceptions (see Section 3.6.1.1).

However, if the $100 million bond can be converted into common shares at only one time in its entirety, the conversion option would not meet the net settlement characteristic because the market for the entity's stock cannot absorb 10 million shares without significantly affecting the stock price.

EXAMPLE 3-4 (ADAPTED FROM ASC 815-10-55-109 THROUGH 55-110): MULTIPLE BONDS EACH HAVING SINGLE CONVERSION OPTION

FACTS

An entity concurrently issues to an investor 100,000 individual $1,000 bonds that each convert into 100 shares of common stock. Each bond has the following characteristics:

- It is not exchange-traded.
- The common stock that would be received upon conversion is publicly traded.
- The market for the entity's stock can absorb 500,000 shares without significantly affecting the entity's stock price.

CONCLUSION AND ANALYSIS

Each individual bond contains an embedded derivative that must be separately evaluated. ASC 815-10-15-123 explains that when assessing the net settlement characteristic through the delivery of an asset that is readily convertible to cash, an entity cannot combine individual instruments for evaluation. Therefore, the entity determines that each bond has a conversion option that meets the net settlement characteristic.

Because the conversion options also have an underlying and notional amount (the stock price and number of shares) and require little or no initial net investment, they have all the characteristics of a derivative instrument. The entity must therefore assess the conversion options for derivative scope exceptions (see Section 3.6.1.1).

3.6.1.1 Exception From Bifurcation (ASC 815-10-15-74(a))

FASB REFERENCES

ASC 815-10-15-74(a), ASC 815-15-55-219 through 55-220, ASC 815-40-15-5C, ASC 815-40-15-7, and ASC 815-40-15-7E

If an embedded conversion option meets the three characteristics of a derivative instrument (see Section 3.4.3), an entity must assess whether the conversion option qualifies for a derivative scope exception. ASC 815-10-15-74(a) states that contracts that are both indexed to an entity's own stock and would be classified in the entity's stockholders' equity if it were freestanding are outside the scope of ASC 815-10 and therefore not considered derivative instruments.

Generally, an embedded conversion option for a fixed number of shares is considered indexed to an entity's own stock because the value of the option varies in response to changes in the entity's share price. In the simple case of a debt instrument convertible into 100 shares of the entity's stock, that point is clear. However, in most cases, contracts provide for adjustments to the number of underlying shares, conversion price, or both. In those circumstances, it is less clear whether a conversion option is indexed to an entity's own stock, and more analysis under ASC 815-40 is generally needed to determine whether the derivative scope exception applies (see Chapter 4).

An entity performs a two-step test under ASC 815-40-15-7 to determine whether an embedded conversion option is indexed to an entity's own stock:

- **Step 1, Evaluate Exercise Contingency Provisions (see Section 4.5.1)** — This step focuses on contingencies that affect whether or when a conversion option can be exercised. A conversion option passes Step 1 (and is then analyzed under Step 2) if its contingent exercise provisions (if any) are not based on an observable market or observable index, other than those for the entity's stock or operations, and once any contingent events occur, the settlement is based solely on the entity's stock.
  - For example, assume an entity issues an instrument convertible into its common stock only upon an IPO. The conversion option is considered indexed to the entity's own stock under Step 1 because the contingent event (the IPO) is not an observable market or observable index, and once the IPO occurs, the conversion option's value is based solely on the entity's stock.
  - Similarly, conversion options with contingent exercise provisions based upon the entity's results (such as sales, EBITDA, or net income) generally are considered indexed to the entity's own stock. In contrast, contingency provisions that are based on external markets or indices (such as the S&P 500, an index of peer company stocks, or the price of a commodity) are not indexed to an entity's own stock.
- **Step 2, Evaluate Settlement Provisions (see Section 4.5.2)** — This step focuses on the instrument's settlement upon exercise or conversion. The instrument passes Step 2 (and is analyzed under the equity classification guidance) when **either** of the following is met:
  - The instrument's settlement amount equals the difference between the fair value of a fixed number of the entity's shares and a fixed monetary amount or fixed amount of debt issued by the entity.
    - For example, an entity has such an instrument when it issues convertible debt for $1,000 that is convertible into 100 shares of common stock at a fixed conversion price of $10. The settlement amount of that instrument is always the fair value of 100 shares at the settlement date less $1,000.

- The exercise price or settlement amount is variable, and the only variables that affect the instrument's settlement amount are inputs to the fair value of a fixed-for-fixed forward or option on equity shares. Those inputs are generally the same as the inputs to the Black-Scholes option pricing model and include:
  - Exercise price
  - Term
  - Expected dividends or other dilutive activities, such as the purchase of stock at above-market prices
  - Stock borrow cost
  - Interest rates
  - Stock price volatility
  - Entity's credit spread
  - Ability to maintain a standard hedge position in the underlying shares (this is an implicit rather than an explicit input, unlike the other inputs above).

  In practice, standard pricing models for those instruments contain specific implicit assumptions. For example, the Black-Scholes option pricing model assumes that stock price changes will be continuous. However, events such as a merger announcement; a spinoff of a subsidiary; or a large, non-recurring cash dividend can cause stock price discontinuities, thereby violating that implicit assumption. Accordingly, when applying Step 2, fair value inputs include adjustments to neutralize the effects of events that can cause stock price discontinuities, as discussed in ASC 815-40-15-7G.

If the conversion option fails Step 2 (for example, because the instrument's settlement incorporates variables other than fair value inputs or features, such as a leverage factor that increases exposure to the variables listed above, exist in a manner that is inconsistent with the fixed-for-fixed model), the instrument is **not** indexed to the entity's own stock.

Further, an entity may issue a convertible instrument with a payoff that is based, in whole or in part, on the stock of a consolidated subsidiary. If the subsidiary is a substantive entity, the conversion option is not precluded from being considered indexed to the entity's own stock. On the other hand, if the payoff is based, in whole or in part, on the stock of another entity not consolidated by the entity (for example, an equity method investee) or on another entity's publicly traded stock, the conversion option is not indexed to an entity's own stock (see Section 4.5.2).

To meet the scope exception in ASC 815-10-15-74(a), embedded conversion options that **are** indexed to an entity's own stock are further analyzed to determine whether they would be classified in the entity's stockholders' equity if they were freestanding. In contrast, embedded conversion options that are **not** indexed to an entity's own stock do **not** meet the scope exception in ASC 815-10-15-74(a) and must be bifurcated from the debt instrument unless the entity elects the fair value option.

NET-CASH-SETTLED CONVERSION FEATURE

To determine whether an embedded conversion option would be classified as equity if it were freestanding, an entity considers the basic model in ASC 815-40-25, which examines whether an embedded conversion option requires or may require net cash settlement. In accordance with ASC 815-40-25-1, contracts that require or may require the entity to **net cash settle** do not meet the derivative scope exception. That includes contracts that give the holder a settlement choice between net cash and share settlement (whether physical or net share settlement).

In contrast, contracts an entity must or may settle in shares meet the derivative scope exception (if all other criteria in the indexation and equity classification guidance are met). That includes contracts that give the entity a settlement choice between net cash and share settlement (whether physical or net share settlement).

If net cash settlement is not required, the entity must consider whether the embedded conversion option also meets the additional conditions in ASC 815-40-25-7 through 25-30, which include **all** the following (see Section 4.6.2):

- Contract requires net cash payments **only** in situations in which all shareholders receive cash
- Contract does not explicitly require net cash settlement if registered shares are unavailable
- Entity has sufficient authorized and unissued shares
- Contract contains an explicit share limit
- There is no required cash payment if the entity fails to timely file with the SEC
- There is no cash-settled top-off or make-whole provisions.

The additional conditions do not apply if the hybrid instrument is a convertible debt instrument in which the holder may only realize the conversion option's value by exercising the option and receiving the entire proceeds in a fixed number of shares or the equivalent cash at the entity's discretion (see Section 4.6.2.6). However, the additional conditions apply in an entity's evaluation of whether any other embedded derivative would qualify for equity classification if freestanding and thereby would be excluded from the scope of derivative accounting.

If the conversion option meets the scope exception in ASC 815-10-15-74(a)… → …the conversion option is not separated from the host contract (see Section 3.7).

The entity must evaluate whether the convertible debt was issued at a substantial premium (see Section 3.6.1.2).

If the conversion option does not meet the scope exception in ASC 815-10-15-74(a)… → …the conversion option must be separated from the host contract and accounted for as a derivative liability (see Section 3.7).

See Chapter 4 for more guidance on determining whether an embedded feature (such as a conversion option) is indexed to an entity's own stock and would be classified in stockholders' equity if it were freestanding.

3.6.1.2 Convertible Debt With Substantial Premium

FASB REFERENCES

ASC 470-20-15-2C through 15-2D, ASC 470-20-25-13, ASC 470-20-55-1A, and ASC 825-10-15-5(f)

If a convertible debt instrument is issued at a substantial premium compared to the principal (or par) amount paid at maturity and the conversion option is not bifurcated, there is a presumption that the premium should be recognized in equity as paid-in capital (see Section 6.2.4.1). An instrument is not eligible for the fair value option if it includes a substantial premium recognized in equity (see Section 3.4.2.1).

The substantial premium guidance also applies in circumstances other than at issuance of the financial instrument; for instance, in a business combination or a debt amendment or exchange accounted for as an extinguishment under ASC 470-50 (that is, when the financial instrument is subject to a new basis event).

The substantial premium guidance also applies to a convertible preferred stock that is classified as a liability under ASC 480; for example, a convertible preferred stock with a stated redemption date and requires an entity to settle the face amount in cash upon exercise of the conversion option. That instrument embodies an unconditional obligation to redeem the entity's shares by transferring assets at a specified or determinable date and therefore is subject to ASC 480. Otherwise, the substantial premium guidance does not apply to a convertible preferred stock that is recognized in permanent or temporary equity.

Also, the substantial premium guidance does not apply to stock-settled debt (that is, a debt instrument that has a conversion option that continuously resets as the underlying stock price changes to provide a fixed value of common stock to the holder at any conversion date) unless that instrument also contains a substantive conversion feature. Stock-settled debt is subject to other U.S. GAAP (such as ASC 480).

BDO INSIGHTS — SUBSTANTIAL PREMIUM

While ASC 470-20 does not define the term "substantial premium," we generally believe a substantial premium is one of at least 10%. However, in some circumstances, a premium of less than 10% may also be considered substantial (for example, if the premium's amortization exceeds the contractual coupon interest expense, which would cause recognizing net interest income if the premium is not recognized in equity).

In some cases, determining whether a debt instrument is issued at a substantial premium requires the application of professional judgment based on the facts and circumstances.

3.6.1.3 Application Example — Convertible Debt

Example 3-5 illustrates an entity's analysis of an embedded conversion option in a debt instrument.

EXAMPLE 3-5: CONVERTIBLE DEBT

FACTS

On January 1, 20X4, Issuer A issues debt for $1 million with the following terms:

- The debt has a principal amount of $1 million.
- The debt matures on January 1, 20X9.
- Interest accrues on the debt at 10% annually.
- The holder may convert the debt or a portion thereof at its election at any time after issuance for an aggregate of 100,000 shares of Issuer A's common stock at a conversion price of $10 per share (subject to appropriate adjustments in the event of any stock dividend, stock split, combination, or other recapitalization).

Shares of Issuer A's common stock publicly trade in an active market that can rapidly absorb 100,000 shares without significantly affecting the stock price. On January 1, 20X4, Issuer A's common stock price is $10 per share. Issuer A did not elect to account for the convertible debt under the fair value option.

CONCLUSION

Issuer A does not bifurcate the conversion option from the debt instrument because it meets a derivative scope exception. It accounts for the debt instrument (including the conversion option) as convertible debt under ASC 470-20.

ANALYSIS

Issuer A evaluates the conversion option for bifurcation.

- Is the embedded conversion option **not** clearly and closely related to the debt host contract?
  - The conversion option has the economic characteristics and risks of an equity instrument, whereas the host contract is a debt instrument. As such, the conversion option is not clearly and closely related to the debt host contract.
- Is the debt instrument **not** remeasured at fair value through earnings each period?
  - The convertible debt does not require remeasurement at fair value through earnings each period, and Issuer A did not elect the fair value option. As such, the convertible debt is not remeasured at fair value through earnings each period.
- Would the embedded conversion option qualify as a derivative instrument if it were freestanding?
  - ASC 815-10-15-83 defines a derivative instrument as a contract with **all** the following characteristics:
    - It has one or more underlying and one or more notional amounts or payment provisions or both.

    - The price of the stock to be issued upon conversion is the underlying and the number of shares to be issued upon conversion is the notional amount. Therefore, the conversion option meets the first characteristic of a derivative instrument.
  - It requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to respond similarly to changes in market factors.
    - The loan proceeds theoretically relate to the debt instrument and the conversion option. However, in accordance with ASC 815-15-25-1(c), the initial net investment for the hybrid instrument is not the initial net investment for the embedded derivative (that is, the conversion option). Accordingly, the embedded conversion option meets the second characteristic of a derivative instrument (see Section 3.4.3.2).
  - Its terms require or allow net settlement, it can readily be net settled by means outside the contract, or it involves delivery of an asset that puts the recipient in a position not substantially different from a net settlement.
    - Issuer A's common stock publicly trades in an active market that can rapidly absorb the underlying shares upon conversion without significantly affecting the stock price. Therefore, the embedded conversion option meets the net settlement characteristic by delivery of an asset that is readily convertible to cash.
- The conversion option would meet the definition of a derivative instrument if it were freestanding. Therefore, Issuer A must next assess whether any derivative scope exception applies.

▶ Does a derivative scope exception apply?

- For contracts involving an entity's own equity, an entity must evaluate whether the contract is both indexed to its own stock and would be classified in stockholders' equity if it were freestanding (see Section 3.6.1.1). Assume Issuer A determines that the scope exception in ASC 815-10-15-74(a) applies because, in this fact pattern:
  - The only variables affecting the settlement amount are inputs to a fixed-for-fixed option or forward contract on the entity's equity shares (see Sections 3.6.1.1 and 4.5). Therefore, the conversion option is indexed to the entity's own stock in accordance with ASC 815-40-15-7.
  - The conversion option meets the conditions for equity classification in accordance with ASC 815-40-25 (see Sections 3.6.1.1 and 4.6).

The conversion option meets the criteria for bifurcation: It is not clearly and closely related to the debt host contract, the debt instrument is not remeasured at fair value, and the conversion option would meet the definition of a derivative instrument if it were freestanding. However, because a derivative scope exception applies, Issuer A does not bifurcate the conversion option from the debt instrument.

Also, because the debt instrument was not issued at a substantial premium (see Section 3.6.1.2), the debt (including the conversion option) is accounted for in its entirety under ASC 470-20.

ANALYSIS OF CONVERSION FEATURES IN AN OUTSTANDING SHARE THAT IS A DEBT HOST

As discussed in Section 3.3.1, an entity must assess whether an outstanding share (for example, preferred stock) is more akin to an equity instrument or a debt instrument. Because changes in fair value of an equity interest is not clearly and closely related to a host contract with debt-like characteristics, a conversion feature and a preferred stock that is more akin to a debt instrument are not clearly and closely related. The entity must therefore assess whether the conversion feature would be a derivative instrument if it were freestanding. If the contract does not require or allow net settlement and if the underlying shares are not publicly traded, the conversion feature does not meet the net settlement characteristic of a derivative instrument and is not bifurcated. On the other hand, if the conversion feature meets all the characteristics of a derivative instrument, the entity must evaluate whether that feature meets any derivative scope exceptions (see Section 3.6.1.1).

3.6.2 Interest-Rate-Related Features

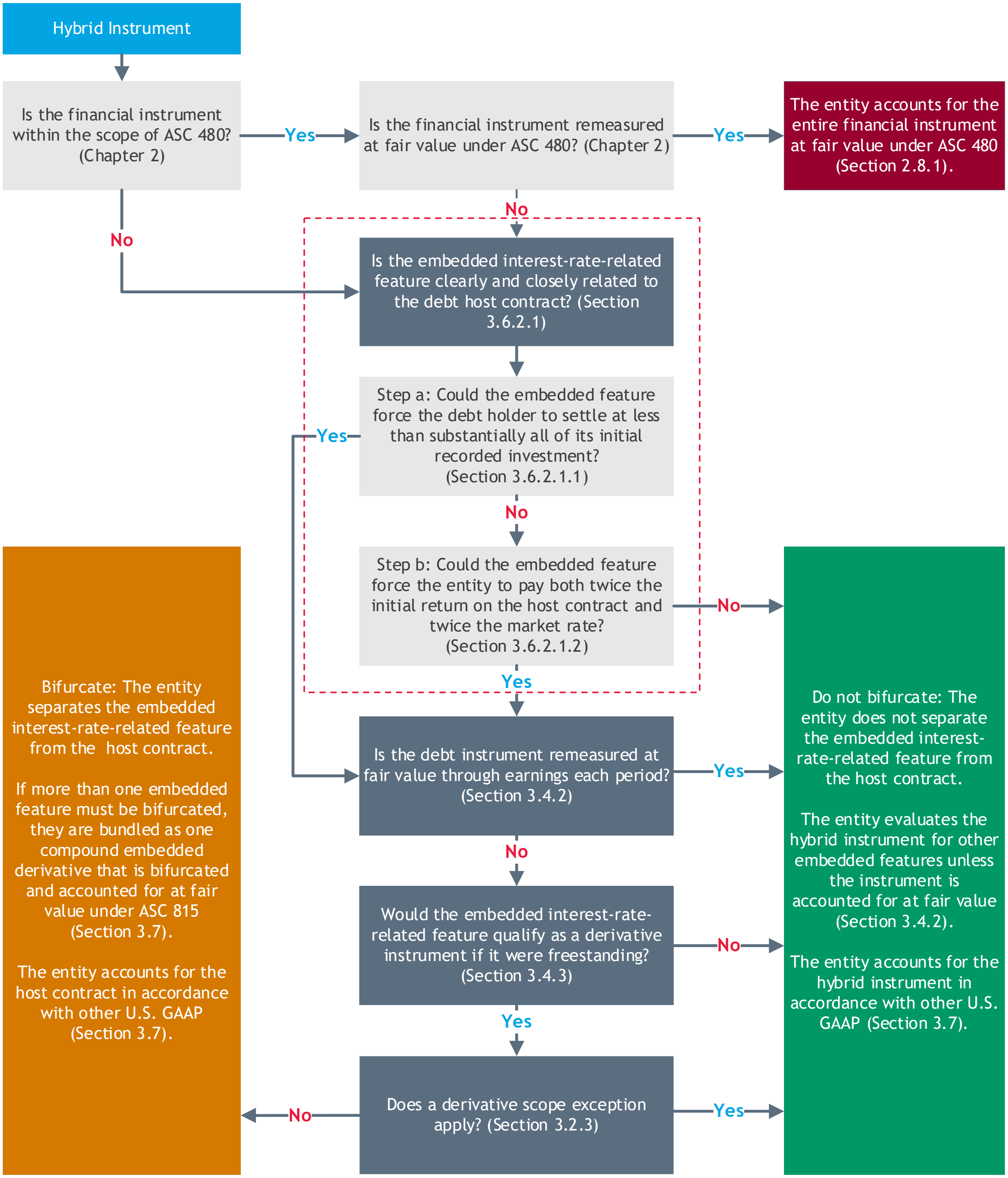
FASB REFERENCES

ASC 815-15-25-26 and ASC 815-15-25-29

Many debt instruments include interest rates that are based on an interest rate index (for example, secured overnight financing rate (SOFR)). Those debt instruments may include caps, floors, or collars. Some debt instruments also include terms that step up the debt's interest rate or allow the entity (that is, the issuer or borrower) to choose the applicable interest rate (for example, from several indices). Those features alter the net interest payments an entity would otherwise pay on an interest-bearing host contract.

Generally, an embedded interest-rate-related feature meets the definition of a derivative instrument because it includes an underlying and a notional amount or payment provision, requires little or no initial net investment, and meets net settlement (see Section 3.4.3). Therefore, if the embedded feature is not clearly and closely related to the debt host contract, the entity must bifurcate the embedded feature unless the entity elects the fair value option to account for the debt (see Section 3.4.2.1). Conversely, if the embedded feature is clearly and closely related to the debt host contract, the entity does not bifurcate the embedded feature.

Presented below is the flowchart discussed in Section 3.1 as applied to an analysis of an embedded interest-rate-related feature and additionally shows the analysis required in ASC 815-15 in evaluating whether the embedded feature is clearly and closely related to the debt host contract.



The table illustrates how an entity generally applies the preceding flowchart in evaluating an embedded interest-rate-related feature for bifurcation. Entities must apply professional judgment based on the facts and circumstances.

BIFURCATION CRITERIA	ANALYSIS
Is the embedded interest-rate-related feature not clearly and closely related to the debt host contract?	Often, determining whether to bifurcate an embedded interest-rate-related feature depends on whether the feature is **not** clearly and closely related to the debt host contract because the other criteria for bifurcation are typically met.
▶ Step a: Could the embedded feature force the debt holder to settle at less than substantially all of its initial recorded investment? ▶ Step b: Could the embedded feature force the entity to pay both twice the initial return on the host contract and twice the market rate?	ASC 815-15 includes two conditions that can cause an embedded interest-rate-related feature to not be clearly and closely related to a debt host contract. First, if the contract could force the investor (debt holder) not to recover substantially all of its initial recorded investment, the first condition is met. Second, if the contract could force the entity (borrower) to pay at least double of both the host contract's initial rate of return (IRR) and the then-current market return for a similar contract by a similar issuer, the second condition is met. If **neither** condition is **met**, the embedded interest-rate-related feature is clearly and closely related to the debt host contract and the entity does not bifurcate the embedded feature from the host contract. If **either** condition is **met**, the embedded interest-rate-related feature is **not** clearly and closely related to the debt host contract (see Section 3.6.2.1). If the embedded interest-rate-related feature is **not** clearly and closely related to the debt host contract, the entity must assess the other two bifurcation criteria below.
Is the debt instrument not remeasured at fair value through earnings each period?	An entity generally does not remeasure debt instruments at fair value through earnings unless it elects the fair value option in ASC 815 or ASC 825. An entity cannot elect the fair value option for debt instruments that have components recognized in equity (see Section 3.4.2.1). If the debt instrument is not remeasured at fair value and the embedded feature is not clearly and closely related to the host contract, the entity must analyze the third criterion for bifurcation.
Would the embedded interest-rate-related feature qualify as a derivative instrument if it were freestanding?	Whether the interest-rate-related feature has the characteristics of a derivative instrument is generally analyzed as shown below.
▶ Does it have one or more underlyings and either (or both) a notional amount or payment provision?	▶ In a typical interest-rate-related feature, the interest rate or interest index is the underlying and the debt's face amount represents the notional amount. The debt also typically includes payment provisions. Therefore, an embedded interest-rate-related feature meets the first characteristic of a derivative instrument (see Section 3.4.3.1).
▶ Does it require little or no initial net investment?	▶ ASC 815-15-25-1(c) states that the initial net investment for the hybrid instrument is **not** the initial net investment for the embedded derivative (that is, the interest-rate-related feature (see Section 3.4.3.2)). Accordingly, an embedded interest-rate-related feature meets the second characteristic of a derivative instrument because it requires little or no initial net investment.

BIFURCATION CRITERIA	ANALYSIS
▶ Does it meet net settlement?	▶ An interest-rate-related feature embedded in a debt host contract meets net settlement under the contract terms because neither party is required to deliver an asset associated with the underlying (such as an interest-bearing security). At settlement, cash is delivered; however, it is not an asset associated with the underlying (see Section 3.4.3.3).
▶ Does a derivative scope exception apply?	▶ If the embedded interest-rate-related feature meets **all** the characteristics of a derivative instrument, the entity must assess whether it qualifies for a derivative scope exception. Generally, no scope exception applies for an embedded interest-rate-related feature.

3.6.2.1 Clearly and Closely Related Analysis for Interest-Rate-Related Features

FASB REFERENCES

ASC 815-15-25-26, ASC 815-15-25-28 through 25-29, and ASC 815-15-25-38

An embedded feature that includes only an interest rate or interest rate index as an underlying and alters net interest payments that otherwise would be paid on an interest-bearing debt host contract is **not** clearly and closely related to the host contract (so the other bifurcation criteria must be assessed) if it results in **either**:

- A settlement under which the holder (investor) would not recover substantially all of its initial recorded investment
- A rate of return that is at least double of **both**:
  - The investor's IRR on the host contract
  - The then-current market return for a similar contract that involves a debt with a similar credit quality as the entity (borrower) at inception.

If neither condition is met, the embedded interest-rate-related feature is clearly and closely related to the debt host contract and the entity does not bifurcate it from the host contract.

The table summarizes the two conditions, as well as an entity's considerations when evaluating whether an interest-rate-related feature is clearly and closely related to a debt host contract.

CONDITIONS (ASC 815-15-25-26)	CLEARLY AND CLOSELY RELATED ANALYSIS	CONSIDERATIONS
Step a (see Section 3.6.2.1.1): Can the debt be settled in such a way that the investor (debt holder) would not recover substantially all of its initial recorded investment?	▶ If the answer is yes, the embedded feature is not clearly and closely related to the debt host contract. ▶ If the answer is no, and Step b is also not met, the embedded feature is clearly and closely related to the debt host contract.	Consider any contractual terms that could force the investor (debt holder or creditor) to accept a settlement that does not recover substantially all of its initial recorded investment, including terms that give the entity (borrower or debtor) the right to force the investor to settle in this manner, regardless of probability. This condition does not apply when the investor is allowed, but not required, to settle in this way.

CONDITIONS (ASC 815-15-25-26)	CLEARLY AND CLOSELY RELATED ANALYSIS	CONSIDERATIONS
Step b (see Section 3.6.2.1.2): Is there a possible future interest rate scenario (however remote) that the embedded feature: ▶ Would at least double the investor's IRR on the debt host contract? ▶ Would yield a return that is at least twice the then-current market return? This is commonly called the "double-double test."	▶ If the answer is yes, the embedded feature is not clearly and closely related to the debt host contract. ▶ If the answer is no, and Step a is also not met, the embedded feature is clearly and closely related to the debt host contract.	Consider any (even remote) possibility that the embedded feature would double both the investor's IRR on the host contract and the then-current market return for a contract with the same terms as the contract involving a debtor with a similar credit quality as the entity at inception. This condition applies only if the investor has the unilateral ability to receive the higher rate of return.

ASC 815-15-25-26 APPLIES ONLY TO INTEREST-RATE-RELATED UNDERLYINGS

The conditions in ASC 815-15-25-26 apply only if the underlying is an interest rate or interest rate index. For example, they do not apply to an embedded derivative that has an equity-based underlying (or another non-interest-rate underlying).

The conditions apply also when evaluating noncontingent call and noncontingent put options that have only an interest rate or interest rate index underlying. They do not apply to contingent call and contingent put options because they include another underlying (that is, the occurrence or nonoccurrence of the contingencies (see Section 3.6.3)).

Further, the conditions apply when evaluating embedded features with interest-rate-related underlyings in an outstanding share that is determined to be a debt host contract.

3.6.2.1.1 Substantially All of Initial Investment Test

FASB REFERENCES

ASC 815-15-25-26(a), ASC 815-15-25-29, and ASC 815-15-55-128 through 55-135

As discussed in Section 3.6.2.1, an entity must analyze two conditions in ASC 815-15-25-26 to determine whether an embedded interest-rate-related feature is **not** clearly and closely related to a debt host contract. The first of those conditions is that the debt's contractual terms could force the investor not to recover substantially all of its initial recorded investment.

The first condition is met if the embedded feature includes any contractual terms that allow **any** possibility that the investor's undiscounted net cash flows over the instrument's life would not recover substantially all of its initial recorded investment in the debt instrument. The condition does not apply if the terms allow, but do not require, the investor to settle the debt in that manner. In contrast, the condition is met if the entity (issuer) has the contractual right to demand a settlement that would cause the investor not to recover substantially all of its initial net investment. Probability is not relevant to the assessment.

If the investor would not recover substantially all of its initial recorded investment (the first condition is met), the interest-rate-related feature **is not** clearly and closely related to the debt host contract. On the other hand, if the contractual terms allow the investor to recover substantially all of its initial recorded investment (the first condition is not met), the feature is clearly and closely related to the debt host contract **only if** the double-double test (the second condition) is **also not met** (see Section 3.6.2.1.2).

BDO INSIGHTS — MEANING OF "SUBSTANTIALLY ALL"

An entity must apply professional judgment based on the facts and circumstances in analyzing whether the investor could be forced not to recover substantially all of its initial recorded investment because U.S. GAAP does not define the term "substantially all" in this context. We interpret substantially all to generally mean at least 90% of the initial recorded investment.

Therefore, when evaluating the first condition in ASC 815-15-25-26, if the investor could be forced to settle in such a way that it would recover less than 90% of its initial recorded investment, we believe the embedded interest-rate-related feature meets the first condition and is not clearly and closely related to the debt host contract.

EXAMPLE 3-6 (ADAPTED FROM ASC 815-15-55-128 THROUGH 55-134): RECOVERING SUBSTANTIALLY ALL OF AN INITIAL RECORDED INVESTMENT

FACTS	CONCLUSION AND ANALYSIS
Scenario 1 An entity issues to an investor Note A, which has the following terms: ▶ 10-year maturity ▶ Investor has the contingent option at the end of Year 2 to put the note back to the entity at its then-fair value.	The first condition (that the investor would not recover substantially all of its initial recorded investment) is not met because the put option is at the investor's option. Therefore, the investor could not be forced into a settlement that would cause it not to recover substantially all of its initial recorded investment. If Note A's fair value declines, the investor could choose not to exercise the option, thereby retaining the ability to recover substantially all of its initial recorded investment. The entity next evaluates if the second condition is also not met (see Section 3.6.2.1.2) to determine whether the embedded feature is clearly and closely related to the debt host contract.

FACTS	CONCLUSION AND ANALYSIS
Scenario 2 An A-credit-rated entity issues to an investor for $10 million Note B, which has the following terms: ▶ $10 million principal ▶ 9.5% coupon interest rate ▶ 10-year maturity. The current market rate for an A-rated debt with similar terms is 7%. The terms require that if, at the beginning of the third year, interest rates for A-rated debt have increased to at least 8% by that date: ▶ The principal would decrease to $7.1 million. ▶ The coupon interest rate would reduce to zero for the remaining term.	The first condition is met because the investor could be forced to accept a settlement that causes it not to recover substantially all of its initial recorded investment. If the interest rates for A-rated debt increase to at least 8%, the investor would receive only $9 million ($7.1 million principal payments plus $1.9 million in interest payments for the first two years) and therefore would not recover substantially all of its $10 million initial net investment. The embedded interest-rate-related feature is not clearly and closely related to the debt host contract.
Scenario 3 An A-credit-rated entity issues to an investor for $10 million Note C, which has the following terms: ▶ $10 million principal ▶ 8.9% coupon interest rate ▶ 10-year maturity. The current market rate for an A-rated debt with similar terms is 7%. The terms require that if interest rates for A-rated debt have increased to at least 10% at the end of two years: ▶ The coupon interest rate would reduce to zero for the remaining term. ▶ The investor must purchase from the entity an additional $10 million note for $10 million with zero coupon and a term of three-and-a-half years.	The first condition is met because the investor could be forced to accept settlement that causes it not to recover substantially all of its initial recorded investment. The requirement to purchase the second $10 million note for more than its fair value (that is, $7.1 million based on a 10% interest rate) is economically equivalent to requiring the investor to pay cash to the entity for the difference (that is, $2.9 million), which is economically equivalent to reducing the principal on the note. The cash flows on the original note and the excess purchase price on the second note* are considered together. The cash inflows on the original note of $11.78 million ($10 million principal plus $1.78 million interest) are reduced by $2.9 million. The resulting net cash inflow of $8.88 is therefore not substantially all of the investor's initial net investment on the original note of $10 million. The embedded interest-rate-related feature is not clearly and closely related to the debt host contract.

*As illustrated with Scenario 3, if an embedded derivative requires an investor to purchase an asset (whether financial or nonfinancial, such as gold) at more than its fair value, the excess purchase price — and not the cash flows related to the purchased asset — must be considered when analyzing whether the hybrid instrument can contractually be settled in such a way that the investor would not recover substantially all of its initial recorded investment.

3.6.2.1.2 Double-Double Test

FASB REFERENCES

ASC 815-15-25-26(b)

As discussed in Section 3.6.2.1, an entity must analyze two conditions in ASC 815-15-25-26 to determine whether an embedded interest-rate-related feature is clearly and closely related to the debt host contract:

- Whether an investor could be forced to accept less than substantially all of its initial recorded investment (see Section 3.6.2.1.1)
- Whether the embedded feature could force the entity (borrower) to pay an amount that is both at least double the investor's IRR on the host contract and at least double what would be the then-current market return for a similar contract by a similar issuer (the "double-double test")

If the embedded feature meets **either** condition, it is **not** clearly and closely related to the debt host contract and the other bifurcation criteria are assessed to determine whether the embedded feature must be bifurcated.

The double-double test includes the following:

- Test 1: The entity evaluates any possible interest rate scenario (however remote) under which the embedded derivative would at least double the investor's IRR on the debt host contract.
- Test 2: The entity evaluates if any of the possible interest rate scenarios that would double the investor's IRR (identified in Test 1) would **at the same time** result in a rate of return that is at least twice the then-current market rate for a contract with the same terms as the host contract involving an issuer with a credit quality similar to the entity's credit quality at inception.

The embedded feature must pass (meet) **both** tests in the double-double test to meet the second condition in ASC 815-15-25-26. If the feature meets only one test, it is clearly and closely related to the debt host contract as long as the investor cannot be forced to settle for less than substantially all of its initial recorded investment (see Section 3.6.2.1.1).

The double-double test does not consider probability. Rather, the tests are met if **any** mathematical possibilities exist in which the embedded feature would double the investor's IRR and the then-current market return based on the contractual terms.

3.6.2.2 Application Examples — Interest-Rate-Related Feature

Examples 3-7 and 3-8 illustrate an entity's analysis of embedded interest-rate-related features.

EXAMPLE 3-7: INTEREST RATE FLOOR

FACTS

Issuer A issued a five-year note with a variable interest rate equal to the prime rate, with a floor of 3%. Based on its credit rating, Issuer A could issue a five-year note without a floor at prime rate plus the entity's credit spread of 1%. The prime rate at inception is 5%. Therefore, the debt host contract has an IRR of 6%.

Issuer A did not elect to account for the note under the fair value option.

CONCLUSION

The embedded interest rate floor is clearly and closely related to the debt host contract, so it is not bifurcated from the debt instrument. Issuer A accounts for the entire debt instrument as a liability in accordance with other U.S. GAAP (for example, ASC 470 or ASC 835-30).

ANALYSIS

Issuer A evaluates the interest rate floor for bifurcation.

- Is the embedded interest rate floor **not** clearly and closely related to the debt host contract?
  - Step a: Could the embedded feature force the debt holder to settle at less than substantially all of its initial recorded investment?
    - No. The contract does not include any terms that could force the debt holder to accept settlement that is less than substantially all of its initial recorded investment.
  - Step b: Could the embedded feature force the entity to pay both twice the initial return on the host contract and twice the market rate?
    - No. No scenario exists in which the interest rate floor could double the host contract's IRR. The interest rate floor is 3%, and there is no scenario in which it would at least double the host contract's IRR to 12% (6% x 2).
    - Because the first condition of the double-double test is not met, analyzing the second condition of the test is not necessary because both conditions must be met for the feature to not be clearly and closely related to the debt host contract.

The interest rate floor is clearly and closely related to the debt host contract.

EXAMPLE 3-8: INTEREST RATE OPTION

FACTS

Issuer A issues a 10-year note that allows it to choose an interest rate of either the prime rate plus 1% or SOFR plus 3% every quarter (that is, it has an interest rate option). Interest is payable quarterly.

Based on Issuer A's credit rating, it could issue a 10-year note without the interest rate option at the prime rate plus 1%.

Issuer A did not elect to account for the note under the fair value option.

CONCLUSION

The embedded interest rate option is clearly and closely related to the debt host contract, so it is not bifurcated from the debt instrument. Issuer A accounts for the entire debt instrument as a liability in accordance with other U.S. GAAP (for example, ASC 470).

ANALYSIS

Issuer A evaluates the interest rate option for bifurcation.

- Is the interest rate option **not** clearly and closely related to the debt host contract?
  - Step a: Could the embedded feature force the debt holder to settle at less than substantially all of its initial recorded investment?
    - No. The contract does not include any terms that could force the debt holder to accept settlement that is less than substantially all of its initial recorded investment.
  - Step b: Could the embedded feature force the entity to pay both twice the initial return on the host contract and twice the market rate?
    - No. While a scenario may exist in which the interest rate option could double the host contract's IRR and result in a rate of return that is double the then-current market rate, the entity could not be forced to choose that rate.

The interest rate option is clearly and closely related to the debt host contract.

3.6.3 Call Options and Put Options on Debt Instruments

FASB REFERENCES

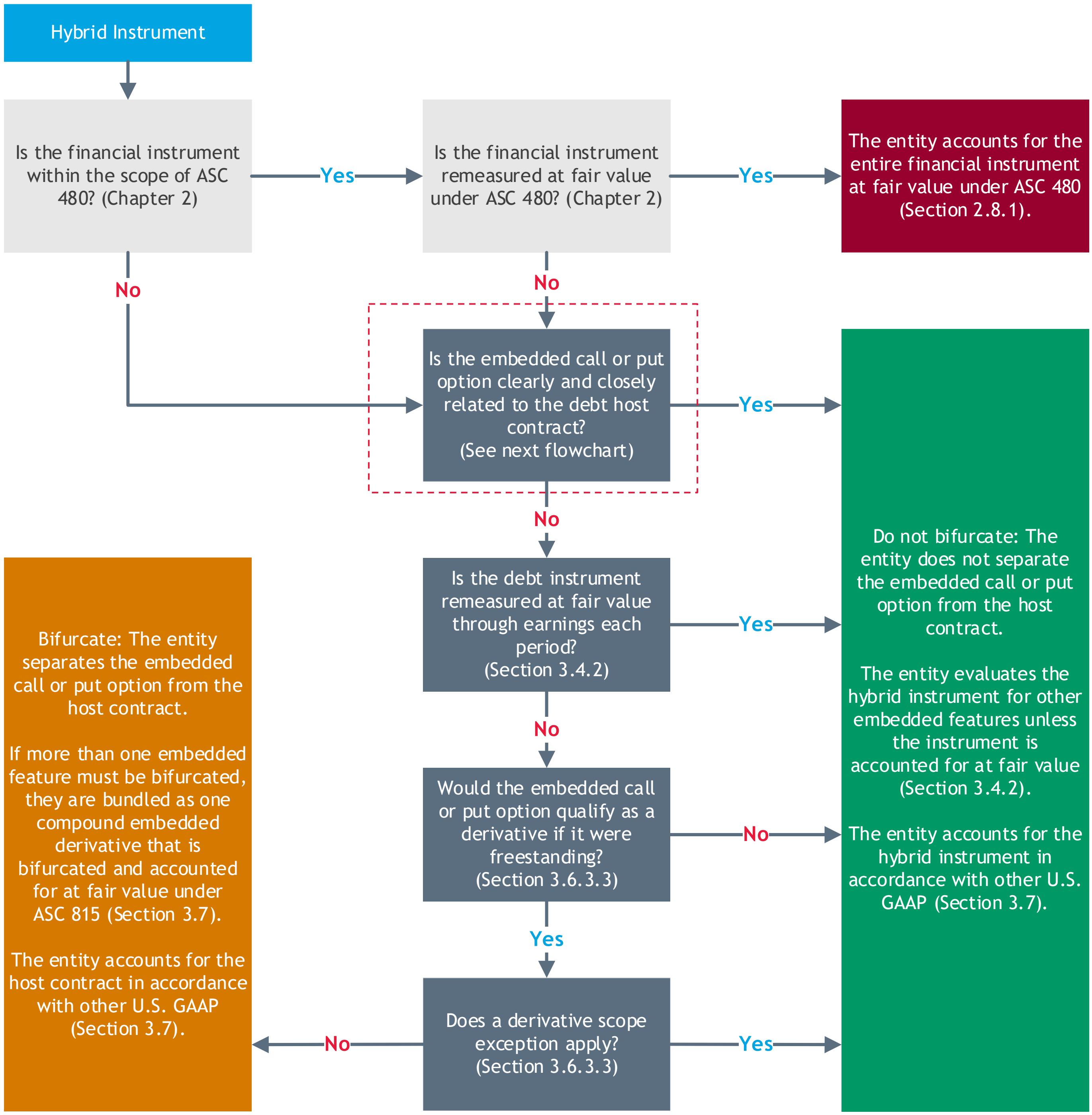
ASC 815-15-25-26, ASC 815-15-25-29, and ASC 815-15-25-41 through 25-42

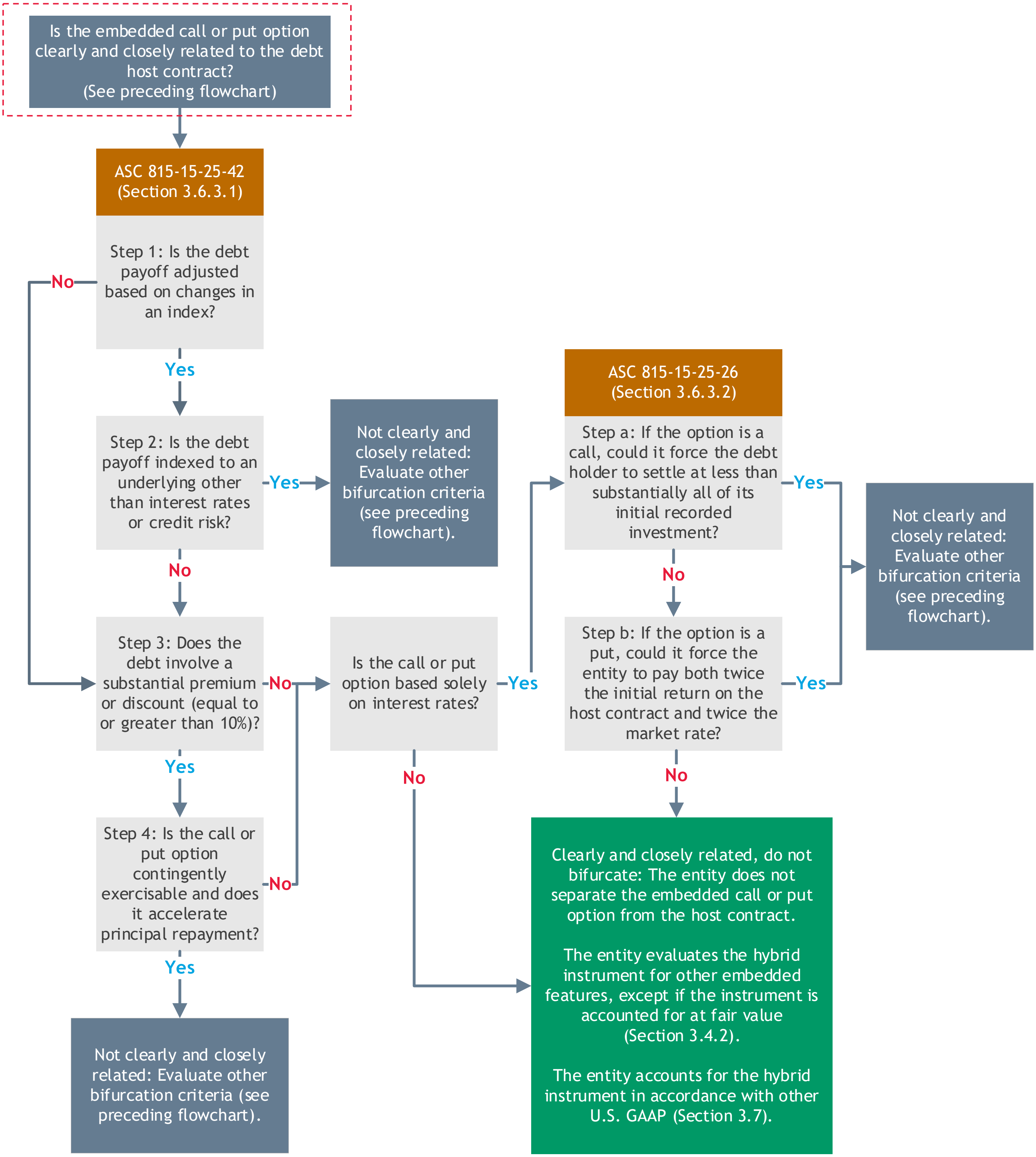
Call options allow the entity (issuer or borrower) to redeem or prepay the debt before maturity and put options allow a debt holder (creditor or lender) to demand repayment before maturity. Those options accelerate the instrument's settlement. If the call or put option does not accelerate the principal repayment but instead requires a cash settlement for the option price on the exercise date, it is not clearly and closely related to the debt host contract. When the call or put option accelerates the instrument's settlement, an entity must determine whether the call option or put option is clearly and closely related to the debt host contract based on the guidance discussed in Sections 3.6.3.1 and 3.6.3.2.

If the embedded call or put option is not clearly and closely related to the debt host contract but the debt instrument is remeasured at fair value, the embedded feature is not bifurcated. However, debt instruments are generally not remeasured at fair value unless the entity elects the fair value option for the instrument (see Section 3.4.2.1).

If the embedded call or put option is not clearly and closely related to the debt host contract and the debt instrument is not remeasured at fair value, the embedded feature is bifurcated if it would meet the definition of a derivative instrument if it were a freestanding instrument. Generally, an embedded call or put option meets the definition of a derivative instrument, regardless of whether the debt instrument is publicly traded, because it has an underlying and a notional amount or payment provision, requires little or no initial net investment, and meets the net settlement characteristic, and no derivative scope exception applies (see Section 3.6.3.3).

Presented below is the flowchart discussed in Section 3.1 as applied to an analysis of an embedded call or put option and additionally shows the analysis required in ASC 815-15 in evaluating whether the feature is clearly and closely related to a debt host contract.




Is the embedded call or put option clearly and closely related to the debt host contract? (See preceding flowchart)
ASC 815-15-25-42 (Section 3.6.3.1)
Step 1: Is the debt payoff adjusted based on changes in an index?
No
Yes
Step 2: Is the debt payoff indexed to an underlying other than interest rates or credit risk?
Yes
Not clearly and closely related: Evaluate other bifurcation criteria (see preceding flowchart).
No
Step 3: Does the debt involve a substantial premium or discount (equal to or greater than 10%)?
No
Is the call or put option based solely on interest rates?
Yes
Yes
Step 4: Is the call or put option contingently exercisable and does it accelerate principal repayment?
No
Yes
Not clearly and closely related: Evaluate other bifurcation criteria (see preceding flowchart).
No
ASC 815-15-25-26 (Section 3.6.3.2)
Step a: If the option is a call, could it force the debt holder to settle at less than substantially all of its initial recorded investment?
Yes
No
Step b: If the option is a put, could it force the entity to pay both twice the initial return on the host contract and twice the market rate?
Yes
Not clearly and closely related: Evaluate other bifurcation criteria (see preceding flowchart).
No
Clearly and closely related, do not bifurcate: The entity does not separate the embedded call or put option from the host contract.
The entity evaluates the hybrid instrument for other embedded features, except if the instrument is accounted for at fair value (Section 3.4.2).
The entity accounts for the hybrid instrument in accordance with other U.S. GAAP (Section 3.7).

The table illustrates how an entity generally applies the preceding flowcharts in evaluating call options and put options in debt host contracts for bifurcation. Entities must apply professional judgment based on the facts and circumstances.

BIFURCATION CRITERIA	ANALYSIS
Is the embedded call or put option not clearly and closely related to the debt host contract?	Often, determining whether to bifurcate a call or put option depends on whether the option is **not** clearly and closely related to the debt host contract because the other criteria for bifurcation are typically met.
▶ Step 1: Is the debt payoff adjusted based on changes in an index? ▶ Step 2: Is the debt payoff indexed to an underlying other than interest rates or credit risk? ▶ Step 3: Does the debt involve a substantial premium or discount (equal to or greater than 10%)? ▶ Step 4: Is the call or put option contingently exercisable and does it accelerate the principal repayment?	ASC 815 includes a four-step decision sequence and guidance to determine whether the economic risks and characteristics of embedded call and put options are not clearly and closely related to the economic characteristics and risks of a debt host contract (see Section 3.6.3.1). Embedded call and put options with a payoff (the amount paid at settlement) that is indexed to an underlying **other than** interest rates or credit risk (for example, indexed to an equity stock price) are not clearly and closely related to a debt host contract. Similarly, call and put options that are contingently exercisable (for example, upon a change in control) and that involve a substantial premium or discount are not clearly and closely related to a debt host contract.
▶ Is the call or put option based solely on interest rates? ▶ Step a: If the option is a call, could it force the debt holder to settle at less than substantially all of its initial recorded investment? ▶ Step b: If the option is a put, could it force the entity to pay both twice the initial return on the host contract and twice the market rate?	ASC 815-15-25-26 includes additional analysis for call and put options that have **only** an interest rate or interest rate index underlying. The additional analysis does not apply to contingent call and contingent put options because they include another underlying, that is, the contingencies (see Section 3.6.3.2). If the call option could force the investor not to recover substantially all of its initial recorded investment, it is not clearly and closely related to the debt host contract. If the put option could force the entity (borrower) to pay both at least double the host contract's IRR and at least double the then-current market return for a similar contract by a similar issuer, the put option is not clearly and closely related to the debt host contract. If the call or put option is not clearly and closely related to the debt host contract, the entity must assess the other two bifurcation criteria below. In contrast, if the call or put option is clearly and closely related to the debt host contract, the feature is not bifurcated.
Is the debt instrument not remeasured at fair value through earnings each period?	An entity generally does not remeasure debt instruments at fair value through earnings unless it elects the fair value option in ASC 815 or ASC 825. An entity cannot elect the fair value option for debt instruments that have components recognized in equity (see Section 3.4.2.1). If the debt instrument is not remeasured at fair value and the embedded feature is not clearly and closely related to the debt host contract, the entity must analyze the third criterion for bifurcation.

Would the embedded call or put option qualify as a derivative instrument if it were freestanding?	Whether the embedded call or put option has the characteristics of a derivative is generally analyzed as shown below.
▶ Does it have one or more underlyings and either (or both) a notional amount or payment provision?	▶ In a typical call or put option, the interest rate, interest rate index, or the occurrence or nonoccurrence of contingencies (if any) represents the underlying, while the debt's face amount represents the notional amount. Debt instruments also typically include payment provisions. Therefore, an embedded call or put option generally meets the first characteristic of a derivative instrument (see Section 3.4.3.1).
▶ Does it require little or no initial net investment?	▶ ASC 815-15-25-1(c) states that the initial net investment for the hybrid instrument is **not** the initial net investment for the embedded derivative (that is, the call or put option (see Section 3.4.3.2)). Accordingly, a call or put option meets the second characteristic of a derivative instrument because it requires little or no initial net investment.
▶ Does it meet net settlement?	▶ The exercise of an embedded call or put option on a debt instrument meets net settlement under the contract terms because neither party is required to deliver an asset associated with the underlying (such as an interest-bearing security). At settlement, cash is delivered, but it is not an asset associated with the underlying (see Section 3.6.3.3).
▶ Does a derivative scope exception apply?	▶ If the embedded call or put option meets all the characteristics of a derivative instrument, the entity must assess whether it qualifies for a derivative scope exception. Generally, no scope exception applies for call and put options embedded in a debt host contract (see Section 3.6.3.3).

SHARE-SETTLED CALL OR PUT OPTIONS

Some instruments include a call or put option that is settleable in a variable number of the entity's shares; for example, debt redeemable in a variable number of shares with a value equal to the debt's principal amount and accrued interest if an entity completes an equity financing event.

A call or put option settleable in a variable number of shares is not assessed as a conversion feature. The entity must assess that embedded feature using the guidance discussed in this section (rather than the guidance discussed in Section 3.6.1).

Further, some embedded features may include elements of both a redemption and conversion feature. For example, some debt instruments are redeemable (or convertible) when a qualified financing occurs for shares issued in that qualified financing. The redemption (or conversion) price is equal to the lesser of (1) the price per share paid in that qualified financing (resulting in issuing a variable number of shares based on the debt's principal amount divided by the price per share of the shares issued at settlement) or (2) a fixed conversion price (resulting in issuing a fixed number of shares). As discussed in Section 3.3.2, an entity must first determine the unit of analysis for the embedded feature, which requires the use of professional judgment based on the facts and circumstances. We believe it is acceptable to evaluate that embedded feature as two units of analysis: one redemption feature for a variable number of shares and one conversion feature for a fixed number of shares. In that case, the entity evaluates the redemption feature under the guidance discussed in this section and the conversion feature under the guidance discussed in Section 3.6.1.

3.6.3.1 Call and Put Options — Four-Step Decision Sequence (ASC 815-15-25-42)

FASB REFERENCES

ASC 815-15-25-42 and ASC 815-15-55-13

As discussed in Section 3.6.3, an entity determines whether call or put options that can accelerate the settlement of debt instruments are clearly and closely related to the debt host contract using a four-step decision sequence:

- Step 1: Is the payoff adjusted based on changes in an index?
- Step 2: Is the payoff indexed to an underlying other than interest rates or credit risk?
- Step 3: Does the debt instrument involve a substantial premium or discount?
- Step 4: Is the call or put option contingently exercisable and does it accelerate the principal repayment?

In Steps 1 and 2, when evaluating embedded call and put options, an entity considers whether the payoff (that is, the amount paid upon settlement) is adjusted based on changes in an index and, if so, whether it is indexed to an underlying other than interest rates or credit risk. If the payoff upon exercise of the call or put option is based on an index other than interest rates or credit risk, the call or put option is not clearly and closely related to the debt host contract.

	EXAMPLES OF WHEN STEPS 1 AND 2 ARE MET	EXAMPLES OF WHEN STEPS 1 AND 2 ARE NOT MET
Payoff based on changes in an index other than interest rates or credit risk	Examples of a payoff indexed to an underlying other than interest rates or credit risk include: ▶ A settlement adjusted based on the market value of the number of shares of an unrelated entity's common stock ▶ Par amount of debt adjusted for the percentage increase in the S&P 500 In those cases, Steps 1 and 2 are met and the feature is **not** clearly and closely related to the debt host contract.	Examples of a payoff not indexed to an underlying other than interest rates or credit risk include: ▶ The par amount of the debt plus any unpaid and accrued interest ▶ 1.5 times the par amount of the debt In those cases, Steps 1 and 2 are not met and Steps 3 and 4 must be assessed.

If Steps 1 and 2 are not met (for instance, settlement amount includes only principal and interest payments indexed to interest rate and credit risk), the entity must further assess the call or put option in accordance with ASC 815-15-25-26 if they are noncontingent. That is true regardless of whether they involve a substantial premium or discount — that is, regardless of whether Step 3 is met (see Section 3.6.3.2).

If the call or put option is contingent (Step 4 is met), ASC 815-15-25-26 does not apply because it applies to embedded features that have only an interest rate or an interest rate index underlying. In other words, a contingently exercisable call or put option includes another underlying (that is, the exercise contingency) other than interest rate and credit risk. Some common examples of contingently exercisable calls and puts include redemption upon:

- S&P index increasing by at least 20%
- The entity's stock price increasing by at least 20%
- A change in control or a business combination
- Completing a qualified financing
- Completing an IPO
- An event of default.

Whether a contingent call or put option is clearly and closely related to the debt host contract depends on whether it involves a substantial premium or discount.

- If it includes a substantial premium or discount (Step 3 is met), it is not clearly and closely related to the debt host contract (because it also meets Step 4).
- If it does not include a substantial premium or discount (Step 3 is not met), it is clearly and closely related to the debt host contract.

BDO INSIGHTS — DETERMINING WHETHER A PREMIUM OR DISCOUNT IS SUBSTANTIAL

U.S. GAAP does not define when a premium or discount is considered substantial; however, we believe that in practice it generally means at least 10%.

In determining whether a call or put involves a substantial premium or discount, we believe an entity should compare:

- The gross proceeds allocated to the debt less fees paid to the creditor
- The amount that would be paid to the creditor when the call or put is exercised (including any premium payable at settlement).

Also, we believe fees paid to third parties and discounts resulting from bifurcating other embedded derivatives generally should not be considered in that computation.

Lastly, we believe a substantial premium or discount may arise in circumstances other than at issuance of the financial instrument; for instance, in a business combination or a debt amendment accounted for as an extinguishment in accordance with ASC 470-50 (that is, when the financial instrument is subject to a new basis event).

	EXAMPLES OF WHEN STEP 3 IS MET	EXAMPLES OF WHEN STEP 3 IS NOT MET
Contingently exercisable calls and puts (Step 4 is met)	Examples of contingently exercisable calls and puts that include a substantial discount or premium include: ▶ Debt with a face amount of $1,000 issued at $950 and puttable by the holder at $1,050 upon a change in control. ▶ Debt with a face amount of $1,000 issued with detachable warrants for gross proceeds of $1,000; warrants and debt allocated $100 and $900, respectively, of the proceeds; and debt callable by the entity at $1,000 upon IPO. In those cases, Steps 3 and 4 are met and the feature is **not** clearly and closely related to the debt host contract.	Examples of contingently exercisable calls and puts that do not include a substantial discount or premium include: ▶ Debt with a face amount of $1,000 issued at par and puttable by the holder at par upon a change in control. ▶ Debt with a face amount of $1,000 issued with detachable warrants for gross proceeds of $1,000; warrants and debt allocated $80 and $920, respectively, of the proceeds; and debt callable by the entity at $1,000 upon IPO. In those cases, Step 4 is met but Step 3 is not met; the feature **is** clearly and closely related to the debt host contract.

EXAMPLE 3-9 (ADAPTED FROM ASC 815-15-55-13): CALL AND PUT OPTIONS IN DEBT INSTRUMENTS

This example applies the four-step decision sequence in determining whether call and put options in debt instruments are clearly and closely related to the debt host contract.

INSTRUMENT	STEPS 1 AND 2: INDEXED PAYOFF?	STEP 3: SUBSTANTIAL DISCOUNT OR PREMIUM?	STEP 4: CONTINGENTLY EXERCISABLE?	EMBEDDED OPTION CLEARLY AND CLOSELY RELATED TO THE DEBT HOST CONTRACT?
Debt issued at par is callable at any time during its term. If the issuer exercises the call, it pays the greater of the debt's par or the market value of 100,000 shares of Entity X's common stock (an unrelated entity).	Yes, based on an equity price (price of Entity X's common stock).	Not applicable. Analysis not required.	Not applicable. Analysis not required.	The embedded call option is not clearly and closely related to the debt host contract because the payoff is indexed to an equity price.
Debt issued at par is puttable if the S&P 500 Index increases by at least 20%. If the investor exercises the put, the issuer pays the debt's par adjusted for the percentage increase in the S&P 500.	Yes, based on an equity index (S&P 500).	Not applicable. Analysis not required.	Not applicable. Analysis not required.	The embedded put option is not clearly and closely related to the debt host contract because the payoff is based on an equity index.
Debt issued at par is puttable if the price of Entity X's common stock (an entity unrelated to the issuer or investor) changes by at least 20%. If the investor exercises the put, the issuer pays an amount based on the value of Entity X's common stock.	Yes, based on an equity price (price of Entity X's common stock).	Not applicable. Analysis not required.	Not applicable. Analysis not required.	The embedded put option is not clearly and closely related to the debt host contract because the payoff is indexed to an equity price.
Debt issued at a slight discount is puttable if interest rates move 200 basis points. If the investor exercises the put, the issuer pays an amount based on the S&P 500.	Yes, based on an equity index (S&P 500).	Not applicable. Analysis not required.	Not applicable. Analysis not required.	The embedded put option is not clearly and closely related to the debt host contract because the payoff is based on an equity index.

INSTRUMENT	STEPS 1 AND 2: INDEXED PAYOFF?	STEP 3: SUBSTANTIAL DISCOUNT OR PREMIUM?	STEP 4: CONTINGENTLY EXERCISABLE?	EMBEDDED OPTION CLEARLY AND CLOSELY RELATED TO THE DEBT HOST CONTRACT?
Debt issued at a substantial discount is callable at any time during its 10-year term. If the issuer exercises the call, it pays the debt's par value plus any unpaid and accrued interest.	No.	Yes.	No.	Because the call is solely based on interest rates, additional analysis under ASC 815-15-25-26 is required (see Section 3.6.3.2).
Debt issued at par is puttable at par upon an IPO.	No.	No.	Not applicable. Analysis not required.	The embedded put option is clearly and closely related to the debt host contract because the debt was not issued at a substantial discount or premium (issued at par and is puttable at par). ASC 815-15-25-26 does not apply because the put is not solely based on interest rates (it is also based on a contingency (the IPO)).
Debt issued at a substantial discount is puttable at par if SOFR changes by 150 basis points.	No. The debt payoff is not affected by changes in SOFR (instead, it is a contingency).	Yes.	Yes, contingent on a SOFR changing by at least 150 basis points.	The put option is not clearly and closely related to the debt host contract because the debt was issued at a substantial discount and the put option is contingently exercisable.
Debt issued at a substantial discount is puttable at par upon a change in control.	No.	Yes.	Yes, contingent on a change in control.	The put option is not clearly and closely related to the debt host contract because the put option is contingently exercisable and the debt was issued at a substantial discount.

INSTRUMENT	STEPS 1 AND 2: INDEXED PAYOFF?	STEP 3: SUBSTANTIAL DISCOUNT OR PREMIUM?	STEP 4: CONTINGENTLY EXERCISABLE?	EMBEDDED OPTION CLEARLY AND CLOSELY RELATED TO THE DEBT HOST CONTRACT?
Debt issued with a zero coupon and at a substantial discount is callable upon a change in control. If the issuer exercises the call, it pays the accreted value (computed per amortization table based on the effective interest rate method).	No.	Yes.	Yes, contingent on a change in control. But because the debt is callable at accreted value, the call option does not accelerate the principal repayment.	The call option is clearly and closely related to the debt host contract. Although the debt was issued at a substantial discount and the call option is contingently exercisable, the call option does not accelerate the principal repayment because the debt is callable at the accreted value.

3.6.3.2 Additional Analysis in ASC 815-15-25-26

FASB REFERENCES

ASC 815-15-25-26, ASC 815-15-25-28, and ASC 815-15-25-38

Noncontingent call and put options that have only interest rates or credit risk underlyings must meet the criteria in ASC 815-15-25-26 to be considered **not** clearly and closely related to the debt host contract. The call and put options meet the criteria (and therefore are not clearly and closely related to the host contract) if the options include a term that could result in **either**:

- A settlement in which the holder would not recover substantially all of its initial recorded investment
- A rate of return that is at least double of **both**:
  - The investor's IRR on the host contract
  - The then-current market return for a similar contract that involves a debt with a similar credit quality as the issuer at inception.

If neither of the two conditions is met, the call or put option is clearly and closely related to the debt host contract and the entity does not bifurcate the embedded feature from the debt instrument.

ASC 815-15-25-26 does not apply if the embedded derivative has an underlying other than interest rates or credit risk (for example, a contingency or a stock price index or other non-interest rate index).

The table summarizes the two conditions and an entity's considerations when evaluating whether a call or put option is clearly and closely related to a debt host contract.

CONDITIONS (ASC 815-15-25-26)	CLEARLY AND CLOSELY RELATED ANALYSIS	CONSIDERATIONS
Step a: Can the debt be settled in such a way that the investor (debt holder) would not recover substantially all of its initial recorded investment?	▶ If the answer is yes, the embedded feature is not clearly and closely related to the debt host contract. ▶ If the answer is no, and Step b is also not met, the embedded feature is clearly and closely related to the debt host contract.	▶ Consider any possibility (per the contractual terms) that the investor's undiscounted net cash inflows over the instrument's life would not recover substantially all of its initial recorded investment, regardless of probability. ▶ This condition does not apply to put options held by the investor because the entity cannot compel the investor into a loss.
Step b: Is there a possible future interest rate scenario (however remote) that the embedded feature: ▶ Would at least double the investor's IRR on the host contract? ▶ Would yield a return that is at least twice the then-current market return? This is commonly called the "double-double test."	▶ If the answer is yes, the embedded feature is not clearly and closely related to the debt host contract, ▶ If the answer is no, and Step a is also not met, the embedded feature is clearly and closely related to the debt host contract.	▶ Consider any possibility (even if remote) that the embedded feature would double both the investor's IRR on the host contract and the then-current market return for a contract with the same terms as the host contract involving a debtor with a similar credit quality as the entity at inception. ▶ This condition applies only if the investor has the unilateral ability to receive the high rate of return, so it does not apply to call options held by the issuer.

The tests in ASC 815-15-25-26 do not consider probability. Instead, they consider any mathematical possibilities based on the contractual terms to determine whether the embedded feature meets the tests.

3.6.3.3 Net Settlement Through Exercise of an Embedded Call or Put Option

FASB REFERENCES

ASC 815-10-15-107 through 15-109

If the embedded call or put feature is not clearly and closely related to the debt host contract and the debt is not remeasured at fair value, the embedded feature is bifurcated if it would meet the definition of a derivative instrument if it were freestanding and no scope exception applies. Generally, an embedded call or put feature in a host contract meets the definition of a derivative instrument because it includes an underlying and a notional amount or payment provision, requires little or no initial net investment, and meets the net settlement characteristic. Also, no derivative scope exception typically applies.

CALL OR PUT OPTIONS IN A DEBT HOST CONTRACT MEET THE NET SETTLEMENT CHARACTERISTIC

As discussed in Section 3.4.3.3, the debtor's potential settlement of its obligation to the creditor upon exercising an embedded call or put option **meets** the net settlement characteristic of a derivative instrument in ASC 815.

ASC 815-10-15-107 through 15-109 indicate that when an entity (debtor) settles its own debt upon exercise of a call or a put option, the settlement does not involve the delivery of an asset that is associated with the underlying. Even if the creditor returns evidence, such as a canceled note payable, to the debtor upon settlement, the conclusion remains that the settlement does not involve the delivery of an asset. The debtor's payment to the creditor to settle the debt obligation is not associated with the underlying because cash paid denominated in the debtor's functional currency is not related to any underlying for the embedded call or put option. Because the debtor does not receive an asset when it settles the debt obligation in conjunction with an exercise of a call or put option and the creditor does not receive an asset associated with the underlying, the net settlement characteristic in ASC 815 is met. That conclusion is based on the fact that an asset associated with the underlying is not delivered, not on whether the debt instrument is readily convertible to cash. Consequently, it is irrelevant whether the debt is publicly traded or not.

Further, we believe a share-settled embedded call or put option in a debt host contract also meets net settlement, regardless of whether the underlying shares delivered at settlement are readily convertible to cash. That is because while the settlement involves delivery of an asset (that is, the entity's shares), the asset is not associated with any underlying for the embedded call or put option. In that instance, shares are used as a form of currency (a variable number of shares with a fixed amount) and the total value does not respond to changes in fair value of the underlying shares.

A call or put option (either cash- or share-settled) in a debt instrument generally meets the definition of a derivative because it also has the first (see Section 3.4.3.1) and second (see Section 3.4.3.2) characteristics of a derivative instrument.

The preceding guidance applies only to embedded put and call options in a hybrid instrument that contains a debt host contract. An entity must not apply that guidance by analogy to embedded options in a hybrid instrument that does not contain a debt host contract.

BDO INSIGHTS — DERIVATIVE SCOPE EXCEPTION FOR CALL OR PUT OPTIONS IN A DEBT HOST CONTRACT

Typically, there is no derivative scope exception that applies to a cash-settled embedded call or put option on a debt instrument. The call or put option will typically not meet an exception even if it must or can be settled in shares (at the entity's option). That is because the entity will typically not be able to conclude it has sufficient authorized and unissued shares to satisfy the embedded feature upon settlement because the number of shares that the entity must issue is unlimited (see Section 4.6.2.3).

If the instrument's debt host contract is an outstanding share, the embedded feature is analyzed to determine whether it meets the scope exception in ASC 815-10-15-74(a) (see Example 3-12).

Determining whether an embedded feature meets a derivative scope exception requires the application of professional judgment based on the facts and circumstances.

3.6.3.4 Application Examples — Embedded Call and Put

Examples 3-10 through 3-12 illustrate an entity's analysis of embedded call and put options in a debt host contract.

EXAMPLE 3-10: EMBEDDED CALL AND PUT OPTIONS IN A DEBT HOST CONTRACT

FACTS

Issuer A issues a debt instrument and a warrant to purchase one share of its common stock to a lender for $100,000. The debt includes the following terms:

- Principal: $100,000
- Maturity date: Principal payable five years after issuance
- Coupon interest rate: 8% per annum, payable monthly
- Noncontingent call option: Issuer A can call the debt at any time after issuance by paying the principal, unpaid accrued interest, and a prepayment fee of 2% of the principal
- Noncontingent put option: The lender can put the debt back to Issuer A two years after issuance and require Issuer A to pay the principal plus unpaid accrued interest
- Events of default put option: If Issuer A violates specified debt covenants, the lender can require Issuer A to pay the principal and unpaid accrued interest plus 3% of the principal
- Change of control put option: The lender can put the debt back to Issuer A upon a change in control and require Issuer A to pay the principal, unpaid accrued interest, and 5% of principal.

The warrant is classified in equity based on its terms. Issuer A estimated the fair value of the debt instrument and the warrant and allocated proceeds between the two financial instruments based on their relative fair values ($95,000 to the debt and $5,000 to the warrants), therefore creating a discount on the debt instrument of $5,000.

Issuer A did not elect to account for the debt under the fair value option.

CONCLUSION

Issuer A's noncontingent call option, the lender's noncontingent put option, and the events of default put option are not bifurcated from the debt instrument. The change in control put option is bifurcated and accounted for separately as a derivative liability; accordingly, it is initially and subsequently measured at fair value. After bifurcating the change in control put option, Issuer A accounts for the debt instrument in accordance with other U.S. GAAP (for example, ASC 470 and ASC 835-30).

ANALYSIS

Issuer A evaluates the embedded redemption features (puts and calls) for bifurcation.

- Are the redemption features not clearly and closely related to the debt host contract?

	ISSUER A'S NONCONTINGENT CALL OPTION	LENDER'S NONCONTINGENT PUT OPTION	EVENTS OF DEFAULT PUT OPTION	LENDER'S CHANGE IN CONTROL PUT OPTION
Analysis under ASC 815-15-25-42				
Step 1: Is the payoff (the amount paid at settlement) adjusted based on changes in an index? If yes, go to Step 2. If no, go to Step 3.	No. The payoff is not based on changes in an index. Go to Step 3.	No. The payoff is not based on changes in an index. Go to Step 3.	No. The payoff is not based on changes in an index. Go to Step 3.	No. The payoff is not based on changes in an index. Go to Step 3.

	ISSUER A'S NONCONTINGENT CALL OPTION	LENDER'S NONCONTINGENT PUT OPTION	EVENTS OF DEFAULT PUT OPTION	LENDER'S CHANGE IN CONTROL PUT OPTION
Step 2: Is the payoff indexed to an underlying other than interest rates or credit risk? If yes, the call or put is not clearly and closely related to the debt host contract. If no, go to Step 3.	Not applicable.	Not applicable.	Not applicable.	Not applicable.
Step 3: Does the debt involve a substantial premium or discount? If yes, go to Step 4. If no, go to "Additional Analysis Under ASC 815-15-25-26."	No. If settled upon exercising the call option, the instrument involves a ~7% premium or discount (payoff of \$102,000 less the debt's initial carrying amount of \$95,000 divided by \$95,000). Go to "Additional Analysis Under ASC 815-15-25-26."	No. If settled upon exercising the put option, the instrument involves a ~5% premium or discount (payoff of \$100,000 less the debt's initial carrying amount of \$95,000 divided by \$95,000). Go to "Additional Analysis Under ASC 815-15-25-26."	No. If settled when the events of default put option is triggered, the instrument involves a ~8% premium or discount (payoff of \$103,000 less the debt's initial carrying amount of \$95,000 divided by \$95,000). Go to "Additional Analysis Under ASC 815-15-25-26."	Yes. If settled when the change in control put is triggered, the instrument involves a ~11% premium or discount (payoff of \$105,000 less the debt's initial carrying amount of \$95,000 divided by \$95,000). Go to Step 4.
Step 4: Is the call or put contingently exercisable? If yes, the call or put is not clearly and closely related to the debt host contract. If no, go to "Additional Analysis Under ASC 815-15-25-26."	Not applicable.	Not applicable.	Not applicable.	Yes. The change in control put option is contingently exercisable. The change in control put is **not** clearly and closely related to the debt host contract.
Is the call or put based solely on interest rates? If yes, further analysis is required under ASC 815-15-25-26. If no, the feature is clearly and closely related to the debt host contract.	Yes. The call option is based solely on interest rates. Further analysis is required.	Yes. The put option is based solely on interest rates. Further analysis is required.	No. The events of default put option is not based solely on interest rates. It contains another underlying, which is the failure to comply with debt covenants. The feature **is** clearly and closely related to the debt host contract.	Not applicable.

	ISSUER A'S NONCONTINGENT CALL OPTION	LENDER'S NONCONTINGENT PUT OPTION	EVENTS OF DEFAULT PUT OPTION	LENDER'S CHANGE IN CONTROL PUT OPTION
Additional analysis under ASC 815-15-25-26				
Step a: If the option is a call, could it force the debt holder to settle at less than substantially all of its initial recorded investment? If yes, the call is not clearly and closely related to the debt host contract. If no, the call is clearly and closely related to the debt host contract.	No. The debt holder could not be forced to settle at less than substantially all of its initial recorded investment. The payoff of $102,000 is more than the initial recorded investment of $95,000. The call option **is** clearly and closely related to the debt host contract.	Not applicable because the feature is a put option, not a call option.	Not applicable.	Not applicable.
Step b: If the option is a put, could it force the entity to pay both twice the initial return on the host contract and twice the market rate? If yes, the put is not clearly and closely related to the debt host contract. If no, the put is clearly and closely related to the debt host contract.	Not applicable because the feature is a call option, not a put option.	No. Issuer A could not be forced to pay twice the debt's IRR. The debt holder's IRR on the debt, without the put option, is 9.25%. If the debt is settled immediately after the second anniversary of the debt issuance, the debt holder earns a return of 10.79%, which is not double its IRR. The put option **is** clearly and closely related to the debt host contract.	Not applicable.	Not applicable.
Are the redemption features **not** clearly and closely related to the debt host contract?	The noncontingent call option **is** clearly and closely related to the debt host contract.	The lender's noncontingent put option **is** clearly and closely related to the debt host contract.	The events of default put option **is** clearly and closely related to the debt host contract.	The change in control put option is **not** clearly and closely related to the debt host contract.

The noncontingent call option, lender's noncontingent put option, and events of default put option are clearly and closely related to the debt host contract and therefore do not meet the criteria for bifurcation from the debt instrument.

Because the change in control put option is not clearly and closely related to the debt host contract, the following additional analysis is performed:

- Is the debt instrument **not** remeasured at fair value through earnings each period?
  - The entity did not elect the fair value option and the debt is not required to be remeasured at fair value through earnings each period.
- Would the change in control put option qualify as a derivative instrument if it were freestanding? If so, does a derivative scope exception apply?
  - Yes, the change in control put option includes at least one underlying (interest rate and occurrence of a change in control) and notional amount (debt's face amount), requires little or no initial net investment (see Section 3.4.3.2), meets net settlement, and no derivative scope exception applies (see Section 3.6.3.3).

Because the change in control put option is not clearly and closely related to the debt host contract, the debt is not remeasured at fair value, and the change in control put option would be a derivative instrument if it were issued as a freestanding put option, Issuer A must bifurcate that put option from the debt instrument.

After the embedded change in control put option is bifurcated, the debt instrument is accounted for under other U.S. GAAP. The bifurcation of the change in control put option creates an additional discount on the debt instrument, which increases the interest recognized periodically under the effective interest method.

EXAMPLE 3-11: PUT OPTION ON PREFERRED STOCK THAT IS A DEBT HOST

FACTS

Issuer A issues 1,000 shares of redeemable preferred stock for $1 million.

- After five years, the holder can require Issuer A to redeem the shares of preferred stock at the original issue price plus accrued and unpaid dividends (put option).
- The preferred stock has 8% cumulative dividends. The preferred stock does not have any voting rights.
- Issuer A determines that the redeemable preferred stock is a debt host (that is, the preferred stock is debt-like (see Section 3.4.1.1)).

CONCLUSION

The put option is not bifurcated from the preferred stock. Issuer A accounts for the preferred stock in accordance with other U.S. GAAP (for example, ASC 505-10 (see Section 6.3.3) or ASC 480-10-S99-3A (see Chapter 5)).

ANALYSIS

Issuer A evaluates the put option for bifurcation.

- Is the put option **not** clearly and closely related to the debt host contract?
  - Step 1: Is the payoff (the amount paid at settlement) adjusted based on changes in an index? If yes, go to Step 2. If no, go to Step 3.
    - No, the payoff is not based on changes in an index.
  - Step 2: Is the payoff indexed to an underlying other than interest rates or credit risk? If yes, the put is not clearly and closely related to the debt host contract. If no, go to Step 3.
    - Not applicable because the payoff is not based on changes in an index.
  - Step 3: Does the preferred stock involve a substantial premium or discount? If yes, go to Step 4. If no, go to "Additional Analysis Under ASC 815-15-25-26."
    - No, the preferred stock does not involve a substantial premium or discount. The repayment amount upon exercise of the put option is the original issue price plus accrued and unpaid dividends. See additional analysis below.

- Step 4: Is the put contingently exercisable?
  - No, the put option is not contingently exercisable. Further, this step does not apply because the preferred stock does not involve a substantial premium or discount.

Because the put option does not have an underlying other than interest rate (that is, the dividend rate), Issuer A performs the following additional analysis:

- Step a: Could the preferred stockholder be forced to settle at less than substantially all of its initial recorded investment?
  - Not applicable to a put option because it could not force the holder to accept settlement that is less than substantially all of its initial recorded investment.
- Step b: Could the entity be forced to pay both twice the initial return on the host contract and twice the market rate?
  - No, exercising the holder's put option cannot double the host contract's IRR because no term adjusts the instrument's yield (dividends).

The put option is clearly and closely related to the debt host contract and therefore does not meet the criteria for bifurcation.

EXAMPLE 3-12: CONVERTIBLE PREFERRED STOCK THAT IS A DEBT HOST AND WITH REDEMPTION FEATURE INDEXED TO STOCK PRICE

FACTS

Issuer A issues 1,000 shares of preferred stock for $10 per share.

- Each share of preferred stock is convertible into one share of common stock at any time at the holder's option (conversion option).
- Issuer A must redeem the shares of preferred stock in cash when a change in control occurs (contingent redemption feature). The redemption price is equal to the stock's conversion value (that is, the fair value of the underlying shares of common stock at the time of redemption).
- The preferred stock has 8% cumulative dividends.
- The preferred stock does not have any voting rights.
- Issuer A is a privately held entity.
- Issuer A determines that the convertible preferred stock has a debt host contract (that is, the preferred stock is debt-like (see Section 3.4.1.1)).

CONCLUSION

Issuer A does not bifurcate the conversion option from the preferred stock. It bifurcates the contingent redemption feature as a derivative liability, initially and subsequently measured at fair value, with fair value changes recognized in earnings. After bifurcating the contingent redemption feature, Issuer A accounts for the preferred stock in accordance with other U.S. GAAP (for example, ASC 505-10 (see Section 6.3.3) or ASC 480-10-S99-3A (see Chapter 5)).

ANALYSIS

Issuer A evaluates the following embedded features for bifurcation: a conversion option and a contingent redemption feature that adjusts the redemption payment based on Issuer A's stock price.

- Are the embedded features **not** clearly and closely related to the debt host contract?
  - The conversion feature has economics and risks characteristics of an equity instrument; therefore, it is not clearly and closely related to the debt host contract (that is, the preferred stock with debt-like characteristics).
  - The contingent redemption feature includes an equity-indexed payment; therefore, it is not clearly and closely related to the debt host contract.

- Step 1: Is the payoff (the amount paid at settlement) adjusted based on changes in an index? If yes, go to Step 2. If no, go to Step 3.
  - Yes, the payoff is potentially based on changes in Issuer A's stock price.
- Step 2: Is the payoff indexed to an underlying other than interest rates or credit risk? If yes, the call or put is not clearly and closely related to the instrument. If no, go to Step 3.
  - Yes, the payoff is indexed to an underlying other than interest rates or credit risk because it is indexed to Issuer A's stock price.
  - The redemption feature is not clearly and closely related to the debt host contract. Therefore, Steps 3 and 4 do not apply.

- Is the preferred stock **not** remeasured at fair value through earnings each period?
  - The preferred stock is not remeasured at fair value through earnings each period, and Issuer A cannot elect the fair value option for the preferred stock (see Section 3.4.2.1).
- Would the embedded features qualify as a derivative instrument if they were freestanding?
  - The conversion option does not meet the definition of a derivative instrument. That is because it does not meet the net settlement characteristic because Issuer A's common and preferred shares are not publicly traded. Also, the conversion option cannot be net settled under the contract terms because Issuer A must deliver the full stated number of common shares in exchange for the full stated number of preferred shares upon conversion (that is, physical settlement).
  - The contingent redemption feature has an underlying (interest rate, stock price, and change in control) and notional amount (see Section 3.4.3.1), requires no initial net investment (see Section 3.4.3.2), and meets net settlement under the contract terms because neither party must deliver an asset associated with the underlying (see Section 3.4.3.3).
- Does a derivative scope exception apply?
  - Not applicable for the conversion option because it does not meet the definition of a derivative instrument. If, in an alternative fact pattern, the conversion option meets the definition of a derivative instrument, Issuer A would analyze whether the conversion option meets the scope exception in ASC 815-10-15-74(a) (see Section 3.6.1.1).
  - For the contingent redemption feature, no exception from derivative accounting applies because the redemption feature would not be classified in Issuer A's stockholders' equity if it were freestanding because it is net cash settled.

The conversion option is not bifurcated because it does not meet the definition of a derivative instrument. The contingent redemption feature must be bifurcated and separately accounted for as a derivative liability because it is not clearly and closely related to the debt host contract, the preferred stock is not remeasured at fair value, and it would meet the definition of a derivative instrument if it were freestanding. Also, no derivative scope exception applies.

3.6.4 Term-Extending Options

FASB REFERENCES

ASC 815-15-25-44

A debt instrument may include a feature that significantly extends the debt's remaining term to maturity automatically, when specific events or conditions occur, or at the election of one of the parties. That term-extending feature is clearly and closely related to a debt host contract (and therefore not bifurcated from the debt instrument) only if **both** the following criteria are met:

- The interest rate concurrently resets to the approximate current market rate for the extended term
- The debt instrument initially involved no significant discount.

If neither or only one criterion is met, the term-extending feature is **not** clearly and closely related to the debt host contract and the entity must bifurcate it from the debt instrument if it meets the other bifurcation criteria.

Unless the entity remeasures the debt instrument at fair value (see Section 3.4.2), the entity must evaluate whether the term-extending feature would meet the definition of a derivative instrument if it were freestanding. Typically, the term-extending feature meets the first two characteristics of a derivative instrument (see Sections 3.4.3.1 and 3.4.3.2), so the focus of the analysis is whether it meets the net settlement characteristic (see Section 3.4.3.3).

Generally, a term-extending feature does not meet the net settlement characteristic if the underlying debt instrument does not publicly trade in an active market. In that case, the feature is not bifurcated from the debt instrument.

Conversely, a term-extending feature meets the net settlement characteristic if the underlying debt instrument publicly trades in an active market that can rapidly absorb the debt instrument without significantly affecting the trading price. If the term-extending feature meets all the characteristics of a derivative instrument, the entity must assess whether it qualifies for a derivative scope exception. If so, the entity does not separate the embedded feature from the debt host contract. If no derivative scope exception applies, the entity must bifurcate the embedded feature from the debt instrument and account for it separately as a derivative instrument at fair value, with changes in fair value recognized in earnings.

BDO INSIGHTS — APPLYING THE LOAN COMMITMENT SCOPE EXCEPTION TO TERM-EXTENDING OPTIONS

If a term-extending option meets the criteria for bifurcation, an entity must evaluate whether any derivative scope exceptions apply. We believe a term-extending option that allows the issuer to extend the debt's term is analogous to a term loan commitment, so the entity may apply by analogy the scope exception discussed in Section 3.2.3.2. However, that exception does not apply if the lender holds the option to extend the debt's term.

Determining whether an embedded derivative qualifies for a derivative scope exception requires the application of professional judgment based on the facts and circumstances.

EXAMPLE 3-13: TERM-EXTENDING OPTIONS

FACTS

Issuer A issues a note at par with an interest rate of 10% per year. The note matures on the four-year anniversary from the issuance date and allows Issuer A to extend the debt's term for another two years after the original maturity date. If exercised, the interest rate resets to the then-current market rate.

CONCLUSION

The term-extending option is not bifurcated from the debt instrument.

ANALYSIS

Issuer A evaluates the term-extending option for bifurcation.

- Is the term-extending option not clearly and closely related to the debt host contract?
  - Two criteria must be met for the term-extending option to be clearly and closely related to the debt host contract: The interest rate must reset to market and the debt instrument must not contain a significant discount. The note's interest rate resets upon exercising the term-extending option, and the note was not issued at a discount. Therefore, the term-extending option is clearly and closely related to the debt host contract and is not bifurcated from the debt instrument.

3.6.5 Embedded Loan Commitments

FASB REFERENCES

ASC 815-10-15-69

An entity may enter a debt arrangement, giving it access to funds by issuing debt on future date(s) (for example, a line of credit, a delayed draw facility, or a tranche debt issuance). That arrangement typically involves issuing multiple financial instruments or components at contract inception — an initially drawn debt instrument and a loan commitment. In that case, an entity must assess whether the loan commitment is freestanding or embedded in the debt instrument (see Section 3.2.3.2).

If the loan commitment is embedded in the debt instrument, the entity must assess whether that embedded feature meets the criteria for bifurcation (see Section 3.4). Typically, a commitment to issue loans with the same debt terms has economic characteristics and risks that are clearly and closely related to a debt host contract. In that case, the entity does not bifurcate the loan commitment from the debt instrument.

However, if the embedded loan commitment is not clearly and closely related to the debt host contract (for example, the loan commitment relates to issuance of additional debt and warrants) and the debt instrument is not remeasured at fair value (see Section 3.4.2), the entity must evaluate whether the embedded loan commitment would meet the definition of a derivative instrument if it were freestanding. Typically, the embedded loan commitment meets the first two characteristics of a derivative instrument (see Sections 3.4.3.1 and 3.4.3.2), so the focus of the analysis is whether the embedded feature meets the net settlement characteristic (see Section 3.4.3.3).

Generally, an embedded loan commitment does not meet the net settlement characteristic if the underlying debt instrument does not publicly trade in an active market. In that case, the entity does not bifurcate the embedded feature.

Conversely, an embedded loan commitment meets the net settlement characteristic if the underlying debt instrument publicly trades in an active market that can rapidly absorb the debt instrument without significantly affecting the trading price. If the embedded loan commitment meets all the characteristics of a derivative instrument, the entity must assess whether it qualifies for a derivative scope exception. If so, the entity does not separate the embedded feature from the debt host contract. If no derivative scope exception applies, the entity must bifurcate the embedded feature from the debt instrument and account for it separately as a derivative instrument at fair value, with changes in fair value recognized in earnings.

APPLYING THE LOAN COMMITMENT EXCEPTION TO EMBEDDED LOAN COMMITMENTS

Loan commitments allowing a potential borrower to originate a loan are exempt from derivative accounting. The exception, however, does not apply if the lender holds the option to require the entity (the borrower) to issue additional debt (that is, the entity has an obligation, not a right, to issue additional debt).

BDO INSIGHTS — PAID-IN-KIND INTEREST

Some loans include PIK interest, which either requires or allows adding the accrued interest to the principal. Because that feature is essentially a future commitment to increase debt, we believe it is similar to and may be evaluated like an embedded loan commitment in determining whether the PIK interest feature must be bifurcated from the debt instrument. An entity must apply professional judgment to determine whether that is an appropriate approach based on the facts and circumstances.

By analogy to embedded loan commitments, we believe PIK interests would not be bifurcated if **any** of the following are met:

- The PIK interest is clearly and closely related to the debt instrument.
- The debt instrument is remeasured at fair value.
- The net settlement characteristic is not met (such as when the debt instrument is not publicly traded).
- The derivative scope exception on loan commitments is met (the entity can elect to pay interest in kind).

3.6.6 Credit-Sensitive Payments

FASB REFERENCES

ASC 815-15-25-46 through 25-47

Features related to the entity's (borrower's) creditworthiness are clearly and closely related to the interest rate on a debt instrument. Therefore, when a debt instrument resets interest rates in any of the circumstances described below, the related embedded feature is considered clearly and closely related to the debt host contract.

- The entity defaults (such as violation of a credit-risk related covenant).
- The entity's published credit rating changes.
- The entity's creditworthiness changes, as indicated by a change in its credit spread over U.S. Treasury bonds.

A feature in a debt instrument that incorporates a credit risk exposure other than those arising from the entity's creditworthiness (for example, payments based on an event of default or creditworthiness of a third party) is not clearly and closely related to the debt host contract.

AN EVENT OF DEFAULT MAY NOT ALWAYS RELATE TO THE ENTITY'S CREDITWORTHINESS

Debt instruments often include terms that require an entity to pay more interest upon an event of default. If the increased interest upon event of default relates to the entity's creditworthiness (for example, when the entity does not make timely payments), the contingent interest feature is clearly and closely related to the debt host contract.

Conversely, if the increased interest upon an event of default does not relate to the entity's creditworthiness (for example, it requires additional interest upon a change in control), the contingent interest feature is not clearly and closely related to the debt host contract.

An entity must evaluate the provisions in the debt agreement to determine how the contract defines an event of default and whether any of those events are not related to the entity's creditworthiness.

If the credit-sensitive payments are not clearly and closely related to the debt host contract and the debt instrument is not remeasured at fair value (see Section 3.4.2), the entity must evaluate whether the embedded feature would meet the definition of a derivative instrument if it were freestanding. Typically, credit-sensitive payments meet the first two characteristics of a derivative instrument (see Sections 3.4.3.1 and 3.4.3.2), so the focus of the analysis is whether it meets the net settlement characteristic (see Section 3.4.3.3).

Generally, a credit-sensitive payment feature meets net settlement under the contract terms because neither party is required to deliver an asset associated with the underlying (such as an interest-bearing security). At settlement, cash is delivered; however, it is not an asset associated with the underlying (see Section 3.4.3.3). Also, generally, no derivative scope exception applies, so the entity must bifurcate the embedded feature from the debt instrument and account for it separately as a derivative instrument at fair value, with changes in fair value recognized in earnings.

3.6.7 Equity-Indexed Payments

FASB REFERENCES

ASC 815-15-25-49

An entity may issue a debt instrument in which the principal or the interest payments adjust based on an equity price or index. The changes in fair value of an equity interest (whether based on a specified common stock or an index based on a basket of equity instruments, such as the S&P 500, NASDAQ, or the Dow Jones Industrial Average) is **not** clearly and closely related to the interest yield on a debt instrument.

Unless the entity remeasures the debt instrument at fair value (see Section 3.4.2), the entity must evaluate whether the equity-indexed feature would meet the definition of a derivative instrument if it were freestanding. Typically, the equity-indexed feature meets the first two characteristics of a derivative instrument (see Sections 3.4.3.1 and 3.4.3.2), so the focus of the analysis is whether it meets the net settlement characteristic (see Section 3.4.3.3).

Generally, an equity-indexed feature meets the net settlement characteristic because neither party is required to deliver an asset associated with the underlying (such as the underlying shares). At settlement, cash is delivered; however, it is not an asset associated with the underlying (see Section 3.4.3.3).

If the equity-indexed feature meets all the characteristics of a derivative instrument, the entity must assess whether it qualifies for a derivative scope exception. If the referenced equity is other than the entity's (issuer's) equity, the scope exception in ASC 815-10-15-74(a) does not apply. Further, even if the referenced equity is the entity's equity, that feature would generally not meet the scope exception in ASC 815-10-15-74(a) because its exercise requires net cash settlement (the analysis would be different if the embedded feature is a conversion feature (see Section 3.6.1.1)). Accordingly, generally, no derivative scope exception applies to embedded equity-indexed derivatives, so the entity must bifurcate and account for them separately at fair value, with changes in fair value recognized in earnings.

3.6.8 Exchange Features

FASB REFERENCES

ASC 470-20-S99-1

A debt instrument may require or allow settlement in a fixed number of shares of a third party (unrelated to the entity), which is referred to as "exchangeable debt." It differs from convertible debt (see Section 3.6.1) because it is not convertible into the entity's own shares, as discussed by the SEC staff and excerpted below.

SEC STAFF GUIDANCE

Comments Made by SEC Observer at Emerging Issues Task Force (EITF)

SEC Observer Comment: Debt Exchangeable for the Stock of Another Entity

> *An issue has been discussed involving an enterprise that holds investments in common stock of other enterprises and issues debt securities that permit the holder to acquire a fixed number of shares of such common stock. These types of transactions are commonly affected through the sale of either debt with detachable warrants that can be exchanged for the stock investment or debt without detachable warrants (the debt itself must be exchanged for the stock investment - also referred to as "exchangeable" debt). Those debt issues differ from traditional warrants or convertible instruments because the traditional instruments involve exchanges for the equity securities of the issuer. There have been questions as to whether the exchangeable debt should be treated similar to traditional convertibles as specified in Subtopic 470-20 or whether the transaction requires separate accounting for the exchangeability feature. The SEC staff believes that Subtopic 470-20 does not apply to the accounting for debt that is exchangeable for the stock of another entity and therefore separation of the debt element and exchangeability feature is required.*

An exchange feature is not clearly and closely related to a debt host contract because the changes in fair value of third-party stock is not clearly and closely related to the interest rate on a debt instrument. Therefore, unless the entity remeasures the debt instrument at fair value (see Section 3.4.2), the entity must evaluate whether the embedded exchange feature would meet the definition of a derivative instrument if it were freestanding. Typically, the exchange feature meets the first two characteristics of a derivative instrument (see Sections 3.4.3.1 and 3.4.3.2), so the focus of the analysis is whether it meets the net settlement characteristic (see Section 3.4.3.3).

The exchange feature meets the net settlement characteristic if the third-party stock publicly trades in an active market that can rapidly absorb the underlying shares without significantly affecting the stock price. Further, no derivative scope exception applies to that exchange feature. Specifically, ASC 815-10-15-74(a) does not apply because the exchange feature is indexed to a third-party stock and not the entity's own stock. In that case, the entity must bifurcate the embedded feature from the debt instrument and account for it separately as a derivative instrument at fair value, with changes in fair value recognized in earnings.

However, if the debt instrument is exchangeable for a fixed number of shares of an entity's consolidated subsidiary, the entity (parent) analyzes the feature as a conversion feature, as long as the subsidiary is a substantive entity (see Section 3.6.1).

3.6.9 Inflation-Indexed Interest Payments

FASB REFERENCES

ASC 815-15-25-50

An entity may issue a debt instrument in which the principal or interest payments adjust based on an inflation rate or index (such as the consumer price index (CPI)). An inflation-indexed feature **is** clearly and closely related to the debt host contract if the indexed payments are based on the inflation rates of the economic environment in which the debt instrument is denominated and they do not include leverage. In that case, the entity does not bifurcate the embedded feature from the debt instrument.

If the embedded inflation-indexed feature is not clearly and closely related to the debt host contract (for example, the payments are indexed to the inflation rate of economic environments other than the denominated currency of the debt instrument or the feature includes leverage; for example, two times CPI) and the debt instrument is not remeasured at fair value (see Section 3.4.2), the entity must evaluate whether the embedded feature would meet the definition of a derivative instrument if it were freestanding. Typically, the embedded inflation-indexed feature meets the first two characteristics of a derivative instrument (see Sections 3.4.3.1 and 3.4.3.2), so the focus of the analysis is whether it meets the net settlement characteristic (see Section 3.4.3.3).

Generally, an embedded inflation-indexed feature meets net settlement under the contract terms because neither party is required to deliver an asset associated with the underlying (such as another debt security). At settlement, cash is delivered; however, it is not an asset associated with the underlying (see Section 3.4.3.3). Also, generally, no derivative scope exception applies, so the entity must bifurcate the embedded feature from the debt instrument and account for it separately as a derivative instrument at fair value, with changes in fair value recognized in earnings.

3.6.10 Foreign Currency Options

FASB REFERENCES

ASC 815-15-15-5 and ASC 815-15-55-209 through 55-212

ASC 815-15 provides an exception for some foreign currency transactions. As discussed in Section 3.2.3.4, unsettled foreign currency transactions, including financial instruments, do not contain an embedded foreign currency derivative if **all** the following criteria are met:

- They are monetary items.
- They have their principal payments, interest payments, or both denominated in a foreign currency.
- They are subject to the requirements in ASC 830-20 to recognize any foreign currency transaction gain or loss in earnings.

The following examples illustrate how the scope exception applies to a debt instrument with foreign currency components.

Scope exception met — account under ASC 830	A dual currency bond that **requires** principal repayment denominated in U.S. dollars (which is the borrower's functional currency) and periodic interest payments denominated in a foreign currency meets the scope exception. Because the transaction (bond) is a monetary item with periodic interest payments denominated in a foreign currency and is subject to ASC 830 with the foreign currency gains or losses recognized in earnings, the instrument meets the exception in ASC 815-15-15-5.
Scope exception not met — evaluate under ASC 815	A loan in U.S. dollars (which is the borrower's functional currency) in which the borrower has the **option** to repay the loan in U.S. dollars or a fixed amount of a specified foreign currency does not meet the scope exception. Because the borrower has the option to repay the loan in U.S. dollars or a fixed amount in a specified foreign currency (that is, a foreign currency option embedded in a functional-currency denominated debt host), ASC 815-15-15-5 does not apply. The foreign currency option also is not clearly and closely related to the debt host contract and would meet the definition of a derivative instrument if it were freestanding. Therefore, unless the debt is remeasured at fair value, the foreign currency option meets the criteria for bifurcation and must be separated from the debt host contract and accounted for in accordance with ASC 815.

3.6.11 Other Indexed Interest or Principal Payments

FASB REFERENCES

ASC 815-10-15-59(b), ASC 815-10-15-59(d), ASC 815-15-25-48, and ASC 815-15-55-10

Features in a debt instrument that adjust principal or interest payments based on a commodity price (such as the price of gold, wheat, or corn) are not clearly and closely related to a noncommodity host contract. Accordingly, the changes in fair value of a commodity and the interest rate on a debt instrument are not clearly and closely related. Similarly, payments indexed to the changes in fair value of nonfinancial assets are not clearly and closely related to the interest rate on a debt instrument. Unless the entity remeasures the debt instrument at fair value (see Section 3.4.2), the entity must evaluate whether the embedded indexed payments would meet the definition of a derivative instrument if they were freestanding.

Typically, those embedded features meet all the characteristics of a derivative instrument (include at least one underlying, notional amount, or payment provision; require little or no initial net investment; and are net cash-settled), so the entity must evaluate whether they qualify for a derivative scope exception.

If a derivative scope exception applies, the entity does not bifurcate those embedded features from the debt instrument. For instance, ASC 815-10-15-59(b) provides a derivative scope exception for nonexchange-traded contracts with an underlying that is based on the price or value of one of the parties' nonfinancial assets (see Section 3.2.3). For that exception to apply, the nonfinancial asset must not be readily convertible to cash, must be unique (that is, not fungible or interchangeable), and must be owned by the party to the contract that would not benefit from an increase in the nonfinancial asset's fair value under the contract.

If no derivative scope exception applies, the entity must bifurcate those embedded features from the debt instrument and account for them separately at fair value, with changes in fair value recognized in earnings.

Similarly, a debt instrument with interest or principal payments indexed to an entity's operational measures includes an embedded feature that is not clearly and closely related to the debt host contract. Typically, that embedded feature meets the definition of a derivative instrument and whether it qualifies for a derivative scope exception must be evaluated. ASC 815-10-15-59(d) provides a derivative scope exception for nonexchange-traded contracts with an underlying that is based on one of the parties' specified volumes of sales or service revenues (see Section 3.2.3). If interest or principal payments are indexed to the entity's revenues (or operating cash flows or EBITDA), the embedded indexed feature qualifies for a derivative scope exception and is not bifurcated from the debt instrument.

Further, an entity must evaluate any embedded features that adjust the debt's principal or interest payments based on events that are not credit risk- or inflation-related for bifurcation because, generally, they are not clearly and closely related to a debt host contract. An entity must bifurcate those embedded features if the debt instrument is not remeasured at fair value and the features would be a derivative instrument if they were freestanding, and no derivative scope exception applies.

3.7 INITIAL RECOGNITION, SUBSEQUENT MEASUREMENT, AND REASSESSMENT

Freestanding financial instruments that are derivatives in their entirety are accounted for as assets or liabilities under ASC 815-10 and are remeasured at fair value, with changes in fair value recognized in earnings (unless the instrument qualifies and is designated as a hedging instrument, in which case some or all of the changes in fair value are recognized in other comprehensive income).

For hybrid instruments, an entity evaluates embedded derivatives under ASC 815-15 to determine whether to account for them separately as derivative liabilities (or derivative assets in some cases). A bifurcated embedded derivative is accounted for separately from the host contract and initially and subsequently measured at fair value, with changes in fair value recognized in earnings (see Sections 3.7.1.1 and 3.7.2). The host contract, after bifurcating the embedded derivative, is accounted for under other U.S. GAAP (see Sections 3.7.1.2 and 3.7.2).

If the entity must bifurcate an embedded derivative but elects the fair value option, or the practicability exception applies (which is not common in practice), it does not separate the embedded derivative from the host contract and instead recognizes the entire hybrid instrument at fair value (see Section 3.7.1).

If the embedded derivatives do not require bifurcation, the entity accounts for the entire hybrid instrument under other U.S. GAAP (see Sections 3.7.1.3 and 3.7.2).

Some bifurcation criteria are continually reassessed to determine whether the bifurcated embedded derivative must continue to be bifurcated. Similarly, a nonbifurcated embedded derivative may subsequently meet the criteria for bifurcation (see Section 3.7.3).

3.7.1 Initial Measurement

FASB REFERENCES

ASC 815-10-25-1 and ASC 815-15-30-1 through 30-2

The table summarizes the initial measurement for the hybrid instrument, host contract, and bifurcated embedded derivative.

HYBRID INSTRUMENTS WITH EMBEDDED DERIVATIVES THAT ARE BIFURCATED	HYBRID INSTRUMENTS WITH EMBEDDED DERIVATIVES THAT REQUIRE BIFURCATION BUT ARE NOT BIFURCATED (HYBRID INSTRUMENTS ACCOUNTED FOR AT FAIR VALUE)	HYBRID INSTRUMENTS WITH EMBEDDED DERIVATIVES THAT DO NOT REQUIRE BIFURCATION
▶ Recognize the bifurcated embedded derivative at fair value (see Section 3.7.1.1) ▶ Recognize the host contract at initial carrying amount, which is the difference between the proceeds allocated to the hybrid instrument and the embedded derivative's initial fair value (see Section 3.7.1.2)	▶ Measure the entire instrument initially at fair value if either: • Fair value option is elected • An entity cannot reliably identify and measure the embedded derivative	▶ Determine the hybrid instrument's initial carrying amount based on allocated proceeds (see Section 3.7.1.3) ▶ Account for the entire hybrid instrument under other U.S. GAAP (for example, ASC 470, ASC 480, ASC 480-10-S99-3A, or ASC 505).

BDO INSIGHTS — BALANCE SHEET PRESENTATION OF BIFURCATED DERIVATIVES

We believe entities should present the host contract and the bifurcated embedded derivative on the balance sheet as follows:

- If the host contract is classified as permanent or temporary equity, present the bifurcated embedded derivative separately from the host contract.
- If the host contract is classified as an asset or liability, present the bifurcated embedded derivative either separately from or together with the host contract. The entity must apply its elected policy consistently.

3.7.1.1 Hybrid Instruments With Bifurcated Embedded Derivatives — Initial Measurement of Bifurcated Embedded Derivatives

FASB REFERENCES

ASC 815-10-25-1, ASC 815-10-30-1, ASC 815-15-25-7 through 25-10, ASC 815-15-30-3 through 30-4, and ASC 815-15-30-6

An entity recognizes bifurcated embedded derivatives as either assets or liabilities (depending on the contractual rights or obligations) initially at fair value. The bifurcated embedded derivative's fair value must reflect all its relevant features.

When more than one embedded feature requires bifurcation, the entity combines them as one compound embedded derivative to be bifurcated from the hybrid instrument. The entity **cannot** separate the compound embedded derivative into components based on different risks (for example, changes in stock price and exchange rate) or different optionality. Any embedded features that are clearly and closely related to the host contract are not bifurcated or included in the compound derivative.

The method for separating an embedded derivative from the host contract depends on whether the embedded derivative is option-based or non-option based (for example, a forward or swap), as summarized in the following table.

SEPARATING AN OPTION-BASED EMBEDDED DERIVATIVE	SEPARATING A NON-OPTION EMBEDDED DERIVATIVE
An entity measures the fair value of an option-based derivative based on the instrument's stated terms. In other words, the terms are not adjusted to result in the embedded derivative being at the money at inception. As a result, the embedded derivative may have an exercise price that differs from the market price of the asset associated with the underlying.	An entity measures the fair value of a non-option embedded derivative using the terms that would result in the embedded derivative's fair value generally being zero at inception. If the non-option embedded derivative has off-market terms at inception, that amount should be quantified and allocated to the host contract because it effectively represents a borrowing. Often, adjusting the contractually stated forward price to align with the market when separating the embedded derivative from the host contract results in the embedded derivative having a fair value of zero at inception. The entity must not create artificial terms to introduce leverage, asymmetry, or some other risk exposure not already present in the hybrid instrument. ASC 815 discusses two examples of non-option-based embedded derivatives: ▶ Example 16, Cases A and B in ASC 815-10-55 on prepaid interest rate swaps ▶ Example 12 in ASC 815-15-55 for a note with an equity-based embedded derivative

3.7.1.2 Hybrid Instruments With Bifurcated Embedded Derivatives — Initial Measurement of the Host Contract

FASB REFERENCES

ASC 815-15-30-2

If an entity issues a hybrid instrument with other financial instruments in a basket transaction, the entity must first allocate the transaction proceeds among those instruments (see Section 2.8.2).

If the hybrid instrument has embedded derivatives requiring bifurcation, the bifurcated embedded derivative is recognized at fair value, and the difference between the proceeds allocated to the hybrid instrument and the fair value of the bifurcated embedded derivative is recognized as the host contract's initial carrying amount. The graphic summarizes those steps.

Step a: Allocate the proceeds among the freestanding financial instruments issued, if applicable (see Section 2.8.2).

Step 1: Determine the subsequent measurement model for each financial instrument issued. → Step 2: Recognize at fair value financial instruments that must be remeasured at fair value. → Step 3: Allocate the remaining proceeds to any remaining instruments on a residual or relative fair value basis.

Step b: Allocate the proceeds between the bifurcated derivative and the host contract.

- Recognize the bifurcated embedded derivative at fair value.
- Allocate the difference between the proceeds allocated to the hybrid instrument and the bifurcated embedded derivative's fair value to the host contract.

BDO INSIGHTS — ALLOCATION APPROACH INVOLVING HYBRID INSTRUMENTS

In practice, proceeds received in financing transactions are allocated to the freestanding instruments (see Section 2.8.2) before evaluating hybrid instruments for bifurcation of embedded derivatives.

Once proceeds have been allocated to freestanding instruments, each instrument must be analyzed to determine whether any embedded derivatives require bifurcation.

EXAMPLE 3-14: HYBRID INSTRUMENT HAS A BIFURCATED DERIVATIVE AND IS ISSUED WITH WARRANTS THAT ARE LIABILITY CLASSIFIED

FACTS

Issuer A issues $1,000 of convertible debt and 1,000 detachable warrants to purchase its common stock for $1,000 of cash proceeds. The debt's conversion option meets the criteria for bifurcation, does not meet a derivative scope exception, and has a fair value of $450. The debt is measured at amortized cost under ASC 470-20. The warrants are classified as liabilities under ASC 480 and have a fair value of $200. (For simplicity, this example ignores transaction costs and taxes.)

CONCLUSION AND ANALYSIS

- **Step a:** Allocate the proceeds among the freestanding financial instruments issued (see Section 2.8.2).
  - **Step 1:** Determine the subsequent measurement model for each financial instrument issued.
    - The subsequent measurement model for the convertible debt is amortized cost (see Section 6.2.2.1).
    - The subsequent measurement model for the warrants is fair value (see Section 2.8.1).
  - **Step 2:** Recognize at fair value financial instruments that must be remeasured at fair value.
    - Because the warrants are subsequently measured at fair value, they are initially recognized at their fair value of $200.
  - **Step 3:** Allocate the remaining proceeds to any remaining instruments.
    - The remaining proceeds of $800 ($1,000 - $200) are allocated to the convertible debt (the hybrid instrument).
- **Step b:** Allocate the proceeds between the bifurcated embedded derivative and the host contract.
  - The bifurcated embedded derivative is recognized at its fair value of $450.
  - The difference between the proceeds allocated to the hybrid instrument ($800) and the bifurcated embedded derivative's fair value ($450) is allocated to the host contract by recognizing a contra-liability for the discount on the convertible debt. Then, the convertible debt is accreted to its par amount of $1,000 through interest cost using the effective interest method in accordance with ASC 835-30-35. The total discount on the convertible debt is therefore $650 ($200 + $450).

Issuer A records the following journal entry on the issuance date:

Debit	Cash	$	1,000		
Debit	Discount on Convertible Debt		650		
Credit	Convertible Debt			$	1,000
Credit	Convertible Debt (Conversion Option Liability)*				450
Credit	Warrant Liability				200

* We believe that although an entity bifurcates an embedded conversion option for measurement, it may present the option on a combined basis with the debt on the balance sheet when both are liabilities.

3.7.1.3 Hybrid Instruments With No Bifurcated Embedded Derivatives — Initial Measurement of Hybrid Instrument

As discussed in Section 3.7.1.2, if an entity issues a hybrid instrument with other financial instruments in a basket transaction, the entity must first allocate the transaction proceeds among the instruments issued.

If the hybrid instrument has no bifurcated embedded derivative and is not remeasured at fair value, its initial carrying amount is the proceeds allocated to the instrument and it is accounted for in accordance with other U.S. GAAP. For example, if convertible debt has a conversion option that is not bifurcated, it is accounted for in its entirety as a liability under ASC 470-20.

EXAMPLE 3-15: HYBRID INSTRUMENT HAS NO BIFURCATED DERIVATIVE AND IS ISSUED WITH WARRANTS THAT ARE LIABILITY CLASSIFIED

FACTS

Issuer A issues $1,000 of convertible debt and 1,000 detachable warrants to purchase its common stock for $1,000 cash proceeds. The convertible debt has no bifurcated embedded derivative and is measured at amortized cost under ASC 470-20. The warrants are classified as liabilities under ASC 480 and have a fair value of $200. (For simplicity, this example ignores transaction costs and taxes.)

CONCLUSION AND ANALYSIS

- **Step a:** Allocate the proceeds among the freestanding financial instruments issued (see Section 2.8.2).
  - **Step 1:** Determine the subsequent measurement model for each financial instrument issued.
    - The subsequent measurement model for the convertible debt is amortized cost (see Section 6.2.2.1).
    - The subsequent measurement model for the warrants is fair value (see Section 2.8.1).
  - **Step 2:** Recognize at fair value financial instruments that must be remeasured at fair value.
    - Because the warrants are subsequently measured at fair value, they are initially recognized at their fair value of $200.
  - **Step 3:** Allocate the remaining proceeds to any remaining instruments.
    - The remaining proceeds of $800 ($1,000 - $200) are allocated to the convertible debt by recognizing a contra-liability for the discount on the convertible debt. Then, the convertible debt is accreted to its par amount of $1,000 through interest cost using the effective interest method in accordance with ASC 835-30-35.
- Step b is not applicable because the hybrid instrument has no bifurcated derivative.

Issuer A records the following journal entry on the issuance date:

Debit	Cash	$	1,000		
Debit	Discount on Convertible Debt		200		
Credit	Convertible Debt			$	1,000
Credit	Warrant Liability				200

3.7.2 Subsequent Measurement

FASB REFERENCES

ASC 815-10-35-1, ASC 815-15-25-54, ASC 815-15-35-1, ASC 815-15-35-2A, and ASC 825-10-45-5

The table summarizes the subsequent measurement for the hybrid instrument, the host contract, and bifurcated embedded derivative.

HYBRID	HYBRID INSTRUMENTS WITH EMBEDDED DERIVATIVES THAT REQUIRE BIFURCATION BUT ARE NOT BIFURCATED (HYBRID INSTRUMENTS ACCOUNTED FOR AT FAIR VALUE)	HYBRID INSTRUMENTS WITH EMBEDDED DERIVATIVES THAT DO NOT REQUIRE BIFURCATION
▶ Subsequently measure the bifurcated embedded derivative at fair value. ▶ Subsequently measure the host contract based on other U.S. GAAP (for example, ASC 470, ASC 480, ASC 480-10-S99-3A, or ASC 505).	▶ Subsequently measure the entire instrument at fair value, with fair value changes recognized in earnings* if **either**: • The fair value option is elected • An entity cannot reliably identify and measure the embedded derivative. The entire contract cannot be designated as a hedging instrument under ASC 815-20. * However, for a financial liability accounted for under the fair value option, the portion that is due to a change in the instrument-specific credit risk is recognized in other comprehensive income.	▶ Account for the entire instrument under other U.S. GAAP (for example, ASC 470, ASC 480, ASC 480-10-S99-3A, or ASC 505).

Bifurcated embedded derivatives are accounted for in the same way as freestanding derivative instruments and are measured subsequently at fair value. Changes in fair value are recognized in earnings.

After bifurcating any embedded features, an entity accounts for the host contract (together with any embedded features that are not bifurcated) based on other U.S. GAAP applicable to the instrument (for example, debt at amortized cost under ASC 835-30). Similarly, an entity accounts for hybrid instruments with no bifurcated embedded derivatives in accordance with other U.S. GAAP. For example, convertible debt with a conversion option that does not require bifurcation is accounted for in its entirety as a liability in accordance with ASC 470-20. Temporary equity (with or without bifurcated derivatives) is accounted for in accordance with ASC 480-10-S99-3A.

ACCOUNTING FOR CHANGES IN FAIR VALUE WHEN FAIR VALUE OPTION IS ELECTED

When an entity elects the fair value option for hybrid financial instruments, it remeasures them at fair value — generally, through earnings.

However, when the fair value option is elected for a financial liability (for example, debt), the entity must recognize the portion of the total change in fair value that results from a change in the instrument-specific credit risk separately in other comprehensive income.

The entity may either 1) consider the portion of the total change in fair value, exclusive of the amount caused by a change in a base market risk (such as a risk-free rate or a benchmark interest rate) as the amount that is due to a change in the instrument-specific credit risk or 2) use another method it considers to faithfully represent that amount. The entity must apply its elected method consistently to each financial liability at each reporting period.

3.7.3 Reassessing Embedded Derivatives

FASB REFERENCES

ASC 815-10-15-118, ASC 815-10-15-139, ASC 815-10-55-84, ASC 815-15-25-27, and ASC 815-40-35-8

The table summarizes the requirements for the ongoing bifurcation reassessment for the embedded derivative.

BIFURCATION CRITERIA	ONGOING REASSESSMENT
The host contract and embedded derivative are not clearly and closely related.	An entity does not reassess whether an embedded derivative and the host contract are clearly and closely related unless the entity modifies the instrument's contractual terms. See the BDO Insights below for more discussion.
The hybrid instrument is not remeasured at fair value.	If the entity did not elect the fair value option upon initial recognition of the instrument, it cannot subsequently elect it unless a remeasurement event occurs. Similarly, if the entity has elected the fair value option for the instrument, it is irrevocable and therefore not subject to reassessment unless a remeasurement event occurs (see Section 3.4.2.1).
The embedded derivative would be a derivative instrument under ASC 815-10 if it were freestanding.	An entity generally does not reassess the first two characteristics of a derivative instrument (underlying, notional amount, payment provision, and little or no initial net investment) and the net settlement characteristic under contract terms unless the instrument's terms are modified. However, an entity evaluates whether net settlement through a market mechanism or by delivery of an asset readily convertible to cash exists on an ongoing basis throughout the contract's life (see Appendix A, Section A.1.3.3). The assessment of the significance of conversion costs in the net settlement criterion by delivery of an asset readily convertible to cash is performed only at inception (see Appendix A, Section A.1.3.3).
No derivative scope exception applies.	An entity continually reassesses whether a derivative scope exception applies. For instance, for the exception for contracts in an entity's own equity, ASC 815-40-35-8 requires an entity to assess an embedded derivative's classification at each balance sheet date; for example, whether there are sufficient authorized but unissued shares to satisfy the maximum number of shares that could be required to net share settle the contract (see Section 4.8).

Based on its reassessment of the bifurcation criteria and derivative scope exception, the entity could determine that a nonbifurcated embedded derivative subsequently meets the criteria for separate accounting (see Section 3.7.3.1) or that a bifurcated embedded derivative no longer meets the criteria for separate accounting (see Section 3.7.3.2).

BDO INSIGHTS — REASSESSMENT OF CLEARLY AND CLOSELY RELATED CRITERION

ASC 815-15 does not explicitly require entities to reassess whether the host contract and the embedded derivative are clearly and closely related. Further, ASC 815-15-25-27 indicates that the criterion is assessed at the instrument's inception. However, we believe an entity may be required to reassess whether an embedded feature is clearly and closely related to the host contract when contractual terms are modified as follows:

- The modification or exchange of debt or equity instrument is accounted for as an extinguishment.
- The modification or exchange of debt or equity instrument is not accounted for as an extinguishment and the changed terms:
  - Have the potential to change the nature of the host contract, including when an embedded feature is added (in which case, the entity must also assess the new embedded feature for bifurcation) or removed. Unless the changes are purely administrative, they typically have the potential to change the nature of the host contract.
  - Modify an existing embedded feature (for example, changing the terms of an interest-rate feature or changing the settlement terms of a call or put option).

Determining when an entity must reassess whether an embedded feature is clearly and closely related to the host contract requires the application of professional judgment based on the facts and circumstances.

3.7.3.1 Accounting for Embedded Derivatives That Are Subsequently Bifurcated

An entity might initially conclude an embedded feature (such as a conversion option) does not require bifurcation. However, upon reassessment, underlying facts and circumstances could change, resulting in the entity bifurcating the embedded feature and accounting for it as a liability.

For instance, a privately held entity does not bifurcate a conversion option in a debt instrument because the conversion option lacks a derivative's net settlement characteristic. If that entity subsequently completes an IPO and listing of its shares and an active market for the shares develops, the conversion option would meet the derivative's net settlement characteristic and require separation from the host contract if it did not meet the exception in ASC 815-10-15-74(a). Similarly, a nonbifurcated conversion option that previously met the scope exception in ASC 815-10-15-74(a) would require bifurcation if it ceased to meet that exception; for example, because the entity no longer has sufficient authorized and unissued shares (see Section 4.8). In that case, the entity recognizes the conversion option at fair value upon bifurcation and subsequently remeasures it at fair value, with fair value changes recognized in earnings.

BDO INSIGHTS — SUBSEQUENTLY BIFURCATING A CONVERSION OPTION UPON REASSESSMENT

ASC 815-15-30-2 requires recognizing the bifurcated embedded derivatives at fair value (see Section 3.7.1.2). However, there is no explicit guidance on how to subsequently bifurcate an embedded derivative (such as a conversion option) from the host contract after the hybrid instrument's initial recognition. We believe when that occurs, the entity should generally recognize a derivative liability for the conversion option's fair value on the date of the change with an offsetting debt discount that is amortized over the debt's remaining life.

The entity should also continue to amortize any initial discount recognized upon the instrument's issuance (for example, debt discount resulting from allocating transaction proceeds).

Determining how to recognize a subsequently bifurcated conversion option requires the application of professional judgment based on the facts and circumstances.

3.7.3.2 Accounting for Previously Bifurcated Embedded Derivatives That No Longer Need to Be Bifurcated

FASB REFERENCES

ASC 815-15-35-4, ASC 815-15-40-1, ASC 815-15-40-4, ASC 815-40-35-10, and ASC 815-10-55-84

There could be events after inception that cause an embedded feature that previously met the definition of a derivative instrument to cease meeting the criteria (such as the entity delisting from a national stock exchange, so the net settlement characteristic is no longer met). Similarly, an embedded derivative that previously did not qualify for the scope exception in ASC 815-10-15-74(a) may subsequently meet that scope exception (for example, because of an increase in the authorized shares when the entity did not previously have sufficient available and unissued shares (see Section 4.8)).

BDO INSIGHTS — RECLASSING PREVIOUSLY BIFURCATED EMBEDDED DERIVATIVES

If a previously bifurcated embedded derivative no longer meets the criteria for bifurcation, we believe an entity must remeasure it at fair value immediately before the reclassification and then recombine it with the host contract.

However, that does not apply to previously bifurcated embedded equity-linked features (such as an embedded conversion option) that are recognized as liabilities and reclassified to equity in accordance with ASC 815-40-35-10. If an embedded equity-linked feature no longer meets the bifurcation criteria (including because it now qualifies for a derivative scope exception), the entity reclassifies it to equity at its fair value on the reclassification date (that is, it is not recombined with the host contract).

If after issuance, circumstances change such that the conversion option no longer requires bifurcation and separate accounting as a derivative liability, the entity remeasures the option at fair value immediately before the reclassification and then reclassifies it to stockholders' equity. The entity continues to amortize any discount recognized when the conversion option was bifurcated from the convertible debt.

Subsequently, the entity accounts for the derecognition of that conversion option as follows:

- If the holder exercises a conversion option previously reclassified from liabilities to stockholders' equity, the entity recognizes any unamortized discount remaining at the date of conversion immediately as interest expense.
- If a debt instrument with a conversion option that had been reclassified from liabilities to stockholders' equity is extinguished for cash or other assets before its maturity date, the entity debits the cash paid equal to the conversion option's fair value at the date of extinguishment to equity. The entity then allocates the remaining reacquisition price to the debt instrument's extinguishment to determine the gain or loss on the transaction.

EXAMPLE 3-16: RECLASSIFICATION OF PREVIOUSLY BIFURCATED CONVERSION OPTION TO EQUITY AND SUBSEQUENT DEBT CONVERSION

FACTS

On January 10, 20X4, Issuer A, a publicly traded company, issued a 10-year convertible debt of $1 million with an 8% coupon, immediately convertible into 10,000 shares of common stock at $100 per share with no price resets.

- The convertible debt was not issued at a substantial premium.
- The convertible debt includes a call option the holder can exercise at any time and that does not require bifurcation.
- At issuance, Issuer A did not have enough authorized and unissued shares to satisfy the conversion option. The inadequate number of authorized shares alone resulted in bifurcating the conversion option and accounting for it as a liability. The convertible debt met all other requirements in ASC 815-40 for equity classification under the derivative scope exception in ASC 815-10-15-74(a).
- The conversion option had a value of $75,000 upon issuance, creating a debt discount on the convertible debt.

On June 6, 20X4, Issuer A authorized sufficient shares to satisfy the conversion option, and the embedded conversion option no longer required liability classification. The conversion option had a fair value of $100,000 on that date.

On January 10, 20X5, the debt holders convert the $1 million debt into 10,000 shares of common stock. The unamortized debt discount on that date was $67,760.

CONCLUSION AND ANALYSIS

On June 6, 20X4, Issuer A:

- Recognizes the change in the conversion option's fair value: a charge of $25,000 ($100,000 - $75,000)
- Decreases the derivative liability for the conversion option for $100,000 and increases APIC by $100,000
- Continues to amortize the initial debt discount of $75,000 (created from initial bifurcation of the embedded conversion option) over the life of the debt
- Makes the following entries:

Debit	Change in derivative liability (expense)	$	25,000		
Debit	Derivative liability		75,000		
Credit	APIC			$	100,000

On January 10, 20X5, Issuer A:

- Computes the unamortized debt discount as $67,760
- Expenses the unamortized discount, $67,760 as interest expense
- Makes the following entries:

Debit	Interest expense	$	67,760		
Debit	Debt		932,240		
Credit	Common stock ($1 par)			$	10,000
Credit	APIC				990,000

EXAMPLE 3-17: RECLASSIFICATION OF PREVIOUSLY BIFURCATED CONVERSION OPTION TO EQUITY AND SUBSEQUENT DEBT EXTINGUISHMENT

FACTS

Assume the same facts as in Example 3-16, except that on January 10, 20X5, instead of the convertible note being converted, Issuer A extinguishes all the debt for $1 million of cash. On that date, the conversion option had a fair value of $125,000 and the unamortized debt discount was $67,760.

CONCLUSION AND ANALYSIS

On June 6, 20X4, the journal entries are the same as in Example 3-16.

On January 10, 20X5, Issuer A:

- Allocates cash equal to the conversion option's fair value ($125,000) to APIC.
- Allocates the remainder ($875,000) to the debt and computes the amount of the gain on extinguishment ($57,240). That amount is the allocated proceeds ($875,000) compared to the carrying amount of the debt ($932,240) ($1 million less unamortized debt discount of $67,760).
- Makes the following entries:

Debit	APIC	$	125,000		
Debit	Debt		932,240		
Credit	Cash			$	1,000,000
Credit	Gain on debt extinguishment				57,240

3.8 INTERACTION WITH OTHER U.S. GAAP

ASC 815 interacts with other U.S. GAAP as summarized in the table.

TOPICS	INTERACTION	GUIDANCE
ASC 815-10 and ASC 480	Instruments in the scope of ASC 480 that meet the definition of a derivative instrument are in the scope of both ASC 480 and ASC 815-10 unless a derivative scope exception (such as the exception for forward purchase contracts in ASC 815-10-15-74(d)) applies. Financial instruments in the scope of both ASC 815-10 and ASC 480 generally are those instruments measured at fair value under ASC 480. While their initial and subsequent measurement might not differ under ASC 480 and ASC 815-10, the entity must consider the required disclosures under both topics.	Chapter 2
ASC 815-15 and ASC 480	If a hybrid instrument is accounted for under ASC 480 but does not require subsequent measurement at fair value, it must be evaluated under ASC 815-15 to determine whether its embedded features require bifurcation. That excludes any feature considered predominant under ASC 480 that resulted in the freestanding instrument being in the scope of that guidance (see Section 2.10).	Section 3.4
ASC 815-15 and ASC 825-10	An entity can elect the fair value option in ASC 815-15-25-4 or ASC 825-10 instrument by instrument or based on a predetermined policy as long as the financial instrument is not in whole or in part classified in equity (that includes instruments classified as temporary equity under ASC 480-10-S99-3A). If the fair value option is elected, the entity must remeasure the instrument at fair value, so no embedded derivatives are bifurcated from the instrument.	Section 3.4.2.1

TOPICS	INTERACTION	GUIDANCE
ASC 815-15 and ASC 815-40	If an embedded feature meets the definition of a derivative instrument, an entity evaluates whether a derivative scope exception applies. For contracts involving an entity's own equity, ASC 815-10-15-74(a) provides an exception if the embedded feature is indexed to the entity's own stock and would be classified in stockholders' equity if freestanding. ASC 815-10-15-74(a) refers to the guidance in ASC 815-40.	Chapter 4
ASC 815-15 and ASC 480-10-S99-3A	ASC 480-10-S99-3A requires public entities to classify redeemable equity instruments as temporary equity (also referred to as "mezzanine equity") if they are redeemable under **any** of the following circumstances: ▶ At a fixed or determinable price on a fixed or determinable date ▶ At the holder's option ▶ Upon the occurrence of an event that is not solely within the entity's control. However, even if the instrument is classified in temporary equity under ASC 480-10-S99-3A, an entity still must evaluate the instrument's embedded derivatives for bifurcation under ASC 815-15-25-1.	Chapter 5

Chapter 4 — Contracts in an Entity's Own Equity

4.1 OVERVIEW

An entity may issue a financial instrument indexed to, and sometimes settled in, its own equity for various reasons (most often to raise capital). The financial instrument may be freestanding or embedded in another instrument and may include multiple settlement choices for the issuer and holder. Such financial instruments are commonly referred to as "equity-linked instruments." U.S. GAAP does not define an equity-linked instrument, but that term generally refers to instruments involving an entity's own equity (for example, contracts to issue or buy back the entity's shares or contracts with settlement based on the value of the entity's shares) that must be evaluated under ASC 815-40.

The entity assesses those instruments under ASC 815-40, which applies to **both**:

- Freestanding instruments, in determining whether an entity must classify the financial instrument as equity
- Embedded derivatives, in determining whether an entity must separate an embedded derivative from the host contract for accounting purposes.

It is important that an entity applies ASC 815-40 to the appropriate unit of account as determined under other U.S. GAAP because the unit of account an entity uses may affect the analysis and result in different conclusions under ASC 815-40 (see Section 4.3).

As discussed in Chapter 2, when evaluating a freestanding equity-linked instrument, the entity first evaluates whether the instrument is a liability (or an asset in some cases) under ASC 480. If the instrument is not within the scope of ASC 480, the entity evaluates whether it meets the definition of a derivative instrument in ASC 815-10 (see Chapter 3 and Appendix A). If the freestanding equity-linked instrument meets the definition of a derivative instrument, the entity evaluates whether the instrument meets the scope exception from derivative accounting in ASC 815-10-15-74(a) (which refers to ASC 815-40). However, an entity must also evaluate any freestanding financial instrument that is potentially indexed to and settled in its own stock under ASC 815-40 regardless of whether it meets the definition of a derivative instrument in ASC 815-10. If the freestanding equity-linked instrument is indexed to the entity's own stock and meets the criteria for equity classification, the entity classifies it as equity under ASC 815-40. If the equity-linked instrument is not indexed to the entity's own stock or does not meet the criteria for classification in the entity's stockholders' equity, the entity accounts for it as an asset or liability at fair value with changes in fair value recognized in earnings.

Further, as discussed in Chapter 3, an entity must evaluate an embedded equity-linked feature (such as a conversion option) to determine whether the embedded feature qualifies for the derivative scope exception in ASC 815-40 if the embedded feature (1) is not clearly and closely related to the host contract, (2) is embedded in an instrument that is not remeasured at fair value, and (3) meets the definition of a derivative. If the embedded feature qualifies, the entity does not separate it from the host contract and the entity accounts for the entire instrument (assuming no other features require bifurcation) in accordance with other U.S. GAAP (for example, ASC 470, ASC 480, ASC 480-10-S99-3A, or ASC 505). If it does not qualify for the derivative scope exception in ASC 815-40, the entity accounts for the embedded feature separately from the host contract as a derivative liability (or derivative asset in some cases) and remeasures it at fair value, with changes in fair value recognized in earnings.

There are two key components to the ASC 815-40 assessment. The entity must assess whether:

The equity-linked instrument is indexed to the entity's own stock under ASC 815-40-15

This is often referred to as the "indexation guidance" and includes a two-step test to determine whether a freestanding or embedded equity-linked instrument is indexed to an entity's own stock (see Section 4.5):

- **Step 1: Evaluate the instrument's exercise contingencies** — This step focuses on contingency provisions that affect whether or when an instrument can be exercised. An instrument passes Step 1 (and would then be analyzed under Step 2) if the instrument's contingent exercise provisions (if any) are not based on an observable market or index (or if based on an observable market or index, it is based on the market for the entity's stock, or an index calculated or measured solely by reference to the entity's own operations).
- **Step 2: Evaluate the instrument's settlement provisions** — This step focuses on the instrument's settlement amount upon exercise or conversion. The instrument passes Step 2 if it meets either of the following conditions:
  - The instrument's settlement amount equals the difference between the fair value of a fixed number of the entity's shares and a fixed monetary amount or fixed amount of debt issued by the entity.
  - If the strike price or settlement amount is variable, the only variables that would affect the instrument's settlement amount are inputs to the fair value of a fixed-for-fixed forward or option on equity shares. Those inputs are generally the same as the inputs to the Black-Scholes option pricing model.

If a freestanding or embedded equity-linked instrument is not indexed to an entity's own stock, the entity accounts for it as an asset or liability. If the instrument passes the two-step test in the indexation guidance, the entity must further analyze it to determine whether it meets the criteria in the equity classification guidance described below.

The equity-linked instrument meets the criteria for equity classification in ASC 815-40-25

This is often referred to as the "equity classification guidance" and is based on the concept that contracts that require or may require an entity to net settle for cash are not considered a component of an entity's stockholders' equity (see Section 4.6).

If a freestanding or embedded equity-linked instrument fails the equity classification criteria, the entity accounts for it as an asset or liability. If the freestanding instrument meets the equity classification criteria (and the indexation's two-step test), the entity classifies it as equity. Also, embedded equity-linked instruments or features that meet the equity classification criteria (and pass the indexation's two-step test) qualify for the derivative scope exception. Thus, the entity does not bifurcate those embedded instruments or features from the host contract.

An entity initially measures at fair value all freestanding financial instruments in the scope of ASC 815-40. However, the entity recognizes freestanding instruments classified as equity based on the allocated proceeds if they are issued with other instruments (see Section 4.7).

The entity subsequently measures freestanding financial instruments classified as assets or liabilities at fair value, with changes in fair value recognized in earnings. The entity does not subsequently remeasure freestanding instruments classified as equity as long as the indexation and equity classification criteria continue to be met (see Section 4.7).

See Sections 3.7.1 and 3.7.2 for initial and subsequent measurement of nonbifurcated and bifurcated embedded derivatives.

An entity must continually reassess the classification of freestanding financial instruments (or embedded derivatives) at each balance sheet date, including when their terms are modified. If an instrument's classification changes, the entity reclassifies the instrument on the date of the event triggering the reclassification. The entity accounts for the instrument's modification and reclassification based on the instrument's classification before and after the reclassification (see Sections 4.8 and 4.9). See Section 3.7.3 for embedded derivative reassessment.

An entity accounts for the instrument's derecognition based on the instrument's classification and the form used for its settlement (see Section 4.10).

4.2 SCOPE

ASC 815-40 applies to all entities that are issuers of financial instruments (see Section 4.2.1). It applies to freestanding financial instruments and embedded derivatives that are potentially indexed to, and potentially settled in, an entity's own stock (see Section 4.2.2).

4.2.1 Entities

FASB REFERENCES

ASC 815-40-15-1 and ASC Master Glossary: Issuer

ASC 815-40 applies to all entities.

This chapter discusses the accounting for freestanding and embedded equity-linked financial instruments from the issuer entity's perspective. An issuer is the entity that issued an equity-linked financial instrument or may be required to issue its equity shares under the terms of the financial instrument. This chapter uses the terms "issuer" and "entity" interchangeably.

ASC 815-40 applies only to contracts in the entity's own equity, so the investor or holder of the freestanding instrument or hybrid instrument with the embedded feature does not apply it. That is because from the investor's perspective, the contract is indexed and settled in another entity's equity (that is, the issuer's equity).

4.2.2 Equity-Linked Instruments

FASB REFERENCES

ASC 815-40-15-2 through 15-4, ASC 718-10-35-10, and ASC 718-10-35-12

ASC 815-40 applies to freestanding instruments and embedded derivatives that are potentially indexed to, and potentially settled in, an entity's own stock.

Freestanding equity-linked Instruments

Common examples of freestanding financial instruments an entity evaluates under ASC 815-40 include:

- Written call options on an entity's shares (for example, warrants)
- Forward sale contracts on an entity's shares
- Purchased call options on an entity's shares
- Purchased put options on an entity's shares (for example, standby equity line of credits and tranche rights)
- Share-settled contingent consideration
- SAFE instruments

Embedded equity-linked instruments

Common examples of embedded equity-linked derivatives an entity evaluates under ASC 815-40 include:

- Written call options (for example, conversion features) in debt or equity instruments
- Purchased call and written put options on an entity's shares (for example, redemption features)
- Forward sale and purchase contracts on an entity's shares
- Purchased put options on an entity's shares (for example, embedded tranche rights)

While most of the financial instruments an entity assesses under ASC 815-40 are those issued in financing transactions, ASC 815-40 also applies to security price guarantees and to contingent consideration the entity issues in connection with a business combination.

The following contracts are also assessed under ASC 815-40:

- Outstanding shares that are contingently returnable (forfeitable) if a specified condition is not met. For example, in some special purpose acquisition company (SPAC) transactions (see Section 4.5.2.9.1), some or all the shares held by the sponsor entity may be forfeitable if a change in control transaction or other event does not occur by a specified date. In that case, although the shares subject to forfeiture are legally outstanding, the contract that provides for share forfeiture is treated as an equity-linked financial instrument.
- Pre-funded (or penny) warrants. For example, some warrants are pre-funded by the holder and exercisable for a nominal amount, such as $0.01 per share.

On the other hand, ASC 815-40 does not apply to any of the following:

- Financial instruments that are accounted for as assets or liabilities under ASC 480 (see Chapter 2)
- A written put option and a purchased call option embedded in the shares of NCI of a consolidated subsidiary if the arrangement is accounted for as a financing under ASC 480 (see Section 2.9)
- Share-based payment arrangements under ASC 718.

INTERACTION OF ASC 815-40 AND ASC 718

Common examples of arrangements that are within ASC 718 and therefore outside the scope of ASC 815-40 include share-based compensation for employees, options or warrants issued to suppliers or vendors in exchange for goods or services, and options or warrants exchanged as part of a revenue transaction with a customer in accordance with ASC 606, *Revenue from Contracts with Customers*. However, those instruments would need to be analyzed under ASC 480 (see Chapter 2) and ASC 815 (including ASC 815-40) if they are modified after any of the following:

- A grantee vests in the award and is no longer providing goods or services
- A grantee vests in the award and is no longer a customer
- A grantee is no longer an employee.

On the other hand, an equity-linked instrument an entity issues to nonemployee investors to establish a market-based measure of the grant-date fair value of employee stock options is not in the scope of ASC 718. The entity must evaluate that instrument in accordance with ASC 815-40.

4.2.3 Contingently Issuable Instruments

FASB REFERENCES

ASC 815-10-20: Firm Commitment and Financial Instrument, ASC 815-10-15-4, ASC 815-40-15-6, and ASC 815-40-20: Lock-Up Options

One of the steps in evaluating a financial instrument is determining the timing for the contract's accounting recognition. Many contracts include provisions with conditional rights or obligations to issue or repurchase shares based upon the occurrence or nonoccurrence of contingent events.

Outstanding instruments in the scope of ASC 815-40 are always considered issued for accounting purposes, except for lock-up options. That means an entity must account for equity-linked contracts even though they are contingently exercisable or settleable (for example, a warrant that becomes exercisable only when a contingency occurs, such as a business combination, IPO, or change in control), except for lock-up options.

ASC 815-40 defines lock-up options as "*contingently exercisable options to purchase equity securities of another party to a business combination, at favorable prices, to encourage successful completion of that combination. If the merger is consummated as proposed, the options expire unexercised. If, however, a specified event occurs that interferes with the planned business combination, the options become exercisable*." Lock-up options are considered issued for accounting purposes only when the options become exercisable.

BDO INSIGHTS — CONTINGENTLY ISSUABLE INSTRUMENTS

ASC 815-40-15-6 states that outstanding instruments within the scope of ASC 815-40 are always considered issued for accounting purposes. In that context, we believe outstanding instruments are those that meet the definition of a financial instrument because ASC 815-40 does not specify any other recognition criteria.

U.S. GAAP defines the term "financial instrument" as cash, evidence of an ownership interest in an entity, or a contract that **both**:

Imposes on one entity a contractual obligation to **either**:

- Deliver cash or another financial instrument to a second entity
- Exchange other financial instruments on potentially unfavorable terms with the second entity.

Conveys to that second entity a contractual right to **either**:

- Receive cash or another financial instrument from the first entity
- Exchange other financial instruments on potentially favorable terms with the first entity.

The definition's use of the term "financial instrument" is recursive (because the term is included in the definition), but it is not circular. The definition requires a chain of contractual obligations that ends with the delivery of cash or an ownership interest in an entity. Any number of obligations to deliver financial instruments can be links in a chain that qualifies a particular contract as a financial instrument.

Contractual rights and obligations encompass both those that are conditioned on the occurrence of a specified event and those that are not. Some contractual rights and obligations that are financial instruments might not be recognized in financial statements (that is, they might be off-balance-sheet) because they fail to meet some other criterion for recognition.

For some financial instruments, the right is held by, or the obligation is due from (or the obligation is owed to or by), a group of entities rather than a single entity.

Accordingly, we believe an entity (issuer) should recognize financial instruments under ASC 815-40 when either of the following occurs:

- The financial instrument is issued (including financial instruments that are contingently exercisable or settleable). Generally, a financial instrument is considered issued when the entity receives the agreed consideration (which may be cash, an enforceable right to receive cash, or another financial instrument, goods, or services).
- Before the financial instrument is issued, but the entity has a contractual right or obligation to issue it; that is typically when the parties' contractual rights and obligations arise from past transactions with economic substance, for example, as compensation for raising capital (a financing cost) or as a deferred cost entitling the entity to issue debt or equity in the future (see Section 6.2.1.3.1).

When it is not clear whether the entity has a contractual right or obligation to issue a financial instrument, we believe the entity should consider whether an agreement that is binding on both parties exists and the parties' rights and obligations are legally enforceable. While the conclusion will depend on facts and circumstances, we believe the Master Glossary's definition of the term "firm commitment" may be helpful for the analysis.

A FIRM COMMITMENT MAY EXIST	A FIRM COMMITMENT MAY NOT EXIST
Generally, a firm commitment exists when it allows one party to enforce performance by the counterparty and has both the following characteristics: ▶ Includes a disincentive for nonperformance that is sufficiently large to make performance probable (for example, the counterparty cannot terminate the contract without a significant penalty) ▶ Specifies all significant terms (including the quantity to be exchanged, the fixed price, and the timing of the transaction).	We generally believe a firm commitment does not exist if the party with the obligation to perform has the unilateral right to terminate the contract without cause or penalty. For example, we believe a firm commitment might not exist if an entity can require an investor to buy the entity's warrants only upon approval of the investor's shareholders or investment committee. Further, if the parties have not agreed on the contract's specific terms, that may prevent the arrangement from being enforceable.

Reaching a conclusion about whether a financial instrument is considered issued for accounting purposes requires the application of professional judgment based on the facts and circumstances.

4.3 DETERMINING THE UNIT OF ACCOUNT

FASB REFERENCES

ASC 815-40-15-2, ASC 815-40-15-4, and ASC 815-40-15-5B

An entity must apply ASC 815-40 to the appropriate unit of account, as determined under other U.S. GAAP (for example, under ASC 480 or ASC 815-10).

As discussed in Section 4.2.2, ASC 815-40 applies to **both**:

- Freestanding instruments (such as warrants), in determining whether the financial instrument must be classified as equity (see Section 4.3.1)
- Embedded derivatives (such as conversion features in debt or equity instruments), in determining whether the embedded derivative must be separated from the host contract (see Section 4.3.2)

4.3.1 Unit of Account for Freestanding Financial Instruments

FASB REFERENCES

ASC 815-10-15-8, ASC 815-10-25-9, and ASC 815-40-20: Freestanding Financial Instrument

Generally, before evaluating a freestanding equity-linked financial instrument (for example, warrants) under ASC 815-40, an entity first determines whether the financial instrument is in the scope of other U.S. GAAP, such as ASC 480. The entity then identifies the unit of account. For instance, because ASC 480 applies only to freestanding financial instruments, the entity must identify all the freestanding financial instruments it issued as part of the same transaction (see Section 2.3.1). If the equity-linked financial instrument is outside the scope of ASC 480, the entity must assess it under ASC 815-40 to determine whether it must classify the financial instrument as equity.

When identifying all the freestanding financial instruments it issued in the transaction, the entity must consider all key contractual terms and understand the arrangement's substance. A financial instrument is freestanding if it is **either**:

- Entered separately and apart from any of the entity's other financial instruments or equity transactions
- Entered in conjunction with some other transaction and is legally detachable and separately exercisable.

While U.S. GAAP does not specifically define the term "legally detachable," generally an instrument that can be legally separated and transferred to another party is considered legally detachable (see Section 2.3.1.2.1).

Typically, a feature is considered separately exercisable if it can be exercised without terminating another item. Generally, if exercising the feature results in the instrument's termination, such as through redemption or conversion, the feature is embedded and not freestanding. Conversely, if the feature can be exercised while the instrument remains outstanding and is also legally detachable, it is freestanding (see Section 2.3.1.2.2).

Generally, an entity must not combine separate financial instruments as a unit. However, if an entity enters two or more legally separate transactions that if combined would generate a result that is economically similar to a single transaction that would be accounted for as a derivative instrument under ASC 815-10, it must determine whether the separate transactions must be combined for accounting purposes (see Section 2.3.2).

Further, a contract may include more than one option. The accounting for that contract depends on whether the options are freestanding (see Section 2.3.3) or embedded (see Section 3.3.2) and are entered with the same or different counterparty. Generally, freestanding options are not combined in one unit of account unless the contract combination guidance applies. Also, options entered with different counterparties are not combined in one unit of account.

4.3.2 Unit of Analysis for Embedded Features

FASB REFERENCES

ASC 815-15-05-1

A freestanding financial instrument that is not a derivative instrument in its entirety (such as debt or stock) may contain embedded derivatives. In that case, the instrument is a hybrid instrument consisting of a host contract and an embedded derivative. An entity must evaluate whether the features in the hybrid instrument are freestanding or embedded by determining whether they are legally detachable and separately exercisable.

Frequently, hybrid instruments contain more than one embedded feature. For example, preferred stock may contain a conversion and redemption option. Further, the conversion or redemption option may include more than one exercise trigger. An entity must identify all the embedded features in the instrument and determine the appropriate unit of analysis using a consistent and rational approach (see Section 3.3.2). ASC 815-10 also addresses how an entity must view a combination of some embedded options (see Section 3.3.2).

4.4 ANALYZING CONTRACTS IN AN ENTITY'S OWN EQUITY

FASB REFERENCES

ASC 815-10-15-77

ASC 815-40 applies to freestanding contracts (or instruments) and embedded derivatives that are potentially indexed to, and settled in, an entity's own stock. The guidance in ASC 815-40-15 applies in determining whether a freestanding instrument meets the first part of the equity classification requirements in ASC 815-40 or an embedded feature qualifies for the first part of the scope exception in ASC 815-10-15-74(a) (see Section 4.5). On the other hand, ASC 815-40-25 applies in determining whether a freestanding instrument meets the second part of the equity classification requirements or an embedded feature qualifies for the second part of the scope exception (see Section 4.6).

4.4.1 Application to Freestanding Financial Instruments

FASB REFERENCES

ASC 815-10-15-74(a) and ASC 815-40-15-5

ASC 815-40 does not apply to freestanding financial instruments that are accounted for as assets or liabilities under ASC 480. Therefore, an entity first determines if the financial instrument is under ASC 480.

A financial instrument outside the scope of ASC 480 may or may not be a derivative instrument in its entirety. An entity accounts for a derivative financial instrument under ASC 815-10 as an asset or liability at fair value, with changes in fair value recognized in earnings unless a scope exception from derivative accounting applies. The most common derivative scope exception for equity-linked financial instruments is for contracts in an entity's own equity in ASC 815-10-15-74(a), which refers to the guidance in ASC 815-40. However, an entity assesses an equity-linked instrument under ASC 815-40 regardless of whether it is a derivative or nonderivative financial instrument.

An entity classifies a freestanding equity-linked instrument as equity if:

It is indexed to the entity's own stock

(see Section 4.5)

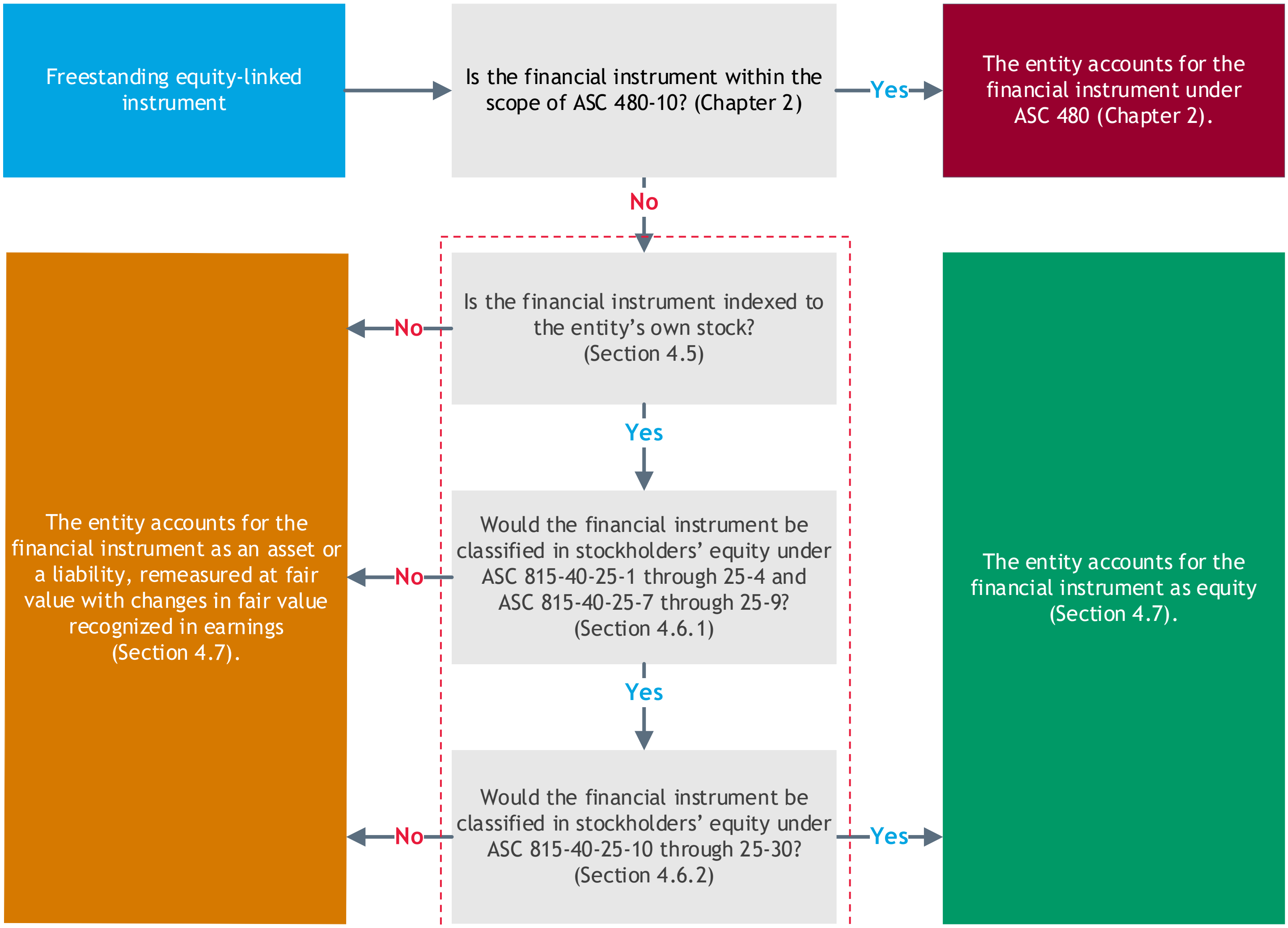
+

It meets the criteria to be classified in the entity's stockholders' equity

(see Section 4.6)

If a financial instrument is not indexed to the entity's own stock **or** it does not meet the criteria to be classified in the entity's stockholders' equity, the entity accounts for the financial instrument as an asset or a liability, measured at fair value on a recurring basis with changes in fair value recognized in earnings.

The flowchart illustrates an analysis of a freestanding equity-linked instrument.



4.4.2 Application to Embedded Features

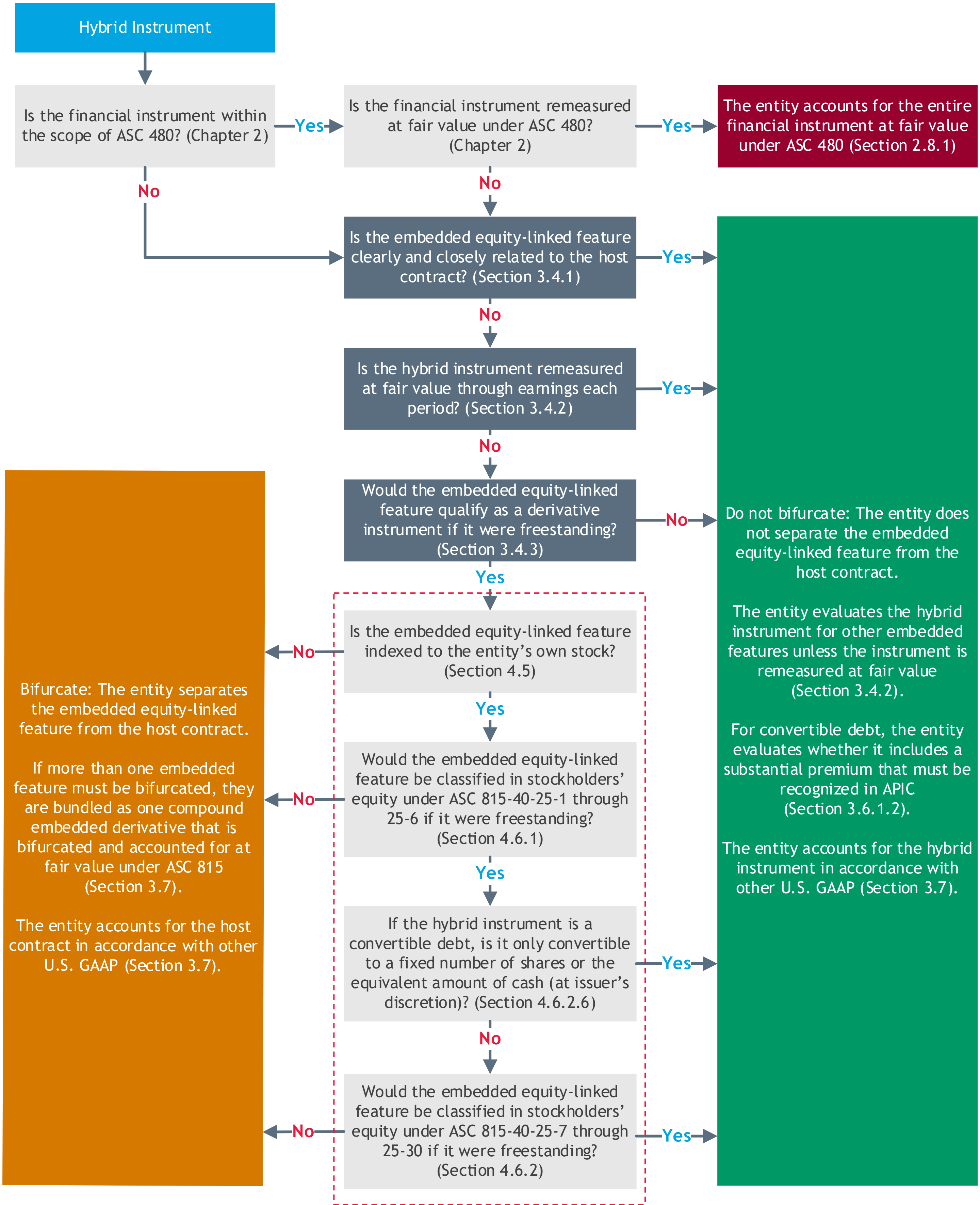
FASB REFERENCES

ASC 815-10-15-74(a)

Because ASC 815-40 determines whether a financial instrument can be classified as equity, the entity does not evaluate financial instruments that are in the form of an outstanding share and legal form debt for classification under ASC 815-40. An outstanding share outside ASC 480 is recognized in permanent equity (or temporary equity, if ASC 480-10-S99-3A applies), while a legal form debt cannot be recognized in equity (it is accounted for under other U.S. GAAP, such as ASC 470). However, if those financial instruments have embedded derivatives, the embedded derivatives are evaluated under ASC 815-40 to determine whether they must be bifurcated and accounted for as a derivative asset or liability separate from the equity or debt host contract.

As discussed in Chapter 3, an entity must evaluate whether an embedded derivative meets the criteria for bifurcation and whether a scope exception from derivative accounting applies. A common derivative scope exception for an embedded equity-linked derivative is when it is indexed to an entity's own stock and would be classified in the entity's stockholders' equity if it were freestanding (the scope exception in ASC 815-10-15-74(a)).

The flowchart illustrates an analysis of a hybrid instrument and its embedded equity-linked derivative.



4.5 INDEXATION GUIDANCE

FASB REFERENCES

ASC 815-40-15-7

An entity evaluates whether an equity-linked financial instrument or embedded derivative is indexed to its own stock using a two-step approach.

Step 1: Evaluate the instrument's contingent exercise provisions, if any (see Section 4.5.1).	Step 2: Evaluate the instrument's settlement provisions (see Section 4.5.2).

If a freestanding equity-linked instrument does not meet the indexation criteria, the entity recognizes it as an asset or liability, initially and subsequently measured at fair value, with changes in fair value recognized in earnings. Similarly, if an embedded equity-linked derivative does not meet the indexation criteria, the entity bifurcates it from the hybrid instrument (if all the bifurcation criteria are met) and recognizes it as an asset or liability at fair value, with changes in fair value recognized in earnings.

If the indexation criteria are met, the entity next evaluates the instrument under the equity classification guidance (see Section 4.6).

4.5.1 Step 1 — Evaluate Exercise Contingencies

FASB REFERENCES

ASC 815-40-15-7A through 15-7B, ASC 815-40-20: Exercise Contingency, ASC 815-40-55-26, and ASC 815-40-55-28

The first step in determining whether an instrument is indexed to an entity's own stock is evaluating any exercise contingencies. ASC 815-40 defines an exercise contingency as a "*provision that entitles the entity (or the counterparty) to exercise an equity-linked financial instrument (or embedded feature) based on changes in an underlying, including the occurrence (or nonoccurrence) of a specified event*." Examples of exercise contingencies include terms that accelerate the timing of an instrument's exercisability and terms that extend an instrument's exercise period.

An instrument (or embedded derivative) is indexed to an entity's (issuer's) own stock even if it includes exercise contingencies so long as the contingencies are **not** based on either of the following:

- An observable market, other than the market for the entity's stock (if applicable)
- An observable index, other than an index calculated or measured solely by reference to the entity's own operations (for example, the entity's sales revenue, EBITDA, or total equity).

The graphic includes examples of exercise contingencies that are permissible (meaning they do not preclude an instrument or embedded derivative from being indexed to an entity's own stock), as well as those that are not permissible (meaning they preclude an instrument or embedded derivative from being indexed to an entity's own stock).

Examples of Exercise Contingencies That Are Permissible

- Entity completing a merger, change in control, tender offer, or other similar transaction
- Entity's stock price reaching a specified threshold
- Initiating or completing an IPO or financing transaction
- Entity's EBITDA, sales revenue, or operating income meeting a specified target

Examples of Exercise Contingencies That Are Not Permissible

- CPI changing by more than a specified percentage during the contract's term
- Third-party stock reaching a specified threshold
- Oil prices decreasing below a specified price per barrel during the contract's term
- An index (for example, Dow Jones, S&P 500, prime rate, or SOFR) decreasing by at least a specified percentage or basis points in the next year

If the instrument (or embedded derivative) does not include an exercise contingency or the entity determines that the exercise contingencies do not preclude the instrument (or embedded derivative) from being indexed to the entity's own stock, the entity moves on to Step 2 (see Section 4.5.2).

If the instrument's (or embedded derivative's) exercise contingencies result in the instrument not being indexed to the entity's own stock, then:

- If a freestanding instrument, the entity accounts for it as an asset or liability (see Section 4.7).
- If an embedded derivative (and all other bifurcation criteria are met), the entity accounts for it separately as a derivative asset or liability in ASC 815-10 (see Section 3.7).

EXERCISE CONTINGENCIES THAT AFFECT THE SETTLEMENT AMOUNT

Sometimes, an exercise contingency also results in an adjustment to the instrument's strike price or the number of shares used to calculate the instrument's settlement amount. In that case, the entity evaluates the exercise contingency in Step 1 (to determine whether it is permissible) and the potential adjustment to the settlement amount in Step 2 (see Section 4.5.2.9.1).

EXAMPLE 4-1 (ADAPTED FROM EXAMPLE 2 IN ASC 815-40-55-26): EXERCISE TERMS BASED ON IPO

FACTS

Entity A issues warrants with the following terms:

- Exercisable for 100 shares of Entity A's common stock for $10 per share.
- Exercisable up to 10 years of the warrants' issuance but only become exercisable if Entity A completes an IPO.

CONCLUSION

The warrants pass Step 1 of the indexation guidance and must be evaluated under Step 2.

ANALYSIS

In determining whether the warrants are indexed to its own stock, Entity A performs the two-step test:

- Step 1 — Evaluate Exercise Contingencies: The warrants include an exercise contingency (Entity A completing an IPO). Because an IPO is not an observable market or index, it is a permissible exercise contingency (that is, it does not preclude the instrument from being indexed to the entity's own stock).
- Step 2 — Evaluate the Settlement Amount: Entity A must evaluate the warrants under Step 2 of the indexation guidance (see Example 4-21).

EXAMPLE 4-2 (ADAPTED FROM EXAMPLE 4 IN ASC 815-40-55-28): EXERCISE CONTINGENCY BASED ON STOCK PRICE INDEX

FACTS

Entity A issues warrants with the following terms:

- Exercisable for 100 shares of Entity A's common stock for $10 per share.
- Exercisable up to 10 years of the warrants' issuance but only become exercisable if the S&P 500 Index increases 500 points within any given calendar year while the warrants are outstanding.

CONCLUSION

The warrants are not indexed to Entity A's own stock and must be accounted for as liabilities, initially and subsequently measured at fair value, with changes in fair value recognized in earnings.

ANALYSIS

In determining whether the warrants are indexed to its own stock, Entity A performs the two-step test:

- Step 1 — Evaluate Exercise Contingencies: The warrants include an exercise contingency (S&P 500 Index increasing 500 points), which is based on an observable index that is not measured solely by reference to Entity A's operations. Therefore, it includes an exercise contingency that precludes the warrants from being indexed to the entity's own stock.
- Step 2 — Evaluate the Settlement Amount: Entity A does not need to evaluate the warrants under Step 2.

Because the warrants fail Step 1 of the indexation guidance, they are not indexed to Entity A's own stock.

4.5.2 Step 2 — Evaluate the Settlement Amount

FASB REFERENCES

ASC 815-40-15-5C and ASC 815-40-15-7C through 15-7G

The second step in determining whether an instrument is indexed to an entity's own stock is evaluating the instrument's settlement amount.

The instrument passes Step 2 if it meets **either** of the following:

- The instrument's settlement amount equals the difference between the fair value of a fixed number of the entity's shares and a fixed monetary amount or fixed amount of debt issued by the entity (commonly referred to as a "fixed-for-fixed settlement").
- If the instrument's settlement amount is variable (that is, settlement differs from a fixed-for-fixed settlement), the only variables that would affect the instrument's settlement amount would be inputs to the fair value of a fixed-for-fixed forward or option on equity shares. Those inputs are generally the same as the inputs to the Black-Scholes option pricing model.

THE FIXED-FOR-FIXED SETTLEMENT CONCEPT

A fixed-for-fixed forward or option on equity shares has a settlement amount that is equal to the difference between the fair value of a fixed number of equity shares and a fixed strike price (a fixed-for-fixed settlement amount), as shown in the graphic.

That settlement amount varies directly with the fair value of the entity's shares.

For example, Issuer A has such an instrument when it issues convertible debt for $1,000 that is convertible into 100 shares of common stock at a fixed conversion price of $10. Upon conversion, the settlement is always the fair value of 100 shares at the settlement date less $1,000. The fixed-for-fixed settlement of the embedded conversion option in that convertible debt passes Step 2 of the indexation guidance. Similarly, a warrant provision that gives the counterparty the right to buy a fixed number of the entity's shares for a fixed price represents a fixed-for-fixed settlement. That settlement provision passes Step 2.

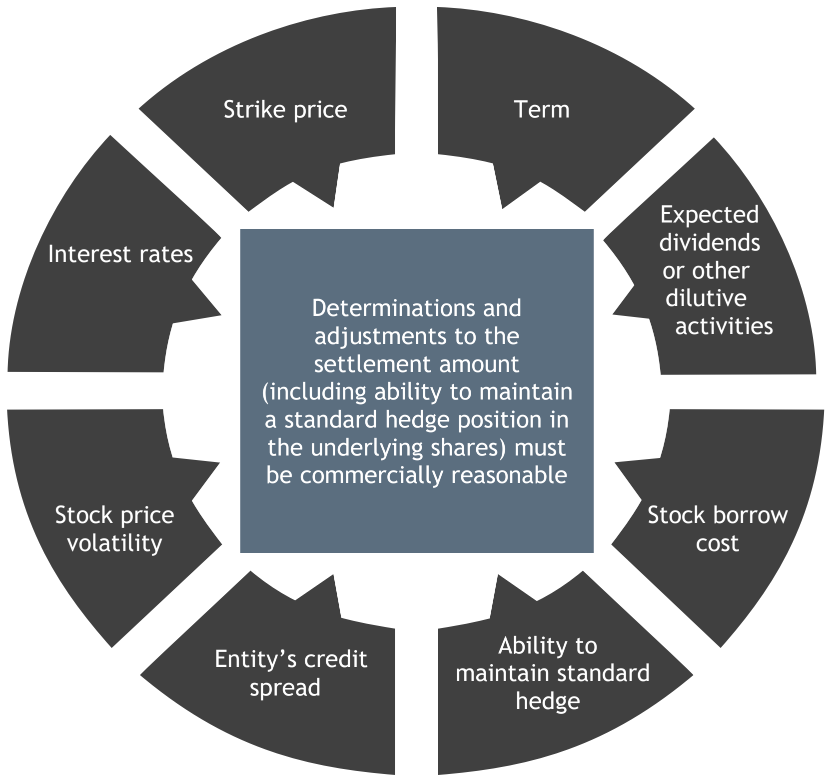
Also, in determining the fair value of a fixed number of shares, the terms of an instrument may provide that the fair value be based on the entity's average share price or volume-weighted average share price (VWAP) over a specified period (rather than the entity's stock price at the settlement date). As illustrated in ASC 815-40-55-38, the use of average stock price over a reasonable period (for example, 30 days) does not preclude an instrument from being indexed to an entity's own stock.

In practice, many financial instruments include provisions that adjust the instruments' exercise price or number of underlying shares and therefore adjust the settlement amount. In those cases, an entity must consider whether the variables that could affect the settlement amount are inputs to the fair value of a fixed-for-fixed forward or option on equity shares, regardless of the probability of any adjustment or whether the adjustments are in the entity's control.

If the instrument's settlement amount varies because of factors extraneous to the pricing of a fixed-for-fixed forward or option on its equity shares, it is not indexed to the entity's own stock even if the entity controls those factors and could prevent the settlement amount from changing.

FAIR VALUE INPUTS OF A FIXED-FOR-FIXED FORWARD OR OPTION ON EQUITY SHARES

The fair value inputs of a fixed-for-fixed forward or option on equity shares generally include the entity's stock price and additional variables. Those are typically the same as the inputs to the Black-Scholes option pricing model and include:



Standard pricing models for equity-linked instruments (such as forward contracts and options) contain both explicit inputs and implicit assumptions. Explicit inputs include the entity's stock price and additional fair value inputs illustrated above. Step 2 of the indexation guidance does not mean there can be no variability in the inputs. However, if the instrument's settlement calculation incorporates variables other than those illustrated above or includes a feature that increases exposure to those additional variables in a manner that is inconsistent with the fixed-for-fixed contract pricing model (such as a leverage factor), the instrument is not indexed to the entity's own stock.

Implicit assumptions include continuous stock price changes, event risks, and the counterparty's ability to hedge the instrument in question. For example, one implicit assumption is that dilutive events (such as an equity restructuring) will not occur (or that the instrument's strike price will be adjusted to offset the dilution caused by such events). Therefore, a provision that adjusts the instrument's terms when dilutive events occur (commonly referred to as "standard antidilution provisions") does not preclude an instrument (or embedded feature) from being indexed to an entity's own stock (see Section 4.5.2.2).

Another implicit assumption is that the stock price exposure inherent in the instrument can be hedged by entering an offsetting position in the underlying equity shares. For example, the Black-Scholes option pricing model assumes that the underlying shares can be sold short without transaction costs and that stock price changes will be continuous (that is, there are no price jumps). However, in practice, stock prices can experience large price jumps (up or down) because of events such as merger announcements or similar events, causing the actual pricing of equity-linked instruments to differ from the price inferred by a standard pricing model. In those cases, the instrument holder would be unable to continuously adjust its hedge position in the underlying shares due to the discontinuous stock price change, causing the changes in the instrument's fair value and the fair value of the offsetting hedge position to differ, creating a gain or loss (or arbitrage) for the instrument holder as a result of the merger announcement. Accordingly, in applying Step 2, fair value inputs include adjustments to neutralize the effects of events that can cause stock price discontinuities (see Section 4.5.2.4).

An entity may issue a financial instrument (or a financial instrument with an embedded feature) with a payoff that is wholly or partly based on its consolidated subsidiary's stock. In the parent's consolidated financial statements:

If the subsidiary is a substantive entity…	…the financial instrument (or embedded feature) is not precluded from being considered indexed to the entity's own stock if the criteria in Section 4.5 are met. That applies whether the instrument was entered by the parent or the subsidiary.
If the subsidiary is not a substantive entity…	…the financial instrument (or embedded feature) is not indexed to an entity's own stock.

Because ASC 815-40 does not define the term "substantive entity," an entity must use judgment to determine whether a subsidiary is a substantive entity.

BDO INSIGHTS — INSTRUMENT (OR EMBEDDED FEATURE) CONVERTIBLE OR EXERCISABLE FOR STOCK OF ANOTHER ENTITY

A subsidiary may issue debt that is convertible into shares of its parent entity. In those cases:

- In the parent's consolidated financial statements (which include the subsidiary), we believe the conversion option may be considered indexed to the entity's own stock because the debt converts into the reporting entity's stock.
- In contrast, in the subsidiary's standalone financial statements, we believe the parent's equity would generally not be considered equity of the subsidiary because the parent is not included in the subsidiary's financial statements. In that case, the conversion feature would not be considered indexed to the subsidiary's own stock.
    - However, in some **limited** situations, debt issued by an operating partnership that is convertible into the stock of its real estate investment trust (REIT) parent may be considered indexed to its own stock in the operating partnership's standalone financial statements. That typically depends on whether the REIT's stock is essentially the same as the operating partnership's stock (as may be the case when the REIT's only significant asset is its investment in the operating partnership). Reaching a conclusion requires the use of professional judgment based on the facts and circumstances.

Further, if the payoff of an instrument (or embedded feature) is wholly or partly based on the stock of another entity that is not consolidated by the reporting entity (for example, an equity method investee), the instrument (or embedded feature) would not be considered indexed to the reporting entity's own stock.

Freestanding financial instruments that fail Step 1 or 2 of the indexation guidance are not indexed to an entity's own stock and are accounted for as assets or liabilities. Similarly, embedded equity-linked features that fail Step 1 or 2 of the indexation guidance do not meet the derivative scope exception in ASC 815-10-15-74(a) and, if they meet all the criteria for bifurcation, are accounted for as derivative assets or liabilities under ASC 815. On the other hand, an entity must further analyze financial instruments (or embedded features) that meet **both** Steps 1 and 2 of the indexation guidance to determine whether they meet the equity classification criteria (see Section 4.6).

4.5.2.1 Variability Involving Stock Price

FASB REFERENCES

ASC 815-40-55-32, ASC 815-40-55-38, and ASC 815-40-55-40 through 55-41

As noted in Section 4.5.2, if an instrument (or an embedded feature) does not have a fixed strike price or fixed number of shares, an entity still considers the instrument (or the embedded feature) indexed to its own stock if the only variables that could affect the settlement amount are inputs to the fair value of a fixed-for-fixed forward or option on its equity shares. Because the entity's stock price is a fair value input of a fixed-for-fixed forward or option on equity shares, generally, variability resulting from terms related to an issuer's stock price does not fail Step 2 of the indexation guidance.

Further, a cap or floor on stock price or a cap on the number of underlying shares does not preclude an instrument from being indexed to an entity's own stock. However, an entity must first evaluate the contract in accordance with ASC 480. For instance, a freestanding equity-linked instrument that embodies an entity's obligation to issue a variable number of shares with a monetary value based solely or predominantly on a fixed amount (such as the variable share forward in Example 2-19) or a variable inversely related to the changes in the fair value of the entity's share (for example, a net-share-settled forward sale contract) is a liability (or an asset in some cases) within the scope of ASC 480 (see Section 2.6).

EXAMPLE 4-3 (ADAPTED FROM EXAMPLE 8 IN ASC 815-40-55-32): CALL OPTIONS WITH A STOCK PRICE CAP

FACTS

- Entity A purchases net-settled call options to buy 100 shares of its common stock for $10 per share.
- The appreciation on the call options is capped when Entity A's stock price rises to $15 per share or above (that is, the counterparty's obligation is capped at $500 ([$15 - $10] x 100 shares)).
- The call options have 10-year terms.
- Entity A can exercise the call options at any time.

CONCLUSION

The call options are indexed to Entity A's own stock. Entity A must assess them under the equity classification guidance (see Section 4.6) to determine whether they would be classified as equity.

ANALYSIS

In determining whether the call options are indexed to its own stock, Entity A performs the two-step test:

- Step 1 — Evaluate Exercise Contingencies: The call options do not include an exercise contingency. Entity A proceeds to Step 2.
- Step 2 — Evaluate the Settlement Amount: Entity A evaluates whether the settlement amount would equal the difference between the fair value of a fixed number of its equity shares and a fixed strike price.
  - When Entity A's stock price is between the stated exercise price ($10) and the price cap ($15), the settlement amount would equal the difference between the fair value of a fixed number of its equity shares (100 shares x stock price) and a fixed strike price (100 shares x $10).
  - When Entity A's stock price exceeds the price cap ($15), effectively, the call options' strike price increases and decreases with corresponding increases and decreases in the entity's stock price to cap the intrinsic value at $5 ($15-$10) per share. Therefore, the call options do not have a fixed strike price. However, the only variable that can cause the settlement amount to vary from a fixed-for-fixed settlement is the entity's stock price, which is an input to the fair value of a fixed-for-fixed option on equity shares. Therefore, the call options pass Step 2.

Because the call options pass Steps 1 and 2 of the indexation guidance, they are indexed to Entity A's own stock.

EXAMPLE 4-4 (ADAPTED FROM EXAMPLE 15 IN ASC 815-40-55-40): FORWARD SALE CONTRACT WITH A STOCK PRICE CAP AND FLOOR

FACTS

- Entity A enters a net-settled forward contract to sell 100 shares of its common stock in one year for $1,000, or $10 per share.
- The contract includes a cap on settlement at maturity as follows:
  - Maximum amount payable to the counterparty is capped when Entity A's stock price exceeds $15 per share (a stock price cap) (that is, Entity A's obligation is capped at $500 ([$15-$10] x 100 shares)).
  - Maximum amount receivable from the counterparty is capped when Entity A's stock price is equal or less than $5 per share (a stock price floor) (that is, the counterparty's obligation is capped at $500 ([$10-$5] x 100 shares)).

CONCLUSION

The forward sale contract is indexed to Entity A's own stock. Entity A must assess it under the equity classification guidance (see Section 4.6) to determine whether it would be classified as equity.

ANALYSIS

In determining whether the forward sale contract is indexed to its own stock, Entity A performs the two-step test:

- Step 1 — Evaluate Exercise Contingencies: The forward sale contract does not include an exercise contingency. Entity A proceeds to Step 2.
- Step 2 — Evaluate the Settlement Amount: Entity A evaluates whether the settlement amount would equal the difference between the fair value of a fixed number of its equity shares and a fixed strike price.
  - If Entity A's stock price is between the stock price floor ($5) and cap ($15) at maturity, the settlement amount would equal the difference between the fair value of a fixed number of its equity shares (100 shares x stock price) and a fixed strike price ($1,000).
  - If Entity A's stock price is outside the $5 to $15 range at maturity, the settlement is capped at $500. Particularly:
    - Entity A's obligation is capped at $500 if the stock price exceeds the cap price ($15).
    - The counterparty's obligation is capped at $500 if the stock price is equal or less than the floor price ($5).
  - The only variable that can cause the settlement amount to vary from a fixed-for-fixed settlement is the entity's stock price (including a floor and cap on the entity's stock price), which is an input to the fair value of a fixed-for-fixed forward contract on equity shares. Therefore, the forward sale contract passes Step 2.

Because the forward sale contract passes Steps 1 and 2 of the indexation guidance, it is indexed to Entity A's own stock.

EXAMPLE 4-5 (ADAPTED FROM EXAMPLE 13 IN ASC 815-40-55-38): FORWARD SALE CONTRACT INVOLVING AVERAGE STOCK PRICE AND INTEREST RATE

FACTS

- Entity A enters a net-settleable forward contract to sell 100 shares of its common stock in one year for $10 per share plus interest calculated at a variable interest rate (federal funds rate plus a fixed spread).
- The share price used to calculate the settlement amount is based on the VWAP of Entity A's common stock for the 30-day period before the settlement date.

CONCLUSION

The forward sale contract is indexed to Entity A's own stock. Entity A must assess it under the equity classification guidance (see Section 4.6) to determine whether it would be classified as equity.

ANALYSIS

In determining whether the forward sale contract is indexed to its own stock, Entity A performs the two-step test:

- Step 1 — Evaluate Exercise Contingencies: The forward sale contract does not include an exercise contingency. Entity A proceeds to Step 2.
- Step 2 — Evaluate the Settlement Amount: Entity A evaluates whether the settlement amount would equal the difference between the fair value of a fixed number of its equity shares and a fixed strike price.
  - The settlement amount will not equal the difference between the fair value of a fixed number of Entity A's shares (100 shares) and a fixed strike price ($10) because the settlement amount is calculated using an average stock price (rather than a fixed price) and an interest rate index.
  - Nonetheless, the forward sale contract passes Step 2 because:
    - The contract's settlement calculation does not incorporate variables other than those used to determine the fair value of a fixed-for-fixed forward contract on equity shares.
      - The pricing inputs of a fixed-for-fixed forward contract include the entity's stock price and interest rates.
    - The contract does not include a leverage factor that increases exposure to the additional variables listed in ASC 815-40-15-7E in a manner that is inconsistent with a fixed-for-fixed forward contract on equity shares.
      - The floating interest rate feature does not include a leverage factor or otherwise increase the effects of interest rate changes on the instrument's fair value.

Because the forward sale contract passes Steps 1 and 2 of the indexation guidance, it is indexed to Entity A's own stock.

EXAMPLE 4-6 (ADAPTED FROM EXAMPLE 16 IN ASC 815-40-55-41): FORWARD SALE CONTRACT WITH CAP ON SHARES ISSUED

FACTS

- Entity A enters a forward contract to sell a variable number of its common shares in one year for $1,000.
- The contract requires Entity A to issue a variable number of shares as follows:

IF ENTITY A'S STOCK PRICE ON MATURITY DATE IS:	ENTITY A MUST ISSUE AT SETTLEMENT:
Greater than $12	83.33 shares
Greater than $10 but equal to or less than $12	Variable number of shares worth $1,000
Equal to or less than $10	100 shares

CONCLUSION

The forward sale contract is indexed to Entity A's own stock. Entity A must assess it under the equity classification guidance (see Section 4.6) to determine whether it would be classified as equity.

ANALYSIS

In determining whether the forward sale contract is indexed to its own stock, Entity A performs the two-step test:

- Step 1 — Evaluate Exercise Contingencies: The forward sale contract does not include an exercise contingency (that is, its exercisability is based on passage of time, one year). Entity A proceeds to Step 2.
- Step 2 — Evaluate the Settlement Amount: Entity A evaluates whether the settlement amount would equal the difference between the fair value of a fixed number of its equity shares and a fixed strike price.
  - The settlement amount will not equal the difference between the fair value of a fixed number of Entity A's shares and a fixed strike price ($1,000) because while Entity A will receive a fixed price at settlement ($1,000), the number of shares it will issue to the counterparty varies based on its stock price on the settlement date.
  - However, the only variable that can cause the settlement amount to vary from a fixed-for-fixed settlement is stock price, which is an input to the fair value of a fixed-for-fixed forward contract on equity shares. Therefore, the forward sale contract passes Step 2.

Because the forward sale contract passes Steps 1 and 2 of the indexation guidance, it is indexed to Entity A's own stock.

ADJUSTMENTS RESULTING IN A FIXED PAYOFF AMOUNT

As illustrated in Example 4-6, an adjustment to the settlement amount that may result in settling the contract for a fixed monetary amount does not preclude an instrument from being indexed to the entity's own stock if the only variable that triggers the fixed payoff is the entity's stock price. However, an entity must first evaluate the contract under ASC 480 to determine whether it is in the scope of that guidance (see Example 2-19).

In contrast, as illustrated in ASC 815-40-55-35, an adjustment to the settlement amount resulting in the contract's settlement for a fixed monetary amount upon occurrence of a contingent event not based on the entity's stock price (in that case, regulatory approval) precludes the contract from being indexed to the entity's own stock (see Example 4-19).

4.5.2.2 Variability Involving Dilutive Events

FASB REFERENCES

ASC 815-40-20: Standard Antidilution Provisions and Equity Restructuring and ASC 815-40-55-42 through 55-43

As illustrated in ASC 815-40-55-42 through 55-43, some dilutive events do not preclude an instrument from being indexed to an entity's own stock. Those events include:

- Distributing a stock dividend or ordinary cash dividend
- Executing a stock split, spinoff, or rights offering
- Recapitalizing through a large, nonrecurring cash dividend
- Issuing shares for an amount below the then-current market price
- Repurchasing shares for an amount above the then-current market price.

DEFINITION OF STANDARD ANTIDILUTION AND EQUITY RESTRUCTURING

According to ASC 815-40, "*Standard Antidilution Provisions are those that result in adjustments to the conversion ratio in the event of an* ***equity restructuring*** *transaction that are designed to maintain the value of the conversion option.*" [Emphasis added]

An equity restructuring is a nonreciprocal transaction between an entity and its shareholders that causes the per-share fair value of the shares underlying an option or similar award to change. Examples of equity restructuring include:

- A stock dividend
- A stock split
- A spinoff
- A rights offering
- A recapitalization through a large, nonrecurring cash dividend.

Typically, antidilution adjustments are based on a mathematical formula to proportionately adjust the exercise price and the number of underlying shares to eliminate the dilution to the counterparty that would otherwise result from the dilutive events. If the formula adjusts for the actual change in the underlying share's market price (which may increase or decrease for other reasons) upon the occurrence of the dilutive events, the instrument would fail Step 2 of the indexation guidance.

As noted in Section 4.5.2, if the instrument (or embedded feature) does not have a fixed strike price or a fixed number of shares, the entity still considers the instrument (or feature) indexed to its own stock if the only variables that could affect the settlement amount are inputs to the fair value of a fixed-for-fixed forward or option on its equity shares.

The standard pricing models for equity-linked instruments (such as forward contracts and options) contain both explicit inputs and implicit assumptions (see Section 4.5.2). For example, the Black-Scholes option pricing model assumes that stock price changes will be continuous. In the real world, stock price discontinuities caused by events such as a merger announcement; a spinoff of a subsidiary; or a large, nonrecurring cash dividend violate that implicit assumption. Accordingly, in applying Step 2 of the indexation guidance, fair value inputs include adjustments to neutralize the effects of events that can cause stock price discontinuities.

For instance, a change in the shares' value that is directly attributable to an entity-initiated and dilutive transaction, such as a stock split, stock dividend, sale of shares at less than current fair value, or share repurchases for an amount exceeding the fair value, would ordinarily allow an adjustment to the exercise or conversion price of a fixed-for-fixed instrument. In contrast, the holder of a fixed-for-fixed instrument bears the risk of loss if the shares' fair value decreases because of changes in the market. Accordingly, standard antidilution provisions that allow the instrument holder to recoup part or all of a loss caused by a market-driven decline in the shares' value, even in remote circumstances, are not consistent with a fixed-for-fixed settlement and will cause the instrument to fail Step 2 of the indexation guidance. Therefore, it is important to assess whether the adjustment to the exercise or conversion price is limited to the change in the shares' value that is directly attributable to the entity's dilutive activities.

For example, an entity issues convertible debt for $1,000 that is convertible into 100 shares of common stock at a fixed conversion price of $10. The instrument includes a provision that the entity will adjust the conversion price for stock splits and dividends. If the entity's stock splits two shares for one, the conversion price is reduced to $5, and the number of shares increases to 200. Because the instrument's post-split settlement amount is the fair value of 200 shares at the settlement date less $1,000, which is economically the same as before the split, the entity would generally consider those types of adjustments as inputs to the fair value of a fixed-for-fixed forward or option on equity shares.

Further, if the instrument has a conversion price that adjusts if the entity sells shares below the then-current market price, to pass Step 2 of the indexation guidance, the adjustment cannot compensate the holder for losses caused by a market-driven decline in the shares' value unless the adjustment meets the definition of a down round feature (see Section 4.5.2.3).

Continuing with the example, assume that one year after issuance, when the shares' post-split current fair value has declined to $3 per share, the entity sells shares at a below-market price of $2 per share to new investors. The instrument would pass Step 2 even if the conversion feature reduces the earlier investor's conversion price for the effect of the sale of shares at a below-market discount of $1 per share (to adjust for the dilution caused by the new investors obtaining shares below the then-current fair value). However, if the conversion feature also adjusts the conversion price for the effect of the decline in market value from $5 to $3, it would fail Step 2 of the indexation guidance — unless the adjustment meets the definition of a down round feature (see Section 4.5.2.3) — because it compensates for a market-based decline in stock price not directly attributable to an entity-initiated and dilutive transaction.

EXAMPLE 4-7 (ADAPTED FROM EXAMPLE 17 IN ASC 815-40-55-42 THROUGH 55-43): FORWARD SALE CONTRACT WITH ANTIDILUTION ADJUSTMENTS

FACTS

- Entity A enters a forward contract to sell 100 shares of its common stock for $10 per share in one year.
- The forward contract's strike price is adjusted to offset the resulting dilution (except for issuances and repurchases that occur upon settlement of outstanding option or forward contracts on equity shares) if Entity A:
  - Distributes a stock dividend or ordinary cash dividend
  - Executes a stock split, spin-off, rights offering, or recapitalization through a large, nonrecurring cash dividend
  - Issues shares for less than the then-current market price
  - Repurchases shares at above the then-current market price.
- The adjustment is based on a mathematical calculation that determines the dilutive events' direct effect on the underlying shares' price.

CONCLUSION

The forward sale contract is indexed to Entity A's own stock. Entity A must assess it under the equity classification guidance (see Section 4.6) to determine whether it would be classified as equity.

ANALYSIS

In determining whether the forward sale contract is indexed to its own stock, Entity A performs the two-step test:

- Step 1 — Evaluate Exercise Contingencies: The forward sale contract does not include an exercise contingency. Entity A proceeds to Step 2.
- Step 2 — Evaluate the Settlement Amount: Entity A evaluates whether the settlement amount would equal the difference between the fair value of a fixed number of its equity shares and a fixed strike price.
  - The settlement amount will not equal the difference between the fair value of a fixed number of Entity A's shares (100 shares) and a fixed strike price ($1,000) because while Entity A will receive a fixed price at settlement ($1,000) if no dilutive events occur, the contract's strike price is adjusted if dilutive events do occur.
  - However, an implicit assumption in standard pricing models for equity-linked financial instruments is that dilutive events will not occur (or that the instrument's strike price will be adjusted to offset the dilution caused by such events). Therefore, the only variables that can cause the settlement amount to vary from a fixed-for-fixed settlement are inputs to the fair value of a fixed-for-fixed forward contract on equity shares. Therefore, the forward sale contract passes Step 2.

Because the forward sale contract passes Steps 1 and 2 of the indexation guidance, it is indexed to Entity A's own stock.

4.5.2.3 Variability Involving Down Round Features

FASB REFERENCES

ASC 260-10-25-1, ASC 260-10-30-1 through 30-2, ASC 260-10-35-1, ASC 260-10-45-12B, ASC 815-40-15-5D, ASC 815-40-20: Down Round Feature, and ASC 815-40-55-33 through 55-34

Many investors demand antidilution protection in convertible loans and warrant agreements. Those provisions protect the investors from declines in the underlying stock price and from dilution caused when subsequent investors receive a better conversion or exercise price (commonly referred to as "down round protection"). Down round protection is a common feature in venture capitalist financing agreements and frequently found in securities purchase and loan agreements.

Because dilution does not have a precise meaning, many investors believe the subsequent sale of shares at a lower price — even when that price reflects the then-current fair value — causes dilution. However, that kind of market-driven dilution is an economic risk borne by the holder of a fixed-for-fixed instrument, and any provision that would insulate the holder from such a loss, even under remote circumstances, is generally not an input to a fixed-for-fixed contract pricing model.

As noted in Section 4.5.2, if the instrument (or embedded feature) does not have a fixed strike price or a fixed number of shares, the entity still considers the instrument (or embedded feature) indexed to its own stock if the only variables that could affect the settlement amount are inputs to the fair value of a fixed-for-fixed forward or option on its equity shares. However, in that analysis, the entity disregards a down round feature. Said differently, a down round feature by itself does not preclude an instrument from being indexed to an entity's own stock. However, the entity must disclose the existence of down round features in the instruments it issues, when the down round features cause a strike price adjustment, and the amount of any such adjustment.

DEFINITION OF A DOWN-ROUND FEATURE

As noted above, a down round feature by itself does not cause an instrument to fail Step 2 of the indexation guidance. ASC 815-40 defines a down round feature as a feature that reduces the strike price of an issued financial instrument if the entity either:

- Sells shares of its stock for an amount less than the currently stated strike price of the issued financial instrument
- Issues an equity-linked financial instrument with a strike price less than the currently stated strike price of the issued financial instrument.

A down round feature includes adjustments that reduce the strike price of a financial instrument to any of the following:

- The current issuance price
- Less than the current issuance price
- An amount based on a formula that results in a price that is at a discount to the original exercise price but above the new issuance price of the shares or limited by a floor.

A standard antidilution provision (see Section 4.5.2.2) is not considered a down round feature.

Entities must evaluate provisions that adjust the instrument's strike price to determine whether they meet the definition of a down round feature.

EXAMPLE 4-8 (ADAPTED FROM EXAMPLE 9 IN ASC 815-40-55-33 THROUGH 55-34): VARIABILITY BASED ON FUTURE EQUITY OFFERINGS

FACTS

- Entity A issues warrants that allow the holder to buy 100 shares of its common stock for $10 per share, with the following down round feature:
  - If Entity A sells common shares for less than $10 per share, the warrant's strike price is adjusted to match that issuance price.
  - If Entity A issues an equity-linked financial instrument with a strike price below $10 per share, the warrant's strike price is adjusted to match the newly issued instrument's strike price.
- The warrants have 10-year terms and can be exercised at any time.

CONCLUSION

The warrants are indexed to Entity A's own stock. Entity A must assess them under the equity classification guidance (see Section 4.6) to determine whether they would be classified as equity.

ANALYSIS

In determining whether the warrants are indexed to its own stock, Entity A performs the two-step test:

- Step 1 — Evaluate Exercise Contingencies: The warrants do not include an exercise contingency. Entity A proceeds to Step 2.
- Step 2 — Evaluate the Settlement Amount: The settlement amount would equal the difference between the fair value of a fixed number of its equity shares and a fixed strike price except for the effect of the down round feature. In applying Step 2 of the indexation guidance, Entity A excludes the down round feature in its analysis in accordance with ASC 815-40-15-5D. The warrants do not contain any other features for assessment, so they pass Step 2.

Because the warrants pass Steps 1 and 2 of the indexation guidance, they are indexed to Entity A's own stock.

BDO INSIGHTS — DOWN ROUND ADJUSTMENTS ACCOMPANIED BY A RECIPROCAL INCREASE IN NUMBER OF SHARES

ASC 815-40 defines a down round feature in terms of reducing the strike price of an issued financial instrument. Therefore, a question arises on whether a simultaneous increase in the number of shares causes an adjustment feature to go beyond the down round definition, thereby precluding equity classification.

Paragraph BC15 in ASU 2017-11, *Accounting for Certain Financial Instruments With Down Round Features*, explicitly contemplates a strike price adjustment and implicitly allows for the number of underlying shares to change in a reciprocal fashion. For instance, it considers the effect of the ASU on convertible preferred shares and convertible debt instruments. That confirms that conversion features embedded in hybrid instruments are eligible for the down round exemption even though the number of shares in those instruments changes in response to a strike price adjustment (that is, the lower the conversion price, the higher the number of underlying shares upon conversion).

Paragraph BC29 in that ASU also says that *"the definition is not limited to situations in which the strike price is reduced to equal the current price of shares issued or to equal the current strike price in a newly issued equity-linked financial instrument. Rather, the new definition applies to down-round features that result in any reduction of the current strike price."*

The example below illustrates a simple reciprocal relationship between a decreasing strike price and increasing share count that has no effect on the investor's aggregate consideration:

- Issuer A issues a single warrant that otherwise allows Investor Y to buy 1,000 shares of Issuer A's common stock for a total of $10,000, or $10 per share. A down round provision embedded in that instrument could adjust both the number of shares and the strike price in varying combinations instead of adjusting only the strike price.
- Subsequently, Issuer A issues a round of common stock at $8 per share, triggering the down round provision. If the strike price adjustment is a full ratchet (Scenario A), it results in a new strike price of $8 per share. The

number of shares referenced in the warrant would change to 1,250 for total proceeds upon exercise of $10,000. Alternatively, if the strike price adjustment is a weighted average (Scenario B), it may result in a new strike price of $9 per share. The number of shares referenced in the warrant would change to 1,111, also for total proceeds of $10,000.

The table below illustrates those scenarios.

	ORIGINAL TERMS	SCENARIO A FULL RATCHET	SCENARIO B WEIGHTED AVERAGE
Strike Price	$ 10	$ 8	$ 9
Shares	1,000	1,250	1,111
Total Proceeds	$ 10,000	$ 10,000	$ 10,000

We believe ASC 815-40-15-5D allows the reciprocal increase in the number of issuable shares resulting from a down round feature if both:

- The adjustment results from a sale of stock or issuance of an equity-linked financial instrument at a price or strike price lower than the exercise price
- The resulting change does not increase the total proceeds due under the instrument upon exercise or conversion.

Based on informal discussions with the FASB staff, we understand that this is acceptable.

Determining whether a provision meets the definition of a down round feature requires the application of professional judgment based on the facts and circumstances.

EXAMPLE 4-9: DOWN ROUND FORMULA THAT DECREASES THE STRIKE PRICE AND INCREASES THE SHARE COUNT

FACTS

Issuer A issues a warrant for 2 million shares with an exercise price of $7.08 and a five-year term to Lender D as part of a debt financing. The warrant is exercisable at any time, in whole or in part.

The warrant includes a down-round protection such that if, during its term, Issuer A issues or sells common stock for a consideration per share less than the warrant exercise price, the exercise price will be reduced based on a formula.

During the warrant's term, Issuer A issues 1 million shares at $5 per share for an aggregate consideration of $5 million. Because the issuance price is below the warrant's original exercise price, it triggers the strike price adjustment.

SUMMARY OF FACTS	
Common shares outstanding before the down round issuance or sale (#CS)	23,815,216
Original exercise price of warrant (EP)	$7.08
Original number of warrant shares (#N)	2 million
Number of shares sold below exercise price (#CS1)	1 million
Share price for shares sold below exercise price (SP)	$5
Aggregate consideration (AC)	$5 million

The warrant's down round formula reduces the exercise price to equal the quotient obtained by dividing:

- The sum of:
  - The product of the common stock outstanding immediately before the down round issuance or sale (#CS) and the exercise price then in effect (EP) and
  - The aggregate consideration (AC) received by Issuer A upon the down round issuance or sale

  by:
- The sum of:
  - The common stock outstanding immediately before the down round issuance or sale (#CS) and
  - The aggregate number of shares of common stock issued or sold by Issuer A in the down round issuance or sale (#CS1).

Issuer A calculates the adjusted exercise price (EP1) as follows:

EXERCISE PRICE ADJUSTMENT	
Formula to determine the adjusted exercise price	EP1 = ((#CS x EP) + AC) / (#CS + #CS1)
Calculate the numerator: (EP x #CS) + AC	((23,815,216 x $7.08) + $5,000,000) = $173,611,729
Calculate the denominator: #CS + #CS1	23,815,216 + 1,000,000 = 24,815,216
Calculate the adjusted exercise price: EP1	$7 (rounded amount) = $173,611,729 / 24,815,216

Further, to maintain the total consideration to exercise the warrant, the warrant agreement increases the number of warrant shares to a number of shares equal to the quotient obtained by dividing:

- The product of:
  - The original exercise price (EP) and
  - The original number of warrant shares issuable upon the warrant exercise immediately before any such adjustment (#N)

  by:
- The exercise price resulting from such adjustment (EP1).

Issuer A calculates the adjusted warrant shares (#N1) as follows:

ADJUSTMENT TO NUMBER OF WARRANT SHARES	
Formula to determine the adjusted number of warrant shares	#N1 = EP x #N / EP1
Calculate the numerator: EP x #N	$7.08 x 2,000,000 = 14,160,000
Calculate the adjusted number of warrant shares: #N1	2,022,857 = 14,160,000 / $7.00

The warrant does not contain any other features for assessment.

CONCLUSION

The warrant is indexed to Issuer A's own stock. Issuer A must assess it under the equity classification guidance (see Section 4.6) to determine whether it would be classified as equity.

ANALYSIS

In determining whether the warrant is indexed to its own stock, Issuer A performs the two-step test:

- Step 1 — Evaluate Exercise Contingencies: The warrant does not include an exercise contingency. Issuer A proceeds to Step 2.
- Step 2 — Evaluate the Settlement Amount: Issuer A evaluates whether the settlement amount would equal the difference between the fair value of a fixed number of its equity shares and a fixed strike price. In applying Step 2, Issuer A excludes the down round feature in its analysis in accordance with ASC 815-40-15-5D, so the warrant passes Step 2.

The purpose of including both a strike price adjustment and an adjustment to the number of warrant shares is to maintain the total consideration to exercise the warrant, while still allowing the holder to participate in the lower strike price, as illustrated in the table.

	ORIGINAL	AS ADJUSTED
Number of warrant shares	2 million	2,022,857
Exercise price	$7.08	$7
Total consideration to exercise the warrant	$14,160,000	$14,160,000

Because the warrant passes Steps 1 and 2 of the indexation guidance, it is indexed to Issuer A's own stock.

BDO INSIGHTS — ADJUSTMENTS THAT ARE NOT CONSIDERED DOWN ROUND FEATURES

Some price adjustments may occur in a financial instrument (for example, Warrant Y) because an entity has modified the exercise or conversion price of a different financial instrument it previously issued (for example, Convertible Debt A). In those circumstances, the adjustment to Warrant Y is not from the entity's sale of shares of its stock or issuance of its equity-linked financial instruments. Based on discussions with the FASB staff, we believe the adjustment to Warrant Y's exercise price, or to any financial instrument with an adjustment in such a fact pattern, is not a down round feature in accordance with ASC 815-40-15-5D and would be ineligible for equity classification.

RECOGNIZING THE EFFECT OF A DOWN ROUND FEATURE

An entity that presents EPS in accordance with ASC 260 must recognize the value of the effect of the down round feature (when the down round feature is triggered) as a deemed dividend, which reduces income available to common stockholders in computing basic EPS (see Section 6.3.5.1). For a freestanding equity-classified financial instrument, such as a warrant, or equity-classified convertible preferred stock (if the conversion feature is not bifurcated), the deemed dividend is measured as the difference between the following amounts (determined immediately after the down round feature is triggered):

- The fair value of the financial instrument (without the down round feature) with the strike price immediately before the down round adjustment
- The fair value of the financial instrument (without the down round feature) with the strike price immediately after the down round adjustment.

The fair values are measured in accordance with ASC 820. The entity recognizes the effect of a down round feature each time it is triggered but does not remeasure the effect of a down round feature previously recognized. Further, the entity does not subsequently amortize the APIC that resulted from recognizing the effect of the down round feature.

If the down round feature of a liability-classified warrant or a bifurcated conversion option is triggered, its effect is included as part of the warrant's or the bifurcated conversion option's fair value remeasurement through earnings.

4.5.2.4 Variability Involving Merger Announcements, Change in Control Provisions, and Other Early Termination Events

FASB REFERENCES

ASC 815-40-15-7G

Equity-linked contracts often include provisions that adjust the settlement amount upon specified events (for example, upon merger, change in control, tender offer, or other similar events). Those provisions may involve any of the following:

- The contract requires the calculation agent (designated in the contract) to determine the adjustment to the strike price or calculate the adjusted settlement amount using commercially reasonable means. The adjustment is intended to neutralize the event's effect on the contract (that is, to compensate for the net gain or loss resulting from the event). That kind of provision is commonly found in ISDA contracts (see Section 4.5.2.4.1).
- The contract allows the holder to receive a settlement amount based on the instrument's Black-Scholes value. That kind of provision is commonly found in fundamental transaction clauses in non-ISDA contracts (see Section 4.5.2.4.2).
- The contract adjusts the exercise price or the number of underlying shares to compensate the holder for lost time value as a result of the contract's early termination (see Section 4.5.2.5).

4.5.2.4.1 Adjustments to Neutralize the Effects of Specified Events

FASB REFERENCES

ASC 815-40-15-7G and ASC 815-40-55-30

As noted in Section 4.5.2, if the instrument (or embedded feature) does not have a fixed strike price or a fixed number of shares, the entity still considers the instrument (or embedded feature) indexed to its own stock if the only variables that could affect the settlement amount are inputs to the fair value of a fixed-for-fixed forward or option on its equity shares. The standard pricing models for equity-linked instruments (such as forward contracts and options) contain both explicit inputs and implicit assumptions.

Implicit assumptions include event risk and the counterparty's ability to hedge the instrument in question. Specifically, standard pricing models assume that pricing inputs are fixed and the instrument can be hedged (that is, the counterparty can create a position in underlying shares to offset the instrument's exposure to changes in stock price). However, some events (such as merger announcements) may occur that affect the pricing inputs and the counterparty's ability to hedge its position.

Many instruments (particularly those that use ISDA contracts) include adjustment and termination provisions to neutralize the effect of merger announcements or similar events. A contract that includes event risk protection provisions that adjust the instrument's terms to offset the net gain or loss resulting from a merger announcement or similar events allows market participants to price the instrument objectively and as if the event will not occur (that is, using the output of a standard option pricing model). If the instrument did not include such provisions, market participants would consider the potential risk of loss and opportunity for gain caused by the event in deciding whether to enter a contract and at what price. In other words, the instrument's actual pricing at inception would be different from the price inferred by a standard option pricing model to reflect the market participants' exposure to such gain or loss.

Therefore, in determining whether a variable affecting the settlement amount is a valid input to the fair value of a fixed-for-fixed forward or option on equity shares:

- The absence of provisions to adjust the instrument's terms when merger announcements or similar events occur does not cause an instrument to fail Step 2 of the indexation guidance.
- Adjustments to neutralize the effects of events that can cause stock price discontinuities are considered fair value inputs and do not cause an instrument to fail Step 2.

ADJUSTMENTS THAT NEUTRALIZE THE EFFECT OF EVENTS THAT CAN CAUSE STOCK PRICE DISCONTINUITIES

A merger announcement might cause an immediate jump (up or down) in the price of an instrument's underlying share. The instrument holder cannot continuously adjust its hedge position in the underlying shares due to discontinuous stock price change, causing the changes in the instrument's fair value and the fair value of an offsetting hedge position in the underlying shares to differ — creating a gain or loss (or arbitrage) for the instrument holder as a result of the merger announcement. Therefore, if the instrument includes provisions that adjust the instrument's terms to offset the net gain or loss resulting from a merger announcement or similar event, those provisions do not preclude the instrument from being indexed to an entity's own stock.

For example, assume the following facts regarding an option upon a merger announcement:

- Fair value of the option before merger announcement: $5.70
- Fair value of the option after merger announcement: $9.70
- Stock price of underlying share before merger announcement: $100
- Stock price of underlying share after merger announcement: $105
- The delta hedge ratio is 0.50.

Absent a provision in the option adjusting for discontinuity in stock prices, the following gain and loss to the option holder would be:

- A gain of $4 on the option (the change in the fair value of the option from $5.70 to $9.70)
- A loss on hedge position of $2.50 (0.50 x ($105 - $100)) based on a standard delta hedge
- A net gain of $1.50 ($4 gain less $2.50 loss).

If the option has a provision to adjust the strike price to equal a price that implies an option value that excludes the net gain from merger announcements — in this case, an option value of $8.20 ($9.70 minus the net gain of $1.50) — that strike price adjustment does not preclude an equity-linked instrument (or embedded feature) from being indexed to an entity's own stock because it only neutralizes the effect of merger announcements.

However, any adjustment must be determined using commercially reasonable means. In the context of a merger, the adjustment is based on an assumption that the counterparty has entered a hedge position in the underlying shares to offset the share price exposure from the instrument and is not based on the counterparty's actual hedge position (that is, the adjustment should not differ in circumstances when the counterparty is over- or under-hedged).

Also, ISDA contracts often include settlement adjustments for other early termination events related to hedge disruption caused by discontinuity in stock prices, such as:

- Hedging disruption
- Loss of stock borrow
- Increased cost of hedging.

The design of those contract provisions generally passes the indexation guidance (that is, the contract requires that the adjustment be calculated using commercially reasonable means and an assumption of a standard hedge). However, the parties can modify those provisions in the trade confirmation or through a side letter. Therefore, entities must evaluate the relevant provisions, including any amendments to the standard ISDA terms.

EXAMPLE 4-10 (ADAPTED FROM EXAMPLE 6 IN ASC 815-40-55-30): ADJUSTMENTS BASED ON MERGER ANNOUNCEMENT

FACTS

- Entity A issues warrants giving the holder the right to buy 100 shares of Entity A's common stock for $10 per share.
- If there is a merger announcement involving Entity A, the warrants' strike price is adjusted to offset the effect of that event on the net change in (1) the warrants' fair value and (2) an offsetting hedge position in the underlying shares. The adjustment must be determined using commercially reasonable means based on an assumption that the counterparty has entered a hedge position in the underlying shares to offset the share price exposure from the warrants.
- The warrants have 10-year terms and can be exercised at any time.

CONCLUSION

The warrants are indexed to Entity A's own stock. Entity A must assess them under the equity classification guidance (see Section 4.6) to determine whether they would be classified as equity.

ANALYSIS

In determining whether the warrants are indexed to its own stock, Entity A performs the two-step test:

- Step 1 — Evaluate Exercise Contingencies: The warrants do not include an exercise contingency. Entity A proceeds to Step 2.
- Step 2 — Evaluate the Settlement Amount: Entity A evaluates whether the settlement amount would equal the difference between the fair value of a fixed number of its equity shares and a fixed strike price.
  - The settlement amount would equal the difference between the fair value of a fixed number of Entity A's shares (100 shares) and a fixed strike price ($10 per share) unless there is a merger announcement whereby it is adjusted to offset the effect of that event on the warrants' fair value. As discussed in ASC 815-40-15-7G, an entity considers adjustments to neutralize the effects of events that can cause stock price discontinuities as fair value inputs in applying Step 2. Therefore, the only variables that could affect the settlement amount are inputs to the fair value of a fixed-for-fixed option on equity shares, so the warrants pass Step 2.

Because the warrants pass Steps 1 and 2 of the indexation guidance, they are indexed to Entity A's own stock.

4.5.2.4.2 Settlement Upon Fundamental Transaction Events

FASB REFERENCES

ASC 815-40-15-7D through 15-7G, ASC 815-40-55-38, ASC 815-40-55-40, and ASC 815-40-55-45 through 55-46

Some fundamental transaction clauses in equity-linked contracts, such as warrants, include provisions that require the entity, either automatically or upon election by the holder, to settle the instrument based on its Black-Scholes value when events such as a merger, tender offer, or change in control occurs. Those fundamental transaction clauses are common in non-ISDA contracts and provide for a settlement amount calculated in a manner specified in the contract. They differ from contract provisions common in ISDA arrangements that adjust the settlement amount for the net gain or loss resulting from the specified events to neutralize their effect on the value of the contract (see Section 4.5.2.4.1).

BDO INSIGHTS — SETTLEMENT BASED ON BLACK-SCHOLES VALUE

The analysis of fundamental transaction clauses that require or may require settlement at the contract's Black-Scholes value depends on the inputs to the settlement's calculation:

- If the Black-Scholes settlement amount is calculated based on market-based inputs at the time of settlement, we believe it does not fail Step 2 of the indexation guidance because it uses variables that are inputs to a fixed-for-fixed contract pricing model. Therefore, it does not preclude the contract from being indexed to the entity's own stock in accordance with ASC 815-40-15-7D through 15-7F.
- If the Black-Scholes settlement amount is calculated based on prespecified inputs (see the BDO Insights below), we are aware of two views for determining whether the fundamental transaction clause precludes equity classification:
  - Some entities believe the potential for a settlement at something other than fair value under ASC 820 precludes equity indexation (the fair value view).
  - Others believe the settlement amount is commercially reasonable and does not preclude equity classification when the prespecified inputs are not extraneous to the pricing of a fixed-for-fixed forward or option on equity shares and there is no leverage in accordance with ASC 815-40-15-7E through 15-7F (the commercially reasonable view).

We believe either view is acceptable. The chosen approach must be applied consistently.

BDO INSIGHTS — SETTLEMENT ADJUSTMENTS BASED ON PRESPECIFIED VOLATILITY INPUTS

A question arises regarding whether provisions that prespecify the inputs (for example, volatility) to be used in calculating the instrument's settlement amount violate the indexation guidance. For instance:

- Some warrant agreements include a provision that entitles the holder to a settlement based on the Black-Scholes value of the warrant when a fundamental transaction occurs. A typical Black-Scholes option pricing model uses market-based inputs, such as the stock price's implied volatility. However, the warrant provision may state that the volatility input that must be used in the Black-Scholes option pricing will be equal to the greater of a fixed volatility (such as 100%) and the market volatility immediately after the merger announcement.
- Sometimes, entities issue a capped call option with convertible notes to reduce the potential dilution to the stockholders when the notes are converted. Typically, the capped call option includes the following terms:
  - Has a strike price equal to the conversion price of the convertible notes.
  - Has a cap price higher than the strike price (economically, the cap price increases the notes' conversion price).
  - Is automatically exercised when the notes are converted or upon the capped call option's expiration date.
  - May be net share or net cash settled (at the entity's option).
  - Adjusts the settlement amount when early termination events occur (such as a merger announcement or early redemption of the convertible notes).

  Economically, the capped call option is one instrument with two components: a purchased call option with the lower strike price and a written call option with the higher strike price (that is, the cap price).

  If an early termination event occurs, the calculation agent that is designated in the contract (typically, the dealer) must calculate the settlement amount using commercially reasonable means. However, parties sometimes enter a side letter agreement to specify some inputs to the settlement amount's calculation. For example, in valuing the components of the capped call option to determine the settlement amount, the side letter may state that the volatility inputs the dealer uses in its option pricing model must be:
  - For the purchased call option, determined by the dealer in good faith and in a commercially reasonable manner, provided it cannot be less than the written call option's volatility input
  - For the written call option, determined by the dealer in good faith and in a commercially reasonable manner, provided it cannot be greater than the purchased call option's volatility input.

In that context, we believe the indexation guidance indicates that an equity-linked contract is considered indexed to the entity's own stock even when the contract's inputs are not adjusted to market, or are subject to a floor or cap, in calculating the settlement amount. For instance:

- Example 13 in ASC 815-40-55-38 describes a forward contract with a settlement amount that varies based on average stock price and federal funds rate plus a fixed spread. That forward contract does not fail Step 2 of the indexation guidance because the settlement amount varies based on stock price and interest rates (which are permissible inputs), even though the referenced interest rate plus a fixed spread might not be at market when determining the settlement value of that forward contract. Rather, in that example, the strike price is adjusted for changes in an interest rate index to mitigate the effect of changes in interest rates on the overall fair value of the forward contract.
- Example 15 in ASC 815-40-55-40 describes a net-settled forward contract with a capped settlement based on the entity's stock price. The settlement amount varies based on the entity's stock price, as well as on the stock price cap and floor that limit the instrument's settlement value. That forward contract does not fail Step 2 of the indexation guidance because the variable that causes the settlement amount to vary is stock price, which is an input to a fixed-for-fixed contract pricing model, regardless of the inclusion of a cap and floor.
- Example 19 in ASC 815-40-55-45 through 55-46 describes a contingently convertible debt instrument that includes a make-whole provision if the entity is acquired for cash before a specified date. The make-whole table includes axes with stock price and time. The potential adjustments to the conversion rate from the make-whole table are fixed at inception because the table is not adjusted for changes in the variables that occur between the instrument's issuance and settlement. In other words, volatility is fixed because the table assumes no changes to the relevant pricing inputs (including volatility) other than stock price and time. The embedded conversion option in that example does not fail Step 2 of the indexation guidance.

Therefore, we believe a prespecified volatility input does not by itself fail Step 2. Instead, if the nature of the input is not extraneous to the pricing of a forward or option on equity shares and does not introduce leverage to the determination of the settlement amount, the input is considered commercially reasonable. Consequently, it does not fail Step 2 of the indexation guidance.

We also believe a provision specifying a fixed volatility (for example, 100%) does not fail Step 2 if the prespecified volatility approximates the volatility used in the instrument's initial pricing. In that case, there are no changes to the volatility input in calculating the settlement amount. We believe the lack of adjustment to all or some of the fair value inputs does not fail Step 2 of the indexation guidance.

Reaching a conclusion about whether a settlement adjustment is commercially reasonable and does not introduce leverage requires the application of professional judgment based on the facts and circumstances.

4.5.2.5 Variability Involving Make-Whole Provisions

FASB REFERENCES

ASC 815-40-55-45 through 55-46

Some contracts include make-whole provisions that require the entity to issue additional (make-whole) shares when an early termination event, such as a merger or early redemption, occurs. The purpose of those provisions is to compensate the counterparty for lost time value from the contract's early termination. The entity typically calculates the number of make-whole shares by reference to a make-whole table with axes of stock price and time. Because stock price and time are inputs to the fair value of a fixed-for-fixed forward or option, variability resulting from make-whole provisions generally does not fail Step 2 of the indexation guidance.

However, the provisions must reflect market-based assumptions to reasonably compensate the holder for lost time value from early contract termination. If a provision results in compensating the counterparty for more than the event's effect on the instrument's time value or if it includes leverage, the instrument is not indexed to the entity's own stock.

EXAMPLE 4-11 (ADAPTED FROM EXAMPLE 19 IN ASC 815-40-55-45 THROUGH 55-46): VARIABILITY BASED ON A MAKE-WHOLE PROVISION

FACTS

Entity A issues a contingently convertible debt instrument with the following terms:

- Has a par value of $1,000.
- Is payable after 10 years.
- Converts into 100 shares of Entity A's common stock at any time after any of the following events occurs:
  - Entity A's stock price exceeds $13 per share (market price trigger).
  - The convertible debt trades at less than 98% of its conversion value (parity provision).
  - Entity A announces a merger.
- Includes a make-whole provision:
  - If Entity A is acquired for cash by a specified date, the debt holder can convert into a number of shares equal to the sum of the fixed conversion ratio (100 shares) and the make-whole shares (determined by reference to a table with axes of stock price and time).
  - The make-whole table is designed so that the deliverable shares' aggregate fair value (100 shares plus the make-whole shares) would approximate the convertible debt's fair value at the settlement date, assuming no change in relevant pricing inputs (other than stock price and time) since the instrument's inception.

CONCLUSION

The convertible debt instrument's embedded conversion option is indexed to Entity A's own stock. Entity A must assess it under the equity classification guidance (see Section 4.6) to determine whether it would be classified as equity if freestanding.

ANALYSIS

In determining whether the convertible debt instrument's embedded conversion option is indexed to its own stock, Entity A performs the two-step test:

- Step 1 — Evaluate Exercise Contingencies: The convertible debt includes exercise contingencies that are based on observable markets (market price and parity triggers) and one that is not based on an observable market or index (merger announcement). Because the contingencies based on observable markets relate solely to the entity stock's market price and the trading price of its convertible debt, the embedded conversion option passes Step 1 of the indexation guidance. Further, a contingency that is not based on an observable market or index, such as the merger announcement, passes Step 1 of the indexation guidance. Entity A therefore proceeds to Step 2.
- Step 2 — Evaluate the Settlement Amount: Entity A evaluates whether the settlement amount would equal the difference between the fair value of a fixed number of its equity shares and a fixed strike price.
  - The settlement amount would equal the difference between the fair value of Entity A's 100 shares and a fixed strike price ($1,000), except if Entity A is acquired for cash before the specified date, wherein the convertible debt may be settled in exchange for 100 shares plus the make-whole shares. The number of make-whole shares is calculated based on a table with axes of stock price and time, which are both fair value inputs of a fixed-for-fixed option on equity shares, so the embedded conversion option passes Step 2.

Because the convertible debt instrument's embedded conversion option passes Steps 1 and 2 of the indexation guidance, it is indexed to Entity A's own stock.

4.5.2.6 Variability Involving Foreign Currency

FASB REFERENCES

ASC 815-40-15-7I, ASC 815-40-55-36, ASC 815-40-55-44, and ASC 815-40-55-47

An equity-linked instrument (or embedded feature) is not indexed to an entity's own stock if the strike price is denominated in a currency other than the entity's functional currency (for example, a convertible debt with a conversion option that is denominated in a currency other than the issuer's functional currency).

A change in exchange rates between the functional currency and the strike price's denominated currency increases or decreases the expected functional currency cash flows upon the instrument's settlement. That exposes the issuer of such equity-linked instrument to changes in currency exchange rates, resulting in the instrument not being indexed to the issuer's own stock.

That analysis does not consider the currency (or currencies) in which the underlying shares trade because an equity share is not inherently denominated in a particular currency.

EXAMPLE 4-12 (ADAPTED FROM EXAMPLE 18 IN ASC 815-40-55-44): FORWARD SALE CONTRACT WITH STRIKE PRICE DENOMINATED IN FOREIGN CURRENCY

FACTS

- Entity A enters a forward contract to sell 100 shares of its common stock for 120 Euros per share in one year.
- Entity A's functional currency is U.S. dollars.

CONCLUSION

The forward sale contract is not indexed to Entity A's own stock. Entity A must account for it as a liability, initially and subsequently measured at fair value, with changes in fair value recognized in earnings.

ANALYSIS

In determining whether the forward sale contract is indexed to its own stock, Entity A performs the two-step test:

- Step 1 — Evaluate Exercise Contingencies: The forward sale contract does not include an exercise contingency. Entity A proceeds to Step 2.
- Step 2 — Evaluate the Settlement Amount: Entity A evaluates whether the settlement amount would equal the difference between the fair value of a fixed number of its equity shares and a fixed strike price.
  - In accordance with ASC 815-40-15-7I, because the forward contract's strike price is denominated in a currency other than Entity A's functional currency, the forward contract fails Step 2.

Because the forward sale contract fails Step 2 of the indexation guidance, it is not indexed to Entity A's own stock.

EXAMPLE 4-13 (ADAPTED FROM EXAMPLE 11 IN ASC 815-40-55-36): WARRANTS WITH STRIKE PRICE DENOMINATED IN FOREIGN CURRENCY

FACTS

- Entity A issues warrants that allow the holder to buy 100 shares of its common stock for $10 Canadian dollars (CAD) per share.
- Entity A's functional currency is U.S. dollars.
- Entity A's shares trade on an exchange on which trades are denominated in CAD.
- The warrants have 10-year terms and can be exercised at any time.

CONCLUSION

The warrants are not indexed to Entity A's own stock. Entity A must account for them as liabilities, initially and subsequently measured at fair value, with changes in fair value recognized in earnings.

ANALYSIS

In determining whether the warrants are indexed to its own stock, Entity A performs the two-step test:

- Step 1 — Evaluate Exercise Contingencies: The warrants do not include an exercise contingency. Entity A proceeds to Step 2.
- Step 2 — Evaluate the Settlement Amount: Entity A evaluates whether the settlement amount would equal the difference between the fair value of a fixed number of its equity shares and a fixed strike price.
  - In accordance with ASC 815-40-15-7I, because the warrants' strike price is denominated in a currency other than Entity A's functional currency, the warrants fail Step 2. The fact that Entity A's shares trade on an exchange on which trades are CAD denominated is irrelevant (that is, an equity share is not denominated in any particular currency).

Because the warrants fail Step 2 of the indexation guidance, they are not indexed to Entity A's own stock.

EXAMPLE 4-14 (ADAPTED FROM EXAMPLE 20 IN ASC 815-40-55-47): DEBT CONVERTIBLE TO A STOCK THAT TRADES IN A CURRENCY OTHER THAN THE ENTITY'S FUNCTIONAL CURRENCY

FACTS

- Entity A issues debt denominated in Chinese yuan (CNY) with a par value of ¥1,000.
- The debt is convertible into 100 shares of Entity A's common stock.
- The convertible debt has a 10-year term and is convertible at any time.
- Entity A's functional currency is CNY.
- Entity A's shares trade only on an exchange in which trades are denominated in U.S. dollars and do not trade on any exchange or other established marketplace denominated in CNY.

CONCLUSION

The debt's embedded conversion option is indexed to Entity A's own stock. Entity A must assess the conversion option under the equity classification guidance (see Section 4.6) to determine whether it would be classified as equity if freestanding.

ANALYSIS

In determining whether the conversion option is indexed to its own stock, Entity A performs the two-step test:

- Step 1 — Evaluate Exercise Contingencies: The embedded conversion option does not include an exercise contingency. Entity A proceeds to Step 2.
- Step 2 — Evaluate the Settlement Amount: Entity A evaluates whether the settlement amount would equal the difference between the fair value of a fixed number of its equity shares and a fixed strike price.
  - When the convertible debt converts to Entity A's common shares, the settlement amount is equal to the difference between the fair value of 100 shares and a fixed amount denominated in Entity A's functional currency (¥1,000). The currency in which the instrument's underlying shares trade is not relevant in determining whether the embedded conversion option is indexed to the entity's own stock.

Because the embedded conversion option passes Steps 1 and 2 of the indexation guidance, it is indexed to Entity A's own stock.

4.5.2.7 Variability Involving Unilateral Ability to Amend Terms

FASB REFERENCES

ASC 815-40-15-7H

Most contracts include a provision that requires the issuer and counterparty's written consent to amend or waive the instrument's contractual terms. However, some contracts include provisions allowing the issuer to unilaterally modify the instrument's terms at any time if the modification benefits the counterparty (such as to reduce the exercise price or extend the exercise period as deemed appropriate by the issuer's board of directors). In applying Step 2 of the indexation guidance, those provisions do not affect whether the instrument (or embedded feature) is indexed to an entity's own stock.

However, the instrument's accounting and classification must be reassessed once the terms are amended.

4.5.2.8 Variability Involving Additional Variables in the Fixed-for-Fixed Contract Pricing Model

FASB REFERENCES

ASC 815-40-15-7E, ASC 815-40-55-37, and ASC 815-40-55-39

As noted in Section 4.5.2, if an instrument (or embedded feature) does not have a fixed strike price or fixed number of shares, the instrument (or embedded feature) is still considered indexed to an entity's own stock if the only variables that could affect the settlement amount are inputs to the fair value of a fixed-for-fixed forward or option on the entity's equity shares. In addition to stock price, the fair value inputs of a fixed-for-fixed forward or option on equity shares may include the following additional variables:

- Strike price of the instrument
- Term of the instrument
- Expected dividends or other dilutive activities
- Stock borrow cost
- Interest rates
- Stock price volatility
- The entity's credit spread
- The ability to maintain a standard hedge position in the underlying shares.

The fixed-for-fixed contract pricing model does not mean there is no variability in the inputs. However, if the instrument's settlement calculation incorporates variables other than those used to determine the fair value of a fixed-for-fixed forward or option on equity shares (such as a leverage factor that increases exposure to the additional variables listed above in a manner that is inconsistent with the fixed-for-fixed contract pricing model), the instrument is not indexed to the entity's own stock.

EXAMPLE 4-15 (ADAPTED FROM EXAMPLE 12 IN ASC 815-40-55-37): FORWARD SALE CONTRACT ADJUSTED FOR DIVIDENDS AND COST OF STOCK BORROWING

FACTS

Entity A enters a one-year forward contract to sell 100 shares of its common stock for $10 per share. The forward contract's strike price is adjusted for the following:

- Entity A has historically paid a dividend of $0.10 on its common shares per quarter. If Entity A declares and pays a different dividend amount per common share during any three-month period, it adjusts the strike price to offset the effect of the dividend differential (actual dividends versus $0.10) on the instrument's fair value.
- If there is an increased cost of borrowing Entity A's shares in the stock loan market, it adjusts the strike price using commercially reasonable means.

CONCLUSION

The forward sale contract is indexed to Entity A's own stock. Entity A must assess the contract under the equity classification guidance (see Section 4.6) to determine whether it would be classified as equity.

ANALYSIS

In determining whether the forward sale contract is indexed to its own stock, Entity A performs the two-step test:

- Step 1 — Evaluate Exercise Contingencies: The forward sale contract does not include an exercise contingency. Entity A proceeds to Step 2.
- Step 2 — Evaluate the Settlement Amount: Entity A evaluates whether the settlement amount would equal the difference between the fair value of a fixed number of its equity shares and a fixed strike price.
  - The settlement amount would equal the difference between the fair value of a fixed number of Entity A's shares (100 shares) and a fixed strike price ($10 per share), unless dividends per common share differ from $0.10 during any three-month period or there is an increased cost of borrowing Entity A's shares. However, the adjustments to the strike price are intended to offset the effects of those events on the instrument's fair value. The only variables that could affect the settlement amount are inputs to the fair value of a fixed-for-fixed forward on equity shares, so the forward sale contract passes Step 2.

Because the forward sale contract passes Steps 1 and 2 of the indexation guidance, it is indexed to Entity A's own stock.

EXAMPLE 4-16 (ADAPTED FROM EXAMPLE 14 IN ASC 815-40-55-39): VARIABILITY BASED ON AN INTEREST INDEX

FACTS

Entity A enters a one-year forward contract to sell 100 shares of its common stock for $10 per share plus interest calculated at a rate that varies inversely with changes in a specified interest rate index (inverse floating rate feature).

CONCLUSION

The forward sale contract is not indexed to Entity A's own stock. Entity A must account for it as a liability, initially and subsequently measured at fair value, with changes in fair value recognized in earnings.

ANALYSIS

In determining whether the forward sale contract is indexed to its own stock, Entity A performs the two-step test:

- Step 1 — Evaluate Exercise Contingencies: The forward sale contract does not include an exercise contingency. Entity A proceeds to Step 2.
- Step 2 — Evaluate the Settlement Amount: Entity A evaluates whether the settlement amount would equal the difference between the fair value of a fixed number of its equity shares and a fixed strike price.
  - The settlement amount would not equal the difference between the fair value of a fixed number of Entity A's shares (100 shares) and a fixed strike price ($10 per share). The inverse floating rate feature increases the

forward contract's fair value exposure to interest rate changes, which is inconsistent with that of a fixed-for-fixed forward contract. Therefore, the instrument fails Step 2.

Because the forward sale contract fails Step 2 of the indexation guidance, it is not indexed to Entity A's own stock.

4.5.2.9 Variability Involving Variables Extraneous to a Fixed-for-Fixed Contract Pricing Model

FASB REFERENCES

ASC 815-40-55-29, ASC 815-40-55-31, ASC 815-40-55-35, and ASC 815-40-55-48

ASC 815-40-55 includes examples in which settlement varies based on variables that are extraneous to the fair value inputs of a fixed-for-fixed forward or option on equity shares, such as:

- Changes in commodity prices
- Revenue targets
- Regulatory approval
- Stock option exercise behavior.

If the instrument's settlement amount varies because of factors extraneous to the pricing of a fixed-for-fixed option or forward contract on its equity shares, the instrument is not indexed to the entity's own stock even if the entity controls those factors and could prevent the settlement amount from changing.

EXAMPLE 4-17 (ADAPTED FROM EXAMPLE 5 IN ASC 815-40-55-29): VARIABILITY INVOLVING A COMMODITY PRICE

FACTS

Entity A issues warrants that allow the holder to buy 100 shares of its common stock in exchange for one ounce of gold. The warrants have 10-year terms but they only become exercisable if Entity A completes an IPO.

CONCLUSION

The warrants are not indexed to Entity A's own stock. Entity A must account for them as liabilities, initially and subsequently measured at fair value, with changes in fair value recognized in earnings.

ANALYSIS

In determining whether the warrants are indexed to its own stock, Entity A performs the two-step test:

- Step 1 — Evaluate Exercise Contingencies: The warrants include an exercise contingency (Entity A completing an IPO). The contingency is not an observable market or index, so the warrants pass Step 1. Entity A proceeds to Step 2.
- Step 2 — Evaluate the Settlement Amount: Entity A evaluates whether the settlement amount would equal the difference between the fair value of a fixed number of its equity shares and a fixed strike price.
  - The settlement amount would not equal the difference between the fair value of a fixed number of Entity A's shares (100 shares) and a fixed strike price. While the number of shares is fixed, the strike price based on the price of one ounce of gold varies, which is not an input to the fair value of a fixed-for-fixed option on equity shares. Therefore, the warrants fail Step 2.

Because the warrants fail Step 2 of the indexation guidance, they are not indexed to Entity A's own stock.

EXAMPLE 4-18 (ADAPTED FROM EXAMPLE 7 IN ASC 815-40-55-31): VARIABILITY CREATED BY A REVENUE TARGET

FACTS

Entity A issues warrants with the following terms:

- Exercisable for 100 shares of Entity A's common stock for an initial price of $10 per share.
- Exercise price reduces by $0.50 after any year in which Entity A fails to achieve revenues of at least $100 million.
- Exercisable at any time up to 10 years of the warrants' issuance date.

CONCLUSION

The warrants are not indexed to Entity A's own stock. Entity A must account for them as liabilities, initially and subsequently measured at fair value, with changes in fair value recognized in earnings.

ANALYSIS

In determining whether the warrants are indexed to its own stock, Entity A performs the two-step test:

- Step 1 — Evaluate Exercise Contingencies: The warrants do not include an exercise contingency. Specifically, the revenue target is not a contingency because the warrants are exercisable throughout their 10-year term. Rather, the revenue target affects the settlement amount. Entity A proceeds to Step 2.
- Step 2 — Evaluate the Settlement Amount: Entity A evaluates whether the settlement amount would equal the difference between the fair value of a fixed number of its equity shares and a fixed strike price.
  - While the number of underlying shares is fixed, the strike price is adjusted after any year in which Entity A does not achieve revenues of at least $100 million. The amount of revenues is not an input to the fair value of a fixed-for-fixed option on equity shares, so the warrants fail Step 2.

Because the warrants fail Step 2 of the indexation guidance, they are not indexed to Entity A's own stock.

EXAMPLE 4-19 (ADAPTED FROM EXAMPLE 10 IN ASC 815-40-55-35): VARIABILITY INVOLVING REGULATORY APPROVAL

FACTS

- Entity A issues warrants that allow the holder to buy 100 shares of its common stock for $10 per share.
- The warrants have 10-year terms and can be exercised at any time.
- Under the contractual terms, if Entity A does not achieve regulatory approval for a particular drug compound within the next five years, the holder can sell the warrants back to Entity A for $2 per warrant, settleable in common shares.

CONCLUSION

The warrants are not indexed to Entity A's own stock. Entity A must account for them as liabilities, initially and subsequently measured at fair value, with changes in fair value recognized in earnings.

ANALYSIS

In determining whether the warrants are indexed to its own stock, Entity A performs the two-step test:

- Step 1 — Evaluate Exercise Contingencies: The warrants do not contain an exercise contingency. Entity A proceeds to Step 2.
- Step 2 — Evaluate the Settlement Amount: Entity A evaluates whether the settlement amount would equal the difference between the fair value of a fixed number of its equity shares and a fixed strike price.
  - The settlement amount would equal the difference between the fair value of a fixed number of Entity A's shares (100 shares) and a fixed strike price ($10 per share), as long as Entity A obtains regulatory approval in the next five years.

- However, if Entity A fails to obtain regulatory approval within the next five years, the holder can require Entity A to settle the warrants at $2 per warrant, resulting in settlement for a fixed monetary value of $200 (100 warrants x $2 per warrant). That settlement differs from a fixed-for-fixed settlement, which results from Entity A failing to obtain regulatory approval, which is not an input to a fixed-for-fixed option on equity shares. Further, a fixed payoff amount upon the occurrence of a contingent event that is not based on the entity's stock price is not indexed to an entity's own stock. Therefore, the warrants fail Step 2.

Because the warrants fail Step 2 of the indexation guidance, they are not indexed to Entity A's own stock.

EXAMPLE 4-20 (ADAPTED FROM EXAMPLE 21 IN ASC 815-40-55-48): VARIABILITY INVOLVING STOCK OPTION EXERCISE BEHAVIOR

FACTS

- Entity A issues a security (a market-based stock option valuation instrument) to investors to establish a market-based measure of the grant-date fair value of a grant of stock options in a share-based payment transaction.
- Entity A must make variable quarterly payments to investors that are based on the net intrinsic value the entity's grantees receive based on actual stock option exercises by the grantees each quarter.
- The instrument has a 10-year term, which matches the contractual term of the underlying stock options.

CONCLUSION

The market-based stock option valuation instrument is not indexed to Entity A's own stock. Entity A must account for it as a liability, initially and subsequently measured at fair value, with changes in fair value recognized in earnings.

ANALYSIS

In determining whether the market-based stock option valuation instrument is indexed to its own stock, Entity A performs the two-step test:

- Step 1 — Evaluate Exercise Contingencies: This analysis depends on the instrument's particular terms and features. However, the instrument fails Step 2.
- Step 2 — Evaluate the Settlement Amount: Entity A evaluates whether the settlement amount would equal the difference between the fair value of a fixed number of its equity shares and a fixed strike price.
  - The market-based stock option valuation instrument contains variable quarterly payments that are based on the actual stock option exercises for the period. In other words, the variable that drives the settlement amount is based on stock option exercise behavior, which is not an input in the fair value of a fixed-for-fixed option on equity shares. The instrument therefore fails Step 2.

Because the market-based stock option valuation instrument fails Step 2 of the indexation guidance, it is not indexed to Entity A's own stock.

4.5.2.9.1 Variability Involving Contingencies

FASB REFERENCES

ASC 815-40-55-26 through 55-27

Some contingencies affect only the instrument's exercisability and timing of settlement, while other contingencies also affect the settlement amount. An instrument's contingent provisions do not preclude an instrument from being indexed to an entity's own stock if they are not based on an observable market or index other than those for the entity's stock or operations, and once any contingent events occur, the instrument's settlement is based solely on the entity's stock.

If an exercise contingency affects the instrument's settlement amount, an entity must assess it under Steps 1 and 2 of the indexation guidance. If the settlement amount varies based on factors extraneous to a fixed-for-fixed pricing of a forward or option on the entity's shares, the instrument fails Step 2.

Generally, an exercise contingency does not affect the settlement amount (and functions only as a trigger or condition to exercise or settle) if it causes the instrument holder to either:

- Receive no shares if the contingency does not occur
- Receive the contract's full stated number of shares if the contingency is resolved.

In contrast, generally, an exercise contingency affects the settlement amount if it results in settlement scenarios in which the instrument holder can potentially exercise for no shares, the full stated number of shares, or any number of shares in between based on the occurrence or nonoccurrence of that contingency. In that case, the entity must evaluate whether the settlement amount is based solely on the entity's stock price (that is, based on variables that are inputs to the fair value of a fixed-for-fixed forward or option on equity shares).

EXAMPLE 4-21 (ADAPTED FROM EXAMPLE 2 IN ASC 815-40-55-26): VARIABILITY INVOLVING AN IPO

FACTS

Entity A issues warrants with the following terms:

- Exercisable for 100 shares of Entity A's common stock for $10 per share.
- Exercisable up to 10 years after the warrants' issuance but only become exercisable if Entity A completes an IPO.

CONCLUSION

The warrants are indexed to Entity A's own stock. Entity A must assess them under the equity classification guidance (see Section 4.6) to determine whether they would be classified as equity.

ANALYSIS

In determining whether the warrants are indexed to its own stock, Entity A performs the two-step test:

- Step 1 — Evaluate Exercise Contingencies: The warrants include an exercise contingency (Entity A completing an IPO). Because an IPO is not an observable market or index, it is a permissible exercise contingency (that is, it does not preclude an instrument from being indexed to the entity's own stock). Entity A proceeds to Step 2.
- Step 2 — Evaluate the Settlement Amount: The exercise contingency does not adjust the warrants' strike price. Also, while it adjusts the number of shares issued upon exercise (that is, if Entity A does not complete an IPO during the warrant's term, zero shares are issued; if Entity A completes an IPO, 100 shares are issued), it represents only a contingency (because either none or all of the underlying shares are issued upon exercise). Because the holder can exercise the warrants only if Entity A completes an IPO, and upon exercise will receive 100 shares, the settlement amount upon exercise would equal the difference between the fair value of a fixed number of Entity A's shares (100 shares) and a fixed strike price ($10 per share). Therefore, the warrants pass Step 2.

Because the warrants pass Steps 1 and 2 of the indexation guidance, they are indexed to Entity A's own stock.

EXAMPLE 4-22 (ADAPTED FROM EXAMPLE 3 IN ASC 815-40-55-27): VARIABILITY BASED ON SALES VOLUME

FACTS

Entity A issues warrants with the following terms:

- Exercisable for 100 shares of Entity A’s common stock for $10 per share.
- Exercisable up to 10 years after the warrants’ issuance but only become exercisable if Entity A accumulates $100 million in sales to third parties.

CONCLUSION

The warrants are indexed to Entity A’s own stock. Entity A must assess them under the equity classification guidance (see Section 4.6) to determine whether they would be classified as equity.

ANALYSIS

In determining whether the warrants are indexed to its own stock, Entity A performs the two-step test:

- Step 1 — Evaluate Exercise Contingencies: The warrants include an exercise contingency (Entity A achieving $100 million cumulative third-party sales, which is an observable index). However, sales volume can be calculated or measured only by reference to Entity A’s sales. Therefore, it is a permissible exercise contingency (that is, it does not preclude the instrument from being indexed to the entity’s own stock). Entity A proceeds to Step 2.
- Step 2 — Evaluate the Settlement Amount: The exercise contingency does not adjust the warrants’ strike price, but it does adjust the number of shares (zero shares are issued if Entity A achieves less than $100 million cumulative third-party sales and 100 shares if the holder exercises the warrants after Entity A achieves $100 million cumulative third-party sales). Because the warrants can be exercised only if Entity A accumulates $100 million third-party sales, the settlement amount upon exercise would equal the difference between the fair value of a fixed number of Entity A’s shares (100 shares) and a fixed strike price ($10 per share). Therefore, the warrants pass Step 2 of the indexation guidance.

Because the warrants pass Steps 1 and 2 of the indexation guidance, they are indexed to Entity A’s own stock.

EXAMPLE 4-23: CONTINGENT CONSIDERATION — VARIABILITY BASED ON REVENUES

FACTS

On January 1, 20X4, Issuer A acquired Company X in a business combination. As part of the acquisition, Issuer A agreed to issue contingent consideration up to 1 million shares to former owners of Company X if its revenues for the 24-month period post-combination are:

- At least $100 million but less than $200 million, in which case Issuer A issues 500,000 shares
- At least $200 million but less than $300 million, in which case Issuer A issues 750,000 shares
- At least $300 million, in which case Issuer A issues 1 million shares.

Issuer A determines that the contingent consideration represents a single unit of account (see Example 2-3). Assume that the contingent consideration is not within the scope of ASC 480.

CONCLUSION

The contingent consideration is not indexed to Issuer A’s own stock. Issuer A must account for it as a liability, initially and subsequently measured at fair value, with changes in fair value recognized in earnings.

ANALYSIS

In determining whether the contingent consideration is indexed to its own stock, Issuer A performs the two-step test:

- Step 1 — Evaluate Exercise Contingencies: The contingent consideration has a settlement contingency (the post combination revenues, which is an observable index). That index can be calculated or measured only by reference to Issuer A's post-combination revenues. Therefore, it is a permissible exercise contingency (that is, it does not preclude the instrument from being indexed to the entity's own stock). Issuer A proceeds to Step 2.

- Step 2 — Evaluate the Settlement Amount: The contingency (revenue thresholds) adjusts the number of shares Issuer A must issue at settlement. Therefore, the settlement differs from a fixed-for-fixed settlement based on the amount of Issuer A's revenues, which is not an input to the fair value of a fixed-for-fixed forward or option on equity shares. The contingent consideration therefore fails Step 2.

Because the contingent consideration fails Step 2 of the indexation guidance, it is not indexed to Issuer A's own stock.

BDO INSIGHTS — EARNOUT WITH CHANGE-IN-CONTROL PROVISION

Some contracts include provisions that adjust the contract's settlement amount if specified events occur (for example, a merger, acquisition, sale of substantially all the entity's assets, change in control, or bankruptcy). Such events are not inputs to the fair value of a fixed-for-fixed forward or option on equity shares and therefore generally would fail Step 2 of the indexation guidance. However, if the adjustment to the settlement amount upon a change in control is triggered by a price that approximates the entity's stock price, it might not preclude an instrument from being indexed to an entity's own stock because stock price is an input to the fair value of a fixed-for-fixed forward or option on equity shares. Therefore, an entity must determine whether the potential adjustment to the settlement amount is based on a) the change in control (when the change-in-control price is not designed to approximate the stock's fair value) — in which case the contract would fail Step 2 — or b) the fair value of the entity's shares (when the change-in-control price is designed to approximate the stock's fair value) — in which case the provision would not fail Step 2.

For instance, a SPAC's acquisition of an operating company typically includes an earnout arrangement. SPACs are companies with no commercial operations that are formed to raise capital through an IPO for the sole purpose of acquiring one or more target businesses (referred to as "de-SPAC transactions"). The de-SPAC's earnout arrangement typically requires the post-combination entity to issue earnout shares to the operating company's legacy shareholders based on target stock price. The earnout arrangement often includes multiple thresholds of the target stock price and a change-in-control provision that may trigger the issuance of earnout shares.

For example, an earnout arrangement may require a SPAC to issue up to 3 million shares to the target's selling shareholders over the next three years as follows:

- 1 million shares if the post-combination entity's stock price reaches $10 per share or there is a change in control at a price of at least $10 per share
- Another 1 million shares if the stock price reaches $15 per share or there is a change in control at a price of at least $15 per share
- Another 1 million shares if the stock price reaches $20 per share or there is a change in control at a price of at least $20 per share.

If in Year 1 the stock price reaches $20 per share or the post-combination entity is acquired at a change-in-control price of at least $20 per share, all 3 million shares are issued.

If the earnout arrangement is not accounted for as a liability under ASC 480, the entity evaluates it under ASC 815-40 to determine whether it should be classified as equity. If the earnout arrangement is a single unit of account and the change-in-control provision requires issuing shares when a change in control occurs at a specified price, we believe the change-in-control provision would not violate Step 2 of the indexation guidance if the change-in-control price that triggers the issuance of shares approximates the stock's fair value. That depends on how the change-in-control price is calculated under the contractual terms. For instance:

- If the change-in-control price per share is calculated using the transaction consideration divided by a fully diluted number of the entity's outstanding shares, including the earnout shares, the change-in-control price reasonably approximates the fair value per share. Therefore, it does not preclude the earnout from passing Step 2 of the indexation guide.
- If the change-in-control price per share is calculated using the transaction consideration divided by a fully diluted number of the entity's outstanding shares that excludes the earnout shares, the change-in-control price

would not approximate the fair value per share. Therefore, it would preclude the earnout from passing Step 2 of the indexation guide.

Reaching a conclusion about how a change-in-control price must be calculated requires the application of professional judgment based on the facts and circumstances.

EXAMPLE 4-24: VARIABILITY CREATED BY A CHANGE-IN-CONTROL PROVISION THAT DOES NOT FAIL THE INDEXATION GUIDANCE

FACTS

A SPAC merges with Company X. The merger agreement requires the post-combination entity to issue up to 3 million shares of common stock to Company X's legacy shareholders (the earnout shares) within three years of the merger date (the earnout period) if the post-combination entity's common stock price targets (the earnout targets) are achieved:

- First earnout target: 1 million shares when the common stock VWAP equals or exceeds $10 for any 20 trading days within 30 consecutive trading days.
- Second earnout target: 1 million shares when the common stock VWAP equals or exceeds $15 for any 20 trading days within 30 consecutive trading days.
- Third earnout target: 1 million shares when the common stock VWAP equals or exceeds $20 for any 20 trading days within 30 consecutive trading days.

Further, if a change in control occurs during the earnout period, the earnout targets are deemed achieved by reference to the change-in-control price. For example, if the change-in-control price is at least $20 per share, all 3 million shares are issued (if not previously issued). Under the contractual terms, the change-in-control price is calculated by dividing the aggregate change in control consideration by the post-combination entity's fully diluted shares, including the earnout shares.

Assume the earnout represents a single unit of account.

CONCLUSION

The earnout shares are indexed to the entity's own stock. The entity must assess them under the equity classification guidance (see Section 4.6) to determine whether they would be classified as equity.

ANALYSIS

In determining whether the earnout shares are indexed to its own stock, the post-combination entity performs the two-step test:

- Step 1 — Evaluate Exercise Contingencies: The earnout arrangement includes exercise contingencies that trigger issuing the earnout shares (the stock price and change in control). The exercise contingencies pass Step 1 because the entity's stock price is an acceptable input. Further, the change in control is not an observable market or index. The entity proceeds to Step 2.
- Step 2 — Evaluate the Settlement Amount: The entity evaluates whether the settlement amount would equal the difference between the fair value of a fixed number of its equity shares and a fixed strike price.
  - The settlement amount changes based on the entity's stock price. Because stock price is an input to the fair value of a fixed-for-fixed forward or option on equity shares, the adjustment based on stock price targets does not fail Step 2 of the indexation guidance.
  - The settlement amount also changes based on the occurrence of a change in control. A change in control is not an input to the fair value of a fixed-for-fixed forward or option on equity shares. However, the entity determines that once a change in control occurs, the change-in-control price (which determines the number of earnout shares that would be issued) approximates the fair value of the entity's shares based on the way it is determined under the contractual terms. Therefore, the entity concludes the change-in-control provision does not fail Step 2.

Because the earnout shares pass Steps 1 and 2 of the indexation guidance, they are indexed to the entity's own stock.

EXAMPLE 4-25: VARIABILITY CREATED BY A CHANGE-IN-CONTROL PROVISION THAT FAILS THE INDEXATION GUIDANCE

FACTS

Assume the same facts as in Example 4-24 except that if a change in control occurs during the earnout period, the legacy shareholders receive all remaining (unissued) shares, irrespective of the change-in-control price.

CONCLUSION

The earnout shares are not indexed to the entity's own stock. The entity must account for them as liabilities, initially and subsequently measured at fair value, with changes in fair value recognized in earnings.

ANALYSIS

In determining whether the earnout shares are indexed to its own stock, the post-combination entity performs the two-step test:

- Step 1 — Evaluate Exercise Contingencies: The earnout arrangement includes exercise contingencies that trigger issuing the earnout shares (the stock price and change in control). The exercise contingencies pass Step 1 because, for the stock price, it is not based on an observable market other than the market for the entity's stock and, for the change in control, it is not an observable market or index. The entity proceeds to Step 2.
- Step 2 — Evaluate the Settlement Amount: The entity evaluates whether the settlement amount would equal the difference between the fair value of a fixed number of its equity shares and a fixed strike price.
  - The settlement amount changes based on the entity's stock price. Because stock price is an input to the fair value of a fixed-for-fixed forward or option on equity shares, the adjustment based on stock price targets passes Step 2 of the indexation guidance.
  - The settlement amount also changes based on the occurrence of a change in control, irrespective of the change-in-control price. For example, if a change in control occurs after the first earnout target has been met, the legacy shareholders would receive the remaining (unissued) 2 million shares. Accordingly, the change in control is not solely a Step 1 contingency because it affects how many shares the legacy shareholders receive. A change in control is not an input to the fair value of a fixed-for-fixed forward or option on equity shares. Therefore, the change-in-control provision fails Step 2.

Because the earnout shares fail Step 2 of the indexation guidance, they are not indexed to the entity's own stock.

4.5.2.9.2 Variability Involving a Percentage of the Entity's Equity

Some contracts include a provision that adjusts the number of shares issuable at settlement based on the number of the entity's total outstanding shares at the settlement date. Because the number of the entity's outstanding shares is not an input for determining fair value of a fixed-for-fixed forward or option on the entity's shares, the provision fails Step 2 of the indexation guidance.

EXAMPLE 4-26: WARRANTS — VARIABILITY BASED ON PERCENTAGE OF EQUITY

FACTS

Issuer A issues a warrant that allows an investor to purchase Issuer A's shares of common stock equal to 9.99% of Issuer A's equity at the time of exercise (computed on a fully diluted basis). The warrant is wholly exercisable on the second anniversary of issuance.

CONCLUSION

The warrant is not indexed to Issuer A's own stock. Issuer A must account for the warrant as a liability, initially and subsequently measured at fair value, with changes in fair value recognized in earnings.

ANALYSIS

In determining whether the warrant is indexed to its own stock, Issuer A performs the two-step test:

- Step 1 — Evaluate Exercise Contingencies: The warrant does not contain an exercise contingency. Issuer A proceeds to Step 2.
- Step 2 — Evaluate the Settlement Amount: The number of shares that Issuer A must issue when the holder exercises the warrant is not fixed. The settlement differs from a fixed-for-fixed settlement based on the number of Issuer A's outstanding shares, which is not an input to a fixed-for-fixed option on equity shares even if Issuer A controls whether additional shares or equity-linked instruments are issued and could prevent the settlement amount from changing. Therefore, the warrant fails Step 2.

Because the warrant fails Step 2 of the indexation guidance, it is not indexed to Issuer A's own stock.

BDO INSIGHTS — EXERCISE CAP BASED ON BENEFICIAL OWNERSHIP PERCENTAGE

Some contracts issued by public companies include share cap provisions limiting the number of shares that can be issued to the holder based on the holder's beneficial ownership percentage at the time of exercise. Contracts typically include the cap to avoid triggering specific SEC reporting requirements for the investor. We believe an entity should evaluate those provisions under Steps 1 and 2 of the indexation guidance as follows:

- Step 1: Evaluate Exercise Contingencies
  - If the instrument's exercisability is contingent on the share cap — for instance, because it entitles the holder to exercise the instrument only when a specified event (that is, the holder meeting the beneficial ownership cap condition) occurs — such exercise contingency is not based on an observable market or index. Therefore, the instrument passes Step 1.
- Step 2: Evaluate the Settlement Amount
  - The entity must evaluate whether the share cap provision results in a settlement amount that varies from a fixed-for-fixed forward or option on equity shares.
    - If the holder can receive the contract's full stated number of shares, the number of shares used in calculating the settlement amount is fixed, and the contract passes Step 2. That will be the case when the holder can partially exercise the instrument, theoretically allowing the holder to defer exercising a portion of the instrument until a later date without exceeding the cap; for instance, by selling other shares held by the investor into the market during the intervening period.
    - If it is possible the holder will receive some, but not all, of the contract's stated number of shares, the number of shares used in calculating the settlement amount is not fixed, and the contract fails Step 2. That will be so when the instrument is required to be settled at one specified date (the instrument cannot be exercised partially at any time). In that case, the holder may receive none, some, or all of the underlying shares (that is, the number of shares varies) based on its beneficial ownership at the time of settlement.
    - If the holder can exercise for only some, and not the full stated number of shares because of a specified contingency (such as a shareholder approval (see Section 4.5.2.9.3)), the settlement amount may not be fixed.

Reaching a conclusion about whether a share cap provision affects an instrument's settlement amount requires the application of professional judgment based on the facts and circumstances.

4.5.2.9.3 Variability Involving Shareholder Approval

Some contracts (such as warrants, convertible notes, or standby equity purchase agreements) include a provision that adjusts the number of issuable shares at settlement based on shareholder approval. As noted in Section 4.5.2.9, if the instrument's settlement amount varies because of factors extraneous to the pricing of a fixed-for-fixed option or forward contract on equity shares, the instrument is not indexed to the entity's own stock regardless of whether the entity controls those factors and could prevent the settlement amount from changing. Therefore, an entity must evaluate whether the instrument's settlement amount varies based on the shareholder approval because obtaining shareholder approval is not an input to the fair value of a fixed-for-fixed option or forward contract on equity shares.

BDO INSIGHTS — VARIABILITY IN SETTLEMENT AMOUNT RESULTING FROM SHAREHOLDER APPROVAL

Some listing exchanges require shareholder approval for some equity issuances in private placements (commonly referred to as the "20% rule"). Generally, the rule requires entities to obtain shareholder approval before issuing 20% or more of their outstanding equity securities or voting securities. As a result, entities sometimes include a contract provision restricting exercise until they obtain shareholder approval. Others include a cap that limits the number of shares the holder can receive upon exercise to 19.99% of the entity's equity or voting power until the required shareholder approval is obtained. We believe an entity should evaluate those provisions under Steps 1 and 2 of the indexation guidance as follows:

- Step 1: Evaluate Exercise Contingencies
  - If the instrument is not exercisable until the entity obtains shareholder approval, the approval is an exercise contingency because it entitles the holder to exercise the instrument when a specified event occurs (that is, when the shareholders approve the transaction). Shareholder approval is not based on an observable market or index. Therefore, the instrument passes Step 1 of the indexation guidance. The entity proceeds to Step 2.
  - If the instrument is exercisable at any time and does not include exercise conditions, the instrument does not have an exercise contingency (for instance, the instrument is immediately exercisable at issuance, albeit subject to a cap). The entity proceeds to Step 2.
- Step 2: Evaluate the Settlement Amount
  - As noted in Section 4.5.2.9.1, an instrument's contingent exercise provision does not preclude it from being indexed to the entity's own stock if, once the contingent event occurs, the instrument's settlement amount is based solely on the entity's stock. In other words, if the holder can receive the contract's full stated number of shares once the contingency is resolved, the number of shares used in calculating the settlement amount is fixed, and the contract passes Step 2. That will be the case if, for example, the instrument is not exercisable or settleable before the entity receives shareholder approval. Therefore, the holder will potentially receive no shares (before shareholder approval) or the full stated number of shares (after shareholder approval), but not a number in between.
  - If it is possible the holder will receive some, but not all, of the contract's stated number of shares, the number of shares used in calculating the settlement amount is not fixed, and the contract fails Step 2. That will be the case if, for example, before obtaining shareholder approval, the instrument is exercisable for the capped number of shares only yet becomes exercisable for shares in excess of the cap after shareholder approval is received. In that situation, the total number of shares the holder may receive under the contract varies based on whether the entity obtains shareholder approval. Because shareholder approval is not an input for determining the fair value of a fixed-for-fixed forward or option on the equity shares, the instrument fails Step 2.

    For example, consider a standby equity purchase agreement (SEPA) that gives the entity a right, but not an obligation, to sell shares to the counterparty from time to time during the duration of the contract. The total number of shares that can be issued under the arrangement is limited to 19.99% of the entity's common stock at the SEPA inception date (often referred to as an "exchange cap"). The exchange cap is removed once the entity's shareholders approve the issuance of shares in excess of the cap under the arrangement. Because shareholder approval is not an input for determining the fair value of a fixed-for-fixed forward or option on the entity's shares, the SEPA fails Step 2.

Reaching a conclusion about whether shareholder approval affects an instrument's settlement amount requires the application of professional judgment based on the facts and circumstances.

4.5.2.9.4 Variability Involving Effective Registration Statements

Some contracts include a provision that discounts the settlement amount for a lack of liquidity resulting from the delivery of unregistered shares (in lieu of registered shares). If the contractual terms require that the adjustment be calculated using commercially reasonable means, the provision by itself does not cause the contract to fail Step 2 of the indexation guidance.

Other contract provisions include different settlement amounts (unrelated to liquidity discounts) based on whether the entity has an effective registration statement at the time of exercise. In those cases, the entity must determine whether the settlement amount varies because of a factor other than stock price, such as the existence or absence of an effective registration statement. If so, the instrument fails Step 2 because an effective registration statement is not a fair value input of a fixed-for-fixed contract pricing model. Contract provisions that result in issuing more shares when there is an effective registration statement fail Step 2 for the same reason.

Accordingly, entities must assess any contract provisions that result in two different settlement amounts that depend on the existence of an effective registration statement to determine whether those provisions fail Step 2 of the indexation guidance.

4.5.2.9.5 Variability Involving the Holder's Identity

SPACs first emerged in the 1990s and are a mechanism for private companies to go public. In its IPO, a SPAC typically issues units to investors consisting of common shares and public warrants for common shares (public warrants). The SPAC also typically issues private placement warrants for common shares to its sponsor (private warrants) in a concurrent private placement.

Public and private warrants typically have common terms, but public warrants are often redeemable (at the SPAC's option) if the stock price equals or exceeds a specified price, while private warrants are redeemable only if the holder is not the sponsor (or its permitted transferee). Public and private warrant agreements also typically include a tender offer or exchange clause that adjusts the exercise price to account for lost time value related to the warrant's early termination when specified events, such as a tender or exchange transaction, occur. The adjustment includes inputs based on the warrant's fair value. Private warrants often state that their fair values will be determined based on the Black-Scholes option pricing model for a capped call option. However, the contract also states that other provisions specific to the sponsor "shall be taken into account." That means that if the warrant holder is the sponsor (or its permitted transferee), the fair value would instead be determined based on an uncapped call option, which would be greater than a valuation based upon a capped call option. That creates a scenario in which the private warrant's settlement terms differ based on the warrant holder's identity (for example, the SPAC's sponsor versus a third party), which is not consistent with the terms of the fixed-for-fixed concept in Step 2 of the indexation guidance. As such, equity classification is precluded for the private warrants with those terms.

In April 2021, the SEC staff issued a statement on the classification of SPAC warrants:

SEC STAFF GUIDANCE

John Coates, Acting Director, Division of Corporation Finance, and Paul Munter, Acting Chief Accountant

April 12, 2021

Excerpt from Staff Statement on Accounting and Reporting Considerations for Warrants Issued by SPACs

> *[U.S. GAAP] includes guidance that entities must consider in determining whether to classify contracts that may be settled in its own stock, such as warrants, as equity of the entity or as an asset or liability. Evaluation of this guidance requires an evaluation of the specific terms of the contract and also of an entity's specific facts and circumstances.*
>
> *An equity-linked financial instrument (or embedded feature) must be considered indexed to an entity's own stock in order to qualify for equity classification. While many instruments include a fixed strike price or a fixed number of shares used to calculate the settlement amount, other instruments may include variables that could affect the settlement amount. Such variables do not preclude a conclusion that the instrument is indexed to an entity's own stock if the*

variables would be inputs to the fair value of a fixed-for-fixed forward or option on equity shares. To assist in an entity's evaluation, GAAP includes a list of such inputs.

We recently evaluated a fact pattern relating to the terms of warrants that were issued by a SPAC. In this fact pattern, the warrants included provisions that provided for potential changes to the settlement amounts dependent upon the characteristics of the holder of the warrant. Because the holder of the instrument is not an input into the pricing of a fixed-for-fixed option on equity shares, OCA staff concluded that, in this fact pattern, such a provision would preclude the warrants from being indexed to the entity's stock, and thus the warrants should be classified as a liability measured at fair value, with changes in fair value each period reported in earnings.

[Footnotes omitted]

4.6 EQUITY CLASSIFICATION GUIDANCE

FASB REFERENCES

ASC 815-40-20: Net Cash Settlement, Net Share Settlement, and Physical Settlement and ASC 815-40-25-1 through 25-2

If a freestanding instrument (or embedded feature) is determined to be indexed to the entity's own stock, the next step is to determine whether it also would be classified in stockholders' equity in accordance with ASC 815-40-25.

In determining whether an instrument (or embedded feature) meets the equity classification criteria, an entity must do **both** of the following:

Evaluate the contract's settlement terms (see Section 4.6.1).

Assess whether the instrument meets the additional conditions for equity classification (see Section 4.6.2).

In accordance with ASC 815-40-25-1, contracts that require net cash settlement are assets or liabilities and contracts that require settlement in shares are equity instruments. If the contract gives the issuer a choice of net cash or share settlement, settlement in shares is assumed. If the contract gives the holder a choice of net cash or share settlement, net settlement in cash is assumed.

The table describes the different forms of contract settlement.

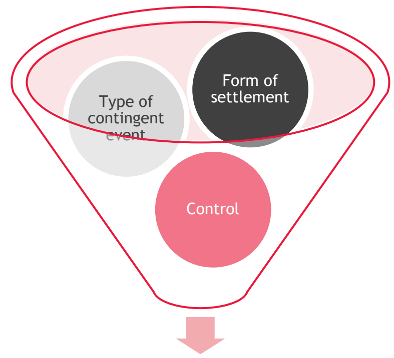
FORM OF SETTLEMENT	DEFINITION	EXAMPLES
Physical Settlement	The entity (issuer) delivers the full stated number of shares of stock to the investor (buyer). The investor delivers the full stated amount of cash or other financial instruments to the entity.	▶ A physically settled written call option (such as a warrant) or a physically settled purchased put option that the entity must settle by delivering the full stated number of shares in exchange for a full stated amount of cash from the investor. ▶ A physically settled purchased call option that the entity must settle by paying the investor the full stated amount of cash in exchange for a full stated number of its own shares.
Net Cash Settlement	The party with a loss delivers to the party with a gain cash equal to the gain, and no shares are exchanged.	▶ A warrant that requires net cash settlement when a fundamental transaction occurs ▶ A forward purchase contract that requires or allows the entity (the party with a loss) to pay cash equal to the contract's loss position (that is, the excess of forward price over the stock price), and no shares are exchanged.
Net Share Settlement	The party with a loss delivers to the party with a gain shares of stock with a current fair value equal to the gain.	▶ A warrant with a cashless exercise provision, with the entity delivering a number of shares with a value equal to the contract's gain position (that is, based on the difference between the stock price and exercise price). ▶ A forward purchase contract with terms that require or allow the entity (the party with a loss) to deliver a number of shares with a value equal to the contract's loss position (that is, the excess of forward price over stock price).

NET CASH SETTLEMENT ANALYSIS

The concept underlying the equity classification guidance is that an entity cannot account for a contract that could require net cash settlement (without regard to probability) as equity (except in those limited circumstances in which holders of underlying shares also would receive cash).

An entity's analysis of the contract's net cash settlement provisions includes evaluating the following:

- Form of settlement — If the contract requires, or could require, an entity to net cash settle the contract, that generally precludes the contract's equity classification.
- Control — Generally, if an event or action triggering net cash settlement requires board approval (that is, because of state law or the company's governing documents), it is within the entity's control unless the instrument holder controls the board. Conversely, if an event or action triggering net cash settlement is based on shareholder approval, it is outside the entity's control. Also, generally, a change in control is outside the entity's control.
- Type of contingent event — Whether the contract requires an entity to net cash settle involves careful consideration of the contract's provisions and the entity's specific facts and circumstances. The probability of events triggering net cash settlement does not change the analysis. However, limited exceptions apply. For example, net cash settlement when a change in control or a nationalization event occurs does not preclude equity classification if the holders of the underlying shares of the contract would also receive cash, even if those events are beyond the entity's control (see Section 4.6.1.2).



Analysis of Net Cash Settlement Clause

Further, an entity must assess additional equity classification conditions (see Section 4.6.2) to determine whether it could be required to net cash settle the contract (that is, whether it controls the events or actions necessary to net share or physically settle a contract). An entity continually assesses those additional conditions throughout the instrument's life, which could result in the instrument's reclassification. However, the additional conditions do not apply to a convertible debt instrument in which the holder can realize the conversion option's value only by exercising the option and receiving the entire proceeds in a fixed number of shares or the equivalent amount of cash at the entity's discretion (see Section 4.6.2.6).

4.6.1 Evaluate the Contract's Settlement Terms

FASB REFERENCES

ASC 815-40-25-1 and ASC 815-40-25-4

If a freestanding financial instrument meets the first part of the equity classification requirements in ASC 815-40 (or an embedded feature meets the first part of the scope exception in ASC 815-10-15-74(a)) — in other words, the contract is indexed to the entity's own stock — the entity assesses the second part (see Section 4.4). For the purpose of determining whether a contract meets the second part of the equity classification requirements (or the scope exception), the guidance in ASC 815-40-25 is based on the concept that:

- Contracts that require net cash settlement are assets or liabilities.
- Contracts that require settlement in shares are equity instruments.

CONTRACT SETTLEMENT'S EFFECT ON CLASSIFICATION	
Unless the economic substance indicates otherwise, contracts are initially classified as **equity** when they **either**: ▶ Require physical settlement or net share settlement. ▶ Give the issuer a choice of net cash settlement or settlement in its own shares (physical or net share settlement), assuming all the additional equity classification conditions (see Section 4.6.2) are met.	Unless the economic substance indicates otherwise, contracts are initially classified as **assets** or **liabilities** when they **either**: ▶ Require net cash settlement, including upon an event occurring outside the entity's control (see Section 4.6.1.2 for limited exceptions). ▶ Give the counterparty a choice of net cash settlement or share settlement (physical settlement or net share settlement).

PHYSICAL SETTLEMENT REQUIRING THE ENTITY TO PAY CASH

Assuming an instrument (or embedded feature) meets all the additional equity classification conditions (see Section 4.6.2), an entity classifies the instrument as equity (or does not separate the embedded feature from the host contract) if the contract requires or allows the entity to settle the instrument in shares (whether physical or net share settlement).

Physical settlement includes settlement in the full stated number of shares, even if the entity is the one paying cash and receiving (rather than delivering) shares. Therefore, a physically settled freestanding purchased call option is not precluded from being classified in equity even if the entity pays cash at settlement (see Section 4.6.1.1). Similarly, a redemption feature embedded in an equity host contract that an entity must or may settle using physical settlement could qualify for the derivative scope exception in ASC 815-10-15-74(a) (see Section 3.5.2).

BDO INSIGHTS — EVALUATING BUY-IN PROVISIONS

Warrants often include a buy-in provision allowing the holder to demand cash payment from the entity if the entity fails to timely deliver the shares upon warrant exercise, forcing the holder to buy shares in the open market to cover an open short position (the buy-in shares). The cash payment is typically equal to the excess of the holder's open-market purchase price over the short-sale price for the buy-in shares. For example, if the holder purchased the buy-in shares for a total open-market purchase price of $11,000 to cover an open short position with a total sell order price of $10,000, the entity would pay the holder $1,000.

Generally, a buy-in provision does not result in the warrants' settlement. Instead, it gives the holder the option to reinstate the portion of the warrants for which the entity did not deliver the shares or to require the entity to deliver the shares that were the subject of the attempted exercise. In that case, we believe the buy-in provision is not a form of net cash settlement under ASC 815-40-25 and does not preclude equity classification for the warrants.

However, if a contract includes a buy-in provision allowing the holder to require the entity to pay cash to the holder in an amount equal to the buy-in shares' total purchase price, and at which point the entity's obligation to deliver shares is terminated, the buy-in provision **does** net cash settle the instrument. In that case, the entity must evaluate whether it controls the events or actions necessary to deliver the shares to determine whether the instrument meets equity classification.

4.6.1.1 Effect of Contract Settlement Method on Classification of Some Contracts

FASB REFERENCES

ASC 815-40-55-13 through 55-14

The table below, adapted from ASC 815-40-55-13 through 55-14, illustrates the effect of contract settlement method on the classification of the following contracts:

- The entity agrees to sell shares of its stock to the counterparty at a specified price in the future (for example, under a forward sale contract, written call option, or a purchased put option).
- The entity has the right, but not the obligation, to buy shares of its stock from the counterparty at a specified price (for example, under a purchased call option).

Such contracts may be settled by physical, net share, or net cash settlement, or the entity or counterparty may have a choice of settlement methods. As shown in the table, equity or asset or liability classification depends on the contract's form of settlement.

	ONE SETTLEMENT METHOD			ENTITY HAS A CHOICE			COUNTERPARTY HAS A CHOICE		
	The contract requires one of the following settlement methods:			The contract allows the entity to choose any of the following settlement methods:			The contract allows the counterparty to choose any of the following settlement methods:		
	Physical[a]	Net share	Net cash	Net share or physical[a]	Net share or net cash	Net cash or physical[a]	Net share or physical[a]	Net share or net cash	Net cash or physical[a]
Initial classification:									
Equity[b]	X	X		X	X	X	X		
Asset or liability			X					X	X
Initial measurement, subsequent classification, and subsequent measurement:									
Fair value, permanent equity — not adjusted for changes in fair value[b]	X	X		X	X[c]	X[c]	X		
Fair value, asset or liability — adjusted for changes in fair value[d]			X					X[e]	X[e]

(a) A contract's physical settlement requires that the entity deliver shares to the holder in exchange for cash.
(b) Equity or temporary equity classification is appropriate only if the conditions in ASC 815-40-25 do not require asset or liability classification of the contract.
(c) If the contracts ultimately settle in net cash, account for the cash paid or received as a reduction of, or an addition to, contributed capital.

(d) Recognize the subsequent changes in fair value in earnings and disclose them in the financial statements.
(e) If the contracts ultimately settle in shares, continue to include any gains or losses on those contracts in earnings.

Note: An entity should reassess the contracts at each reporting period in all cases above to determine whether the contract must be reclassified.

BDO INSIGHTS — NET CASH SETTLEMENT THROUGH THE CONTRACT'S UNDERLYING SHARES

In some cases, the contract does not explicitly require net cash settlement, but the underlying shares the entity must deliver may result in net cash settlement.

For instance, a freestanding purchased put option allows an entity to sell shares to the counterparty. If the shares underlying the purchased put option are immediately redeemable for cash or other assets, we believe delivering the underlying shares results in net cash settlement. However, if the underlying shares are redeemable only when a substantive contingent event occurs (such as a change in control), we believe, based on discussions with the SEC staff, that delivering the contingently redeemable shares generally does not result in net cash settlement. That is because the counterparty is exposed to the economic risks and rewards of share ownership before the shares can be redeemed upon the occurrence of the contingent event.

Determining whether net cash settlement in the contract's underlying shares results in the contract's net cash settlement requires the application of professional judgment based on the facts and circumstances.

4.6.1.1.1 Contracts With Multiple Settlement Alternatives

FASB REFERENCES

ASC 815-40-25-36 through 25-38

An entity evaluates a contract that includes multiple settlement alternatives that differ in gain and loss positions as shown in the table.

	WHEN THE CONTRACT IS IN A LOSS POSITION, THE CONTRACT REQUIRES:	WHEN THE CONTRACT IS IN A GAIN POSITION, THE CONTRACT REQUIRES:	THE CONTRACT SHOULD BE CLASSIFIED AS:
Contract X	The entity to pay net cash	The entity to receive (a) net shares or (b) either net cash or net shares (at the entity's option)	An asset or liability (because the entity does not control whether the contract will be in a loss position, and settlement requires net cash in that case)
Contract Y	The entity to pay (a) net shares or (b) either net cash or net shares (at the entity's option)	The entity to receive net cash	Equity (because the entity is not required to pay cash)

However, Contract Y should be accounted for as an asset or liability if it is predominantly a purchased option in which the entity could receive cash in a gain position that is significantly larger than the amount it might pay when the contract is in a loss position (for example, because there is a small contractual limit on the amount of the loss).

4.6.1.2 Net Cash Settlement Only When Shareholders Receive Cash

FASB REFERENCES

ASC 815-40-25-7 through 25-9 and ASC 815-40-55-2 through 55-6

Generally, if circumstances outside the entity's control can require it to net settle the contract in cash, the contract is precluded from being classified as equity. However, there are limited exceptions under which a contract is not precluded from equity classification even if the entity can be required to net cash settle the contract beyond its control. Those limited circumstances are:

- For a change-in-control provision under which the instrument holder will always receive upon settlement the same form of consideration (for example, cash, debt, or other assets) as holders of the shares underlying the contract
- In nationalization events in which the instrument holder could receive cash, as is the case for holders of the shares underlying the contract (because cash compensation would be the consideration for the expropriated assets)
- For settlement provisions requiring payment of cash only in the event of an entity's final liquidation

The likelihood of the event occurring is not a factor in the analysis.

LIMITED EXCEPTION FOR NET CASH SETTLEMENT UPON CHANGE IN CONTROL

Except in limited circumstances, a contract is generally classified as an asset or liability if it can require the entity to net cash settle the contract if an event outside its control occurs. One such limited circumstance is a change in control (which is generally not within the entity's control, as stated in ASC 815-40-55-2). If the fundamental transaction results in a change in control, the provision by itself will not preclude equity classification if this limited exception in ASC 815-40-55-3 is met:

> *If a change-in-control provision requires that the counterparty receive, or permits the counterparty to deliver upon settlement, the same form of consideration (for example, cash, debt, or other assets) as holders of the shares underlying the contract, permanent equity classification would not be precluded because of the change-in-control provision. In that circumstance, if the holders of the shares underlying the contract were to receive cash in the transaction causing the change in control, the counterparty to the contract could also receive cash based on the value of its position under the contract.*

If upon a change in control, the instrument holder would receive the **same form** of consideration the holders of the contract's underlying shares receive, equity classification is not precluded (that is, the limited exception in ASC 815-40-55-3 applies). In that case, while the instrument holder could receive cash based on the value of its position under the contract, it would receive only the form of consideration a stockholder receives. The limited exception applies even if the instrument holder is given a choice of what form of consideration it will receive, as long as the holders of the contract's underlying shares are also given the same choice.

In contrast, if instead of cash, holders of the contract's underlying shares could receive other forms of consideration (for example, shares or notes receivable) while the instrument holder receives cash, the limited exception in ASC 815-40-55-3 does not apply.

Further, a change-in-control provision that specifies that the contract will be indexed to the shares of the purchaser specified in the business combination agreement if all stockholders receive stock of the acquirer does not affect the contract's classification.

In practice, the following transactions are generally considered to represent a change in control:

- Change in shareholders who have the right to elect more than 50% of the board of directors
- Transfer or sale of more than 50% of the entity's voting securities
- Transfer or sale of 50% or more of the entity's voting securities (that is, the previous controlling shareholder no longer controls the entity even though there is no new controlling shareholder).

Reaching a conclusion about whether a transaction represents a change in control and the limited exception applies requires the use of professional judgment based on the facts and circumstances.

Many contracts include provisions for settling the instrument when a fundamental transaction occurs (such as the sale of substantially all the entity's assets or a merger, consolidation, or change in control). For example, warrants commonly include fundamental transaction clauses that require the entity to redeem the warrants (for example, based on a Black-Scholes value). In those cases, entities often include provisions that dictate the form of consideration based on whether the fundamental transaction is within the entity's control; for instance:

- If the transaction is within the entity's control, including approved by the entity's board of directors (such as in a friendly takeover) — the redemption provision does not specify the form of consideration required. In other words, the instrument holder could receive consideration in cash, which may not be the same form of consideration the holders of the underlying shares received.
- If the transaction is outside the entity's control, including not approved by the entity's board (such as in a hostile takeover) — the redemption provision requires settlement be in the same form of consideration the holders of the underlying shares are entitled to receive.

The entity must assess the fundamental transaction clause to determine whether settlement in cash is within its control (for example, the instrument holder does not control the entity's board of directors). The potential settlement in cash upon a fundamental transaction does not preclude equity classification if it passes Steps 1 and 2 of the indexation guidance and the fundamental transaction is within the entity's control or meets the limited exception discussed above.

EXAMPLE 4-27: FUNDAMENTAL TRANSACTION SETTLEMENT CLAUSE

FACTS

- Issuer A issues a warrant for one share of its common stock at $5 per share.
- The warrant includes a provision that allows the warrant holder to require Issuer A to redeem the warrant at the Black-Scholes value when a fundamental transaction occurs.
- The warrant defines a fundamental transaction as any of the following: any merger, sale of all or substantially all of Issuer A's assets, or any tender or exchange offer that is accepted by more than 50% of Issuer A's voting stockholders.
- However, if the fundamental transaction is not within Issuer A's control, including not approved by Issuer A's board of directors, the warrant holder is entitled to receive only the same type or form of consideration being offered and paid to the holders of Issuer A's common stock.
- The warrant holder does not control Issuer A's board and does not have controlling voting power in Issuer A. Further, the warrant holder does not have rights to elect board members.
- The warrant is indexed to Issuer A's own stock (see Section 4.5).

CONCLUSION

The warrant's fundamental transaction clause does not preclude it from being classified as equity in accordance with ASC 815-40-25.

ANALYSIS

Because the warrant is indexed to Issuer A's own stock, Issuer A next evaluates whether the warrant would be classified in its stockholders' equity in accordance with ASC 815-40-25.

Issuer A evaluates the warrant's potential net cash settlement upon a fundamental transaction:

- If a fundamental transaction within Issuer A's control occurs (such as a merger requiring Issuer A's board approval), Issuer A could be required to settle the warrant for cash. However, because the warrant holder does not control the board, avoiding net cash settlement is within Issuer A's control (that is, the board can choose not to approve any merger transaction). The provision does not preclude equity classification.

- If a fundamental transaction outside Issuer A's control occurs (such as a tender offer or other form of hostile takeover), the warrant holder can require Issuer A to settle the warrant only in the same type or form of consideration offered and paid to the holders of Issuer A's common stock. The provision does not preclude equity classification because the limited exception in ASC 815-40-55-3 applies.

BDO INSIGHTS — TENDER OFFER PROVISIONS FOR ENTITIES WITH MULTIPLE CLASSES OF STOCK

Fundamental transactions that can require net cash settlement include many forms of transactions. One such transaction is a third-party tender offer, which may cause the acquisition of all or some of the entity's shares. If the tender offer would **always** result in a change in control, the provision by itself will not preclude equity classification, assuming the limited exception in ASC 815-40-55-3 applies.

Often, tender offer provisions relate to a potential buyer acquiring more than 50% of the entity's voting stock, thereby generally resulting in a change in control. However, if the tender offer involves the acquisition of a particular class of the entity's stock, and the entity has multiple classes of voting stock, the transaction might not result in a change in control. In that case, the limited exception does not apply because the exception narrowly applies to change in control events; therefore, the entity must recognize the instrument as an asset or liability.

For instance, SPAC warrants typically include a provision allowing the warrant holder to require the entity to redeem the warrant for cash in the event of a tender offer initiated by a third party (which might not always result in a change in control). The SEC staff statement below indicates that the possibility of that scenario precludes the warrant's equity classification because ASC 815-40-55-3 does not apply.

We understand the lack of a change in control when an entity has more than one class of stock in the tender offer transaction distinguishes it from the exception to liability accounting in ASC 815-40-55-3. That stems from the fact that a SPAC with a dual-class structure, such as one with Classes A and B stock, may undergo a tender offer for more than 50% of its Class A shares that might not result in a change in control, but would cause the SPAC warrants to be settled in cash under the warrant's terms. In other words, the Class B shares might not be part of the tender offer exchange and the voting rights in the Class B shares might prevent a change in control even though more than 50% of the Class A shares are acquired. Accordingly, tender offer provisions with net cash settlement typically do not meet the limited exception in ASC 815-40-55-3 when the entity has more than one class of voting stock and the tender offer relates to one or more, but not all, of the voting classes. For the limited exception to apply, the tender offer would need to **always** result in a change in control.

In contrast, we believe a tender offer for a SPAC with a single class of voting stock might not preclude the warrant's equity classification, assuming it meets all other criteria. For example, when a SPAC merges with an operating company, the Class B shares often convert to Class A equity. Therefore, a tender offer for a majority of the entity's only class of voting stock after the de-SPAC transaction would be expected to always result in a change in control. As such, the SPAC warrants tender offer provision might not preclude equity classification once the SPAC completes its merger with an operating company, assuming the conditions in ASC 815-40-55-3 are met.

Reaching a conclusion about whether a net cash settlement provision meets the limited exception in ASC 815-40-55-3 requires the application of professional judgment based on the facts and circumstances.

An April 2021 SEC staff statement on the classification of SPAC warrants articulates the concept.

SEC STAFF GUIDANCE

John Coates, Acting Director, Division of Corporation Finance, and Paul Munter, Acting Chief Accountant

April 12, 2021

Excerpt from Staff Statement on Accounting and Reporting Considerations for Warrants Issued by SPACs

> *[U.S. GAAP] includes guidance that entities must consider in determining whether to classify contracts that may be settled in its own stock, such as warrants, as equity of the entity or as an asset or liability. Evaluation of this guidance requires an evaluation of the specific terms of the contract and also of an entity's specific facts and circumstances…*
>
> *GAAP further includes a general principle that if an event that is not within the entity's control could require net cash settlement, then the contract should be classified as an asset or a liability rather than as equity. However, GAAP provides an exception to this general principle whereby equity classification would not be precluded if net cash settlement can only be triggered in circumstances in which the holders of the shares underlying the contract also would receive cash. Scenarios where this exception would apply include events that fundamentally change the ownership or capitalization of an entity, such as a change in control of the entity, or a nationalization of the entity.*
>
> *We recently evaluated a fact pattern involving warrants issued by a SPAC. The terms of those warrants included a provision that in the event of a tender or exchange offer made to and accepted by holders of more than 50% of the outstanding shares of a single class of common stock, all holders of the warrants would be entitled to receive cash for their warrants. In other words, in the event of a qualifying cash tender offer (which could be outside the control of the entity), all warrant holders would be entitled to cash, while only certain of the holders of the underlying shares of common stock would be entitled to cash. OCA staff concluded that, in this fact pattern, the tender offer provision would require the warrants to be classified as a liability measured at fair value, with changes in fair value reported each period in earnings.*
>
> *The evaluation of the accounting for contracts in an entity's own equity, such as warrants issued by a SPAC, requires careful consideration of the specific facts and circumstances for each entity and each contract.*

4.6.2 Evaluate Additional Conditions Necessary for Equity Classification

FASB REFERENCES

ASC 815-40-25-10 through 25-10A, ASC 815-40-25-39, and ASC 815-40-25-42

ASC 815-40-25 requires contracts to meet additional conditions before an entity can classify them in equity. The conditions are based on the concept that any conditions that can require net cash settlement for the contract precludes equity classification. However, as discussed in Section 4.6.1.2, there are limited exceptions under which a contract is not precluded from equity classification even if the entity can be required to net cash settle the contract beyond its control, such as when the contract requires net cash payments only in situations in which holders of the contract's underlying shares also received cash.

The additional conditions include **all** the following:

- Contract does not explicitly require net cash settlement if registered shares are unavailable (see Section 4.6.2.1).
- Entity has sufficient authorized and unissued shares (see Section 4.6.2.2).
- Contract contains an explicit share limit (see Section 4.6.2.3).
- Contract does not require cash payment if entity fails to file (see Section 4.6.2.4).
- Contract does not include cash-settled top-off or make-whole provisions (see Section 4.6.2.5).

Those additional conditions do not apply in an entity's evaluation of whether a conversion option meets the equity classification conditions if the hybrid instrument is a convertible debt in which the holder may realize the conversion option's value only by exercising the option and receiving the entire proceeds in a fixed number of shares or the equivalent amount of cash at the entity's discretion (see Section 4.6.2.6). A convertible preferred stock instrument with a mandatory redemption date may qualify for that exception if it is determined to be a debt host.

Further, the following conditions do not preclude equity classification, so an entity does not need to assess them:

- Whether settlement is required in registered shares (unless the contract explicitly requires net cash settlement if registered shares are unavailable)
- Whether counterparty rights rank higher than shareholder rights (even if a contract provision indicates that the counterparty has rights that rank higher than those of a shareholder, that does not preclude equity classification)
- Whether collateral is required (even if a contract provision requires the entity to post collateral at any time for any reason, that does not preclude equity classification).

4.6.2.1 Contract Does Not Explicitly Require Net Cash Settlement if Registered Shares Are Unavailable

FASB REFERENCES

ASC 815-40-25-10A, ASC 815-40-25-43, and ASC 825-20-25-1 through 25-3

Contracts (such as warrants) issued in offerings registered with the SEC may require, explicitly or implicitly (for example, through the securities laws), that the shares issued at settlement be registered under an effective registration statement. Those provisions are typically not relevant to the classification of the contract, and equity classification is appropriate, assuming the contract meets all the equity classification criteria.

However, if the contract includes an **explicit** provision requiring net cash settlement when registered shares are unavailable, equity classification is precluded because filing and maintaining an effective registration statement is outside an entity's control. That is because registration statements must include the information required by the SEC's rules and regulations, including audited financial statements. In that context, an entity cannot control the receipt of an audit opinion or whether the SEC will declare the registration statement effective.

Also, instruments issued in private placements typically do not require settlement in registered shares. Similarly, contracts that do not require a second investment decision (such as convertible notes) might not require settlement in registered shares even if they were issued in a registered offering. Even so, the parties might enter a registration payment arrangement requiring registration of the shares issuable under those contracts. Often, the arrangement includes a monetary penalty (for example, a percentage of the instrument's purchase price) if the entity fails to file and maintain an effective registration statement for a specified period.

ASC 825-20 requires an entity to recognize and measure a registration payment arrangement that is in its scope as a separate unit of account from the financial instruments subject to that arrangement. The entity accounts for required penalty payments under the arrangement in accordance with ASC 450, accruing the payments as liability when the obligation is probable (see Section 6.4.1). Further, it accounts for the financial instruments subject to the registration payment arrangement under other U.S. GAAP, such as ASC 815-40, without regard to the contingent obligation to transfer consideration under that arrangement. Accordingly, a penalty provision in a registration payment arrangement does not preclude the entity from classifying an instrument as equity, assuming the instrument would not be settled in exchange for the payment of the monetary penalty. However, if payment of the penalty settles the instrument, that cash settlement provision would preclude the entity from classifying it as equity.

4.6.2.2 Entity Has Sufficient Authorized and Unissued Shares

FASB REFERENCES

ASC 815-40-25-19 through 25-24

To be classified as equity, there must be no scenario in which the entity could be required to net cash settle the instrument that is outside its control. Therefore, if an entity must (or may be required at the holder's option to) settle the contract in shares, it must have sufficient authorized and unissued shares to do so.

Accordingly, the entity must assess whether, based on its outstanding instruments (which includes all equity instruments and instruments that may convert into shares), there are enough authorized and unissued shares to satisfy the instrument or embedded feature upon exercise. If there are not enough authorized and unissued shares, the instrument or embedded feature is precluded from equity classification under the presumption that the contract must be settled in cash if the entity cannot settle in shares.

The entity determines at the classification assessment date (the instrument's issuance date and each balance sheet date) whether it has sufficient authorized and unissued shares to satisfy the contract's share settlement by comparing the following:

Number of authorized but unissued shares − Maximum number of shares deliverable during the contract period under existing commitments = Number of available shares → Compared to → Maximum number of shares deliverable under share settlement (net share or physical) of the contract being evaluated

If the number of available shares (number of authorized but unissued shares less existing share commitments) is greater than the maximum number of shares deliverable under the contract being evaluated, the entity has enough available authorized and unissued shares to settle the contract and the contract meets that equity classification condition. The entity continues to assess the contract under the other classification conditions.

If the number of available shares is less than the maximum number of shares deliverable under the contract being evaluated, the entity does not have enough available authorized and unissued shares and must assess whether authorizing additional shares is within its control. Often, a change in the number of the entity's authorized shares requires shareholder approval, which an entity does not control. In that case, the instrument is precluded from equity classification (or if the equity-linked contract is an embedded feature, it must be bifurcated from the host contract if it meets the other bifurcation criteria) and must be recognized as an asset or liability at fair value, with changes in fair value recognized in earnings. However, the entity must reassess the contract for reclassification once it obtains shareholder approval that results in it having enough authorized and unissued shares (see Section 4.8).

The entity must also consider applicable rules and regulations, which may differ between jurisdictions. For example, some jurisdictions outside the U.S. allow entities to issue an unlimited number of shares, while others allow the entity's board of directors, rather than the shareholders, to approve any changes in authorized shares. Therefore, in assessing whether it has enough authorized and unissued shares to share settle the instrument being evaluated, an entity must consider its individual facts and circumstances.

DETERMINING THE MAXIMUM NUMBER OF SHARES REQUIRED TO SETTLE EQUITY CONTRACTS

In determining the maximum number of shares deliverable under existing share commitments, the entity must include the following instruments (that are currently exercisable or will become exercisable during the contract period):

- Outstanding convertible debt
- Outstanding stock options
- Other financial instruments settleable in the entity's own stock (such as share-settled contingent consideration, convertible preferred stock, warrants, forward sale contracts, and share-based payment awards).

An entity also considers the maximum number of shares required under a registration payment arrangement as an existing share commitment, regardless of whether the instrument being evaluated is subject to that registration payment arrangement.

In determining the maximum number of shares required to share settle an equity contract that includes a choice of form of settlement, the computation depends on who can elect the form of settlement.

If the issuer has a choice between net share and physical settlement… → …use the number of shares under the settlement alternative that results in the lesser number of maximum shares.

If the counterparty has a choice between cash and share settlement (net share or physical) … → …use the number of shares under the settlement alternative that requires the greater number of shares (even if the contract is classified as an asset or a liability because the counterparty can require the contract's settlement in cash).

BDO INSIGHTS — ESTABLISHING A SEQUENCING POLICY

If there are not enough authorized and unissued shares to satisfy the entity's existing commitments (including the instrument being evaluated) to deliver shares, the entity must apply a sequencing policy of allocating the authorized and unissued shares (the available shares) among those commitments. The policy must be systematic, rational, and consistently applied. Based on the guidance in ASC 815-40-35-12, we believe **any** of the following policies are acceptable:

POLICY	ALLOCATION METHOD
Based on instrument inception date — earliest to latest	The available shares are allocated in the order of the instruments' issuance dates from earliest to latest.
Based on instrument inception date — latest to earliest	The available shares are allocated in the order of the instruments' issuance dates from latest to earliest.
Based on instrument maturity date — earliest to latest	The available shares are allocated in the order of the instruments' maturity dates from earliest to latest.
Based on instrument maturity date — latest to earliest	The available shares are allocated in the order of the instruments' maturity dates from latest to earliest.

If two or more contracts have the same inception or maturity date, we believe the entity should use a systematic and rational approach to determine the instrument's order of priority (such as a multistep allocation policy). For example, the policy may require that the available shares are allocated first based on the inception date and, then, if any contracts have the same inception date, based on the maturity date.

Determining an appropriate policy requires the application of professional judgment based on the facts and circumstances.

4.6.2.3 Contract Contains an Explicit Share Limit

FASB REFERENCES

ASC 815-40-25-26 through 25-28

To qualify for equity classification, there must be no scenario in which the entity could be required to net cash settle the instrument that is outside its control. Therefore, if an entity must or may settle the contract in shares, it must have sufficient authorized and unissued shares to do so, as noted in Section 4.6.2.2. To determine whether the entity has enough available authorized and unissued shares, the contract must contain an explicit limit (that is, the entity must be able to compute the maximum number of shares needed to share settle the contract). If the number of shares deliverable to net share settle the contract is indeterminate, the entity cannot conclude that it has enough available authorized and unissued shares. In that case, net share settlement is outside its control.

The requirements that an entity have sufficient authorized and unissued shares and the contract contain an explicit share limit are related conditions the entity must assess together. Those conditions reflect the point that the entity must be able to satisfy the agreement's share settlement provisions for equity classification to be appropriate. That operates on the presumption that if the entity is unable to deliver the required shares, the holder would be entitled to cash settlement, which would cause the instrument to be classified as a liability.

DETERMINING WHETHER A CONTRACT HAS AN EXPLICIT SHARE LIMIT

In many cases, an instrument's terms establish the maximum number of shares that could be required in its share settlement. For example, a convertible debt agreement with a principal of $20 million that allows the holder to convert each $1,000 increment to 200 common shares contains an explicit share limit of 4 million common shares. The entity can therefore satisfy the agreement's share settlement as long as it has sufficient authorized and unissued shares available. That is the case regardless of whether the conversion rate is subject to adjustments as long as they are based on events that are within the entity's control (such as adjustments for stock dividends, stock splits, or a voluntary sale of additional shares). In contrast, if the adjustment is triggered by events outside the entity's control, the entity cannot conclude that it controls the issuance of shares and the potential net cash settlement for the instrument. However, if the event is a change in control, the entity evaluates whether it meets the limited scope exception in ASC 815-40-55-3 (see Section 4.6.1.2).

For other obligations, the number of shares might not be capped. For example, an entity issues $20 million of debt that can be converted at any time into common stock at a conversion price equal to the lower of $5 per share or 80% of the daily average common share price. If the common share price is $9, the conversion price would be $5 per common share and the entity would issue 4 million common shares upon conversion. If the common share price decreased, and the conversion price became $1 per share, 20 million common shares would be issued. If the conversion price became $0.01 per share, the entity would be required to issue 2 billion common shares to settle the conversion option. The likelihood of the share price falling to such a low level is not relevant to the analysis.

In that example, because there is no limit on the number of common shares that might be needed to settle the conversion option, the entity cannot conclude that it has sufficient authorized and unissued shares available. Consequently, the embedded conversion option must be bifurcated from the host contract and classified as a liability if all the bifurcation criteria are met (see Section 3.6.1). Also, because of the variable-share settlement feature, other instruments analyzed in accordance with ASC 815-40 may have to be classified as liabilities, depending on the policy adopted by the entity (see Section 4.8.1).

Some contract structures cap the number of shares that must be delivered upon share settlement (the capped obligation) and allows the contract value in excess of the cap (the excess obligation) to be delivered in cash or shares at the entity's option when authorized and unissued shares become available based on a best-efforts basis. If the entity has sufficient authorized and unissued shares to satisfy the capped obligation (and therefore the capped obligation does not preclude equity classification), the entity must evaluate the excess obligation as follows:

- If the number of shares required to settle the excess obligation is fixed on the date of net share settlement, the entity does not need to include the excess shares to determine whether it has sufficient authorized and unissued shares. That is because obtaining sufficient authorized and unissued shares on best-efforts basis is within the entity's control.
- If the number of shares required to settle the excess obligation is equal to a dollar amount fixed on the date of net share settlement and the number of shares is calculated based on the stock's market value on the date of the excess obligation's settlement, the excess obligation is a stock-settled debt. Therefore, the excess obligation precludes equity classification for the contract (or, if the contract can be partially net share settled, the excess obligation is precluded from being classified as equity).

4.6.2.4 No Required Cash Payment if Entity Fails to Timely File

FASB REFERENCES

ASC 815-40-25-29

Contracts that require or allow an entity to settle in shares are generally equity classified. To qualify for equity classification, there must be no scenario in which the entity could be required to net cash settle the contract outside its control. For instance, contracts an entity must net settle in cash if it does not make timely filings with the SEC must be accounted for as assets or liabilities. In other words, provisions that require net cash settlement preclude a freestanding equity-linked instrument (such as a warrant) from equity classification and an embedded feature (such as a conversion option) from qualifying for the derivative scope exception in ASC 815-10-15-74(a). That is because periodic filings with the SEC (for example, annual reports on Form 10-K) must include audited financial statements. The completion of its financial statements audit is outside the entity's control, so the ability to make timely SEC filings is also outside the entity's control.

PENALTY PAYMENTS UPON FAILING TO TIMELY FILE

Penalty payments imposed on the entity upon failing to timely file with the SEC do not preclude equity classification because those payments do not result in the contract's settlement. For example, some convertible notes require additional interest (such as on an annual rate of X% on the principal for each day the entity's failure to file with the SEC has occurred). That penalty payment does not result in the convertible note's settlement, so it does not preclude the conversion feature from meeting the derivative scope exception in ASC 815-10-15-74(a).

4.6.2.5 No Cash-Settled Top-Off or Make-Whole Provisions

FASB REFERENCES

ASC 815-40-20: Make-Whole Provision and Top-Off Provision and ASC 815-40-25-30

The exact terms of top-off or make-whole provisions vary, but U.S. GAAP describes them as *"a cash payment to a counterparty if the shares initially delivered upon settlement are subsequently sold by the counterparty and the sales proceeds are insufficient to provide the counterparty with full return of the amount due."* Those provisions generally are intended to reimburse the counterparty for any losses it incurs or to transfer to the entity any gains the counterparty recognizes on the difference between:

- The settlement date value
- The value received by the counterparty in subsequent sales of the securities within a specified time after the settlement date.

Those provisions effectively guarantee the holder a defined return (the holder is entitled to cash payments if a specified level of return on investment is not achieved). To qualify for equity classification, they must meet **all** the following conditions:

- Can be net share settled
- Has a maximum number of shares deliverable that is **both**:
  - Fixed
  - Less than the number of available authorized and unissued shares (see Section 4.6.2.2).

Without net share settlement, those provisions represent net cash settlement and would cause liability classification for a freestanding contract or bifurcation of an embedded derivative from the host contract (if it also meets the other bifurcation criteria).

4.6.2.6 Simplified Analysis for Plain Vanilla Convertible Debt Instruments

FASB REFERENCES

ASC 815-40-20: Standard Antidilution Provisions and ASC 815-40-25-39 through 25-42

The analysis of whether an embedded conversion option would be classified as equity if freestanding is simplified for some "plain vanilla" convertible debt instruments in which the holder can realize the conversion option's value only by exercising the option and receiving the entire conversion proceeds in a fixed number of shares or the equivalent amount of cash (at the entity's discretion); when evaluating the classification guidance for that conversion option, the requirements in ASC 815-40-25-7 (see Section 4.6.1.2) through 25-30 (see Sections 4.6.2.1 through 4.6.2.5) do not apply. However, there is no comparable exception in the indexation guidance in ASC 815-40-15.

The plain vanilla exception applies even if the option is either or both:

- Based on the passage of time or a contingent event
- Subject to standard antidilution provisions.

However, the exception does not apply when evaluating any other embedded derivative in the convertible debt or stock.

CONVERTIBLE DEBT INSTRUMENTS ARE RARELY PLAIN VANILLA

If the number of shares could change for any reason other than because of standard antidilution provisions (see Section 4.6.2.6.2), whether or not within the entity's control, the hybrid instrument is not plain vanilla. In addition to debt instruments, convertible preferred stock with a mandatory redemption date may qualify for the exception if the economic characteristics indicate that the instrument is more akin to debt than equity (see Section 3.4.1.1).

If the convertible debt instrument is considered plain vanilla and ASC 815-40-25-1 through 25-6 are satisfied (that is, net cash settlement is not required), the embedded conversion option does not have to be analyzed further in accordance with ASC 815-40-25-7 through 25-30.

If the convertible debt instrument does not qualify as plain vanilla, the entity must evaluate the conversion option in accordance with ASC 815-40-25-7 through 25-30 to determine whether the conversion option would be classified as equity if it were freestanding. See Section 3.6.1 for more guidance on convertible debt.

The next three sections focus on key points in determining whether a debt instrument qualifies as plain vanilla (that is, whether it is convertible into a fixed number of shares or an equivalent amount of cash (at the entity's discretion)).

4.6.2.6.1 Fixed Number of Shares

A convertible instrument agreement that allows the holder to convert into common shares at any time based on a fixed conversion price (for example, $12 per share) qualifies as plain vanilla because the entire proceeds are received in a fixed number of shares. An agreement with a conversion price that varies is not plain vanilla because the number of shares to be issued upon conversion is not fixed.

4.6.2.6.2 Antidilution Provisions

ASC 815-40-25-41 clarifies that standard antidilution provisions do not preclude a conclusion that an instrument is convertible into a fixed number of shares. Standard antidilution provisions are "*those that result in adjustments to the conversion ratio in the event of an equity restructuring transaction that are designed to maintain the conversion option's value*."

Standard antidilution provisions include equity restructuring such as a stock dividend; stock split; spinoff; rights offering; or recapitalization through a large, nonrecurring cash dividend, but do not include adjustments for normal dividends.

4.6.2.6.3 Entire Proceeds

In accordance with ASC 815-40-25-39 through 25-42, an instrument may give the entity the choice to settle the conversion option by paying cash rather than issuing the fixed number of shares as long as the entity settles the conversion value entirely in either cash or shares. That is consistent with the provisions of ASC 815-40-25-1 through 25-6 in which net share settlement is assumed if the entity has the choice of settling in cash or shares (see Section 4.6.1).

If instead of the entity (issuer), the holder can elect net cash settlement, the conversion option would not meet the conditions for equity classification in accordance with ASC 815-40-25 (see Section 4.6.1).

The table illustrates whether a convertible debt meets the conditions for simplified analysis.

FACTS	ELIGIBLE FOR SIMPLIFIED ANALYSIS?	ANALYSIS
Debt is convertible at any time by the holder into a fixed number of shares of common stock based on a conversion price that does not change.	Yes	The number of shares to be issued upon conversion is fixed and will never change.
Debt is convertible by the holder into a fixed number of shares based on a conversion price that changes only under conditions that are not standard antidilution provisions.	No	Because the number of shares issued upon conversion is subject to change under conditions that do not qualify as standard antidilution provisions (as defined), the instrument does not meet the conditions for simplified analysis.
Debt is convertible by the holder after one year or if the entity completes a subsequent offering of shares into a fixed number of common shares based on a conversion price that does not change.	Yes	The conditions in ASC 815-40-25-39 through 25-42 do not depend on the ability to immediately exercise the conversion option. Even though the holder cannot immediately convert, after passage of time (or upon the event's occurrence), the holder will be able to convert.

Example 4-28 illustrates how an entity determines whether a convertible debt qualifies for the simplified analysis in ASC 815-40-25-39 through 25-42.

EXAMPLE 4-28: CONVERTIBLE DEBT THAT QUALIFIES AS PLAIN VANILLA

FACTS

Issuer A issues senior debt for $1 million that is convertible into common shares at the holder's option. The instrument has the following additional features:

- The conversion price is $5 per share.
- Issuer A must settle the conversion option by issuing 200,000 shares of common stock ($1 million / $5 per share).
- The holder can exercise the conversion option after either:
  - The passage of one year
  - The completion of a secondary share offering.
- Upon a stock split or stock dividend, the conversion price will adjust such that the holder is entitled to receive the post-split equivalent of the 200,000 pre-split shares. For example, if Issuer A effects a 2-for-1 stock split, the conversion price will decrease to $2.50 per share, entitling the holder to receive 400,000 shares.

CONCLUSION

The senior debt is eligible for the simplified analysis in ASC 815-40-25-39 through 25-42.

ANALYSIS

The analysis of whether an embedded conversion option would be equity if freestanding is simplified for some plain vanilla convertible debt instruments in which the holder can realize the conversion option's value only by exercising the option and receiving the entire conversion proceeds in a fixed number of shares or the equivalent amount of cash (at the entity's discretion).

- Fixed number of shares — None of the instrument's features preclude the debt instrument from qualifying as convertible into a fixed number of shares. The conversion price is set so that the holder receives a fixed number of shares and is not subject to change except upon a stock split or stock dividend (a standard antidilution provision). Restrictions on the conversion option's exercisability do not affect whether the debt is convertible into a fixed number of shares.
- Antidilution provisions — Standard antidilution provisions do not preclude an instrument from qualifying as convertible into a fixed number of shares. The conversion price (and the number of shares issued upon conversion) adjusts only when all shareholders will remain on equal footing.
- Entire proceeds — Issuer A must settle the entire conversion proceeds in a fixed number of shares. However, the conclusion and analysis would be the same even if Issuer A had the option of settling the senior debt's conversion value entirely in cash.

Because the instrument is convertible debt that qualifies as convertible only into a fixed number of shares, it is eligible for the simplified analysis in ASC 815-40-25-39 through 25-42.

4.7 INITIAL RECOGNITION AND SUBSEQUENT MEASUREMENT

FASB REFERENCES

ASC 815-40-30-1, ASC 815-40-35-2, and ASC 815-40-35-4

The initial recognition and subsequent measurement for a freestanding financial instrument (or embedded derivative) depends on whether the instrument (or the embedded derivative) meets the indexation and equity classification criteria in ASC 815-40.

Instrument meets both the indexation and equity classification criteria	▶ If the instrument is a freestanding financial instrument, the entity classifies it as equity. ▶ If the instrument is an embedded derivative, the entity does not separate the embedded derivative from the host instrument (see Section 3.7).

Instrument fails **either** the indexation or the equity classification criteria	▶ If the instrument is a freestanding financial instrument, the entity accounts for it as an asset or a liability. ▶ If the instrument is an embedded derivative, the entity bifurcates the embedded derivative from the host instrument and separately accounts for it as a derivative asset or liability under ASC 815 (see Section 3.7).

The table summarizes how freestanding financial instruments that are classified as equity or assets or liabilities under ASC 815-40-25 are initially recognized and subsequently measured.

	INSTRUMENTS CLASSIFIED AS EQUITY	INSTRUMENTS CLASSIFIED AS ASSETS OR LIABILITIES
Initial recognition	Recognize initially at fair value or allocated proceeds if issued with other instruments (see Section 2.8.2).	Recognize initially at fair value.
Subsequent measurement	No subsequent adjustment; the entity does not recognize changes in fair value as long as the instrument remains equity classified.	Remeasure at fair value, with changes in fair value recognized in earnings.

See Sections 3.7.1 and 3.7.2 for more guidance on how an entity initially and subsequently measures bifurcated embedded derivatives and hybrid financial instruments with no bifurcated derivatives.

4.8 CONTRACT RECLASSIFICATION

FASB REFERENCES

ASC 815-40-35-8 through 35-10

An entity must reassess the classification of freestanding financial instruments at each balance sheet date. If the instrument's classification changes, the entity reclassifies the instrument on the date an event triggers the reclassification. There is no limit on how many times the entity may reclassify a contract. Common events that may trigger an instrument's reclassification include:

- Resolution of a contingency or terms that lapse (for example, the time period for an IPO has expired, resulting in a variable strike price to become fixed)
- Change in the entity's functional currency
- Increase in the number of authorized and unissued shares.

The assessment does not depend on whether the events leading up to the reclassification are within the entity's control. Further, the entity may need to also reassess the freestanding instrument under ASC 480 (see Sections 2.5.7 and 2.6.6).

The table summarizes how an entity accounts for a freestanding instrument's reclassification in accordance with ASC 815-40.

INITIAL CLASSIFICATION	SUBSEQUENT CLASSIFICATION	ACCOUNTING FOR RECLASSIFICATION
Equity (permanent or temporary)	Asset or liability	▶ Recognize the change in fair value for the equity instrument since issuance in stockholders' equity. ▶ Reclassify the financial instrument to asset or liability at its fair value on the reclassification date. ▶ Recognize subsequent changes in fair value in earnings.
Asset or liability	Equity (permanent or temporary)	▶ Mark the instrument to fair value immediately before the reclassification. ▶ Reclassify the financial instrument to equity at its fair value on the reclassification date. ▶ Do not reverse previous gains and losses recognized in earnings for changes in the instrument's fair value while it was classified as an asset or a liability. ▶ Do not remeasure the instrument after reclassification to equity.

Further, if a modification to the contractual terms causes an instrument's reclassification, an entity considers whether the transaction includes other elements that must be recognized (see Section 4.9.2).

Similarly, an entity continually reassesses whether an embedded equity-linked derivative meets the scope exception in ASC 815-10-15-74(a) (see Section 3.7.3). Based on its reassessment, the entity could determine that a nonbifurcated embedded derivative subsequently meets the criteria for separate accounting (see Section 3.7.3.1) or that a bifurcated embedded derivative no longer meets the criteria for separate accounting (see Section 3.7.3.2).

4.8.1 Partial Reclassification

FASB REFERENCES

ASC 815-40-35-11 through 35-13

As noted in Section 4.8, an entity must continually reassess the classification of its contracts. If an entity determines that it must reclassify its contracts because of a change in it authorized and unissued shares and there are no longer enough shares available to satisfy all its share-settled commitments, it may need to perform a partial reclassification.

For example, if the entity's available shares can no longer satisfy an equity-classified contract's total notional amount, any portion that can be net share settled as of the balance sheet date remains classified in equity (if the contract allows partial net share settlement). The entity then classifies the remaining portion as an asset, liability, or temporary equity, as appropriate.

Similarly, if the entity has two or more share-settled contracts and not enough available shares to satisfy their share settlement, it must perform a partial reclassification using a systematic and rational method that it applies consistently, which may include **any** of the following:

- Partial reclassification of all contracts proportionately (contracts must allow partial settlement)
- Reclassification of contracts with the earliest inception date first
- Reclassification of contracts with the earliest maturity date first
- Reclassification of contracts with the latest inception or maturity date first
- Reclassification of contracts with the latest maturity date first.

For example, if an entity issues a share-settled financial instrument with no limit in the number of shares issued at settlement, it cannot conclude that it has enough authorized and unissued shares to settle all contracts under ASC 815-40. In that case, the entity may need to reclass some or all contracts requiring share settlement based on the entity's reclassification policy.

EXAMPLE 4-29: RECLASSIFICATION BASED ON INCEPTION DATE

FACTS

Issuer A has 500,000 authorized common shares, of which 300,000 are issued and outstanding. Issuer A issues debt on January 10, 20X0, that matures on January 10, 20X5, and is convertible into common stock based on the stock's fair market value at the conversion date (that is, it converts into a variable, and potentially unlimited, number of shares).

Issuer A has the following equity-classified instruments outstanding, which were all issued before the debt's issuance and provide for one common share for each option or warrant:

- 50,000 employee stock options, exercisable at any time, and expiring December 15, 20X9
- 100,000 Class A warrants, exercisable at any time, and expiring January 5, 20X6.

Further, on March 30, 20X0 (subsequent to the debt's issuance), Issuer A issues 25,000 Class B warrants expiring March 30, 20X4. The Class B warrants are exercisable at any time.

Issuer A adopts the reclassification approach in which contracts with the latest issuance date are reclassified (from equity to asset or liability) first. Under that approach, the available shares are allocated in the order of the instruments' issuance dates, from earliest to latest, resulting in reclassification of contracts with the latest issuance date first.

CONCLUSION AND ANALYSIS

Issuer A applies its reclassification policy and reclassifies instruments with the latest issuance date first from equity (that is, it allocates the available shares to equity-settled instruments with the earliest issuance date first to determine whether they meet the equity classification condition), as shown in the table.

ISSUANCE DATE	INSTRUMENT	NUMBER OF SHARES
Before January 10, 20X0	Employee stock options	50,000
Before January 10, 20X0	Class A warrants	100,000
January 10, 20X0	Convertible debt	Unlimited
March 30, 20X0	Class B warrants	25,000

Employee stock options are outside the scope of ASC 815-40; Issuer A must determine their classification in accordance with ASC 718.

Despite the issuance of the convertible debt, the Class A warrants continue to qualify as equity (if they meet all the equity classification requirements).

The debt's conversion feature does not meet the derivative scope exception in ASC 815-10-15-74(a) because it is potentially settleable in an unlimited number of shares. Therefore, the conversion feature would be bifurcated if it meets all the bifurcation criteria.

The Class B warrants, issued after the convertible debt, are classified as liabilities because Issuer A does not have sufficient available shares to settle it.

EXAMPLE 4-30: RECLASSIFICATION APPROACH BASED ON MATURITY DATE

FACTS

Assume the same facts as in Example 4-29, except that Issuer A adopts a reclassification approach in which contracts with the latest maturity date are reclassified (from equity to asset or liability) first. Under that approach, the available shares are allocated in the order of the instruments' maturity dates, from earliest to latest, resulting in reclassification of contracts with the latest maturity date first.

CONCLUSION AND ANALYSIS

Issuer A applies its reclassification policy and reclassifies the instruments with the latest maturity date first from equity (that is, it allocates the available shares to equity-settled instruments with the earliest maturity date first to determine whether they meet the equity classification condition), as shown in the table.

MATURITY DATE	INSTRUMENT	NUMBER OF SHARES
March 30, 20X4	Class B warrants	25,000
January 10, 20X5	Convertible debt	Unlimited
January 5, 20X6	Class A warrants	100,000
December 15, 20X9	Employee stock options	50,000

Employee stock options are outside the scope of ASC 815-40; Issuer A must determine their classification in accordance with ASC 718.

Issuer A must reclassify the Class A warrants from equity to liability upon the issuance of the convertible debt because the Class A warrants have a later maturity date than the convertible debt.

The conversion feature of the debt does not meet the derivative scope exception in ASC 815-10-15-74(a) because it is potentially settleable in an unlimited number of shares. Therefore, the conversion feature would be bifurcated if it meets all the bifurcation criteria.

The Class B warrants, however, would be classified as equity at issuance (if they meet all the equity classification requirements) because their expiration date is before the convertible debt's maturity date.

4.9 CONTRACT MODIFICATION

An entity and the counterparty may modify a contract's terms (such as the strike price or number of underlying shares) for various reasons. Often, contractual terms are modified in relation to new financings or because an existing debt instrument is amended. When a contract modification occurs, the accounting for the modification depends on the contract's classification before and after the modification. Changes in an instrument's terms (such as the exercise price or number of shares issuable at settlement) when a down round feature is triggered (that is, upon the occurrence of the triggering event that reduces the instrument's strike price) are not accounted for as contract modifications (see Section 4.5.2.3).

4.9.1 Modification or Exchange of a Freestanding Equity-Classified Written Call Option

FASB REFERENCES

ASC 815-40-35-14 through 35-17 and ASC 815-40-55-49 through 55-52

When an equity-classified freestanding written call option (for example, a warrant) remains equity classified after a modification or exchange, the entity must consider all the following when determining how to account for the transaction:

- The circumstances and reason for the modification or exchange
- All the terms and conditions of the modification or exchange
- Other transactions entered contemporaneously or in contemplation of the modification or exchange
- Other rights and privileges obtained or obligations incurred (including services) because of the modification or exchange
- The overall economic effects of the modification or exchange.

The entity treats the transaction as an exchange of the original instrument for a new instrument (effectively, the entity repurchases the original instrument by issuing a new instrument).

The entity recognizes the effect of the modification or exchange in the same manner as if cash had been paid as consideration (assuming the transaction is not in scope of other U.S. GAAP, such as ASC 718).

Financing transaction to raise equity

When the modification or exchange is directly attributable to a proposed or actual equity offering:

- Any increase in fair value (any excess of the fair value of the modified or exchanged instrument over the fair value of that instrument immediately before the modification or exchange) is recognized as an equity issuance cost.
  - The entity may defer equity issuance costs that are incremental and directly attributable to a proposed or actual securities offering and recognize them as an offset against the gross proceeds of the offering when the proceeds are received (see Section 6.3).

Financing transaction to raise debt

When the modification or exchange is part of or directly related to an issuance of a debt instrument:

- If the option counterparty is the creditor, any increase in fair value (any excess of the fair value of the modified or exchanged instrument over the fair value of that instrument immediately before the modification or exchange) is recognized as a debt discount.
- If the option counterparty is a third party (for example, an underwriter or law firm), any increase in fair value (as defined above) is recognized as a debt issuance cost.

Modification to an existing debt instrument

When the modification or exchange is part of or directly related to a modification or an exchange of an existing debt instrument:

- If the option counterparty is the creditor, any change in fair value (the difference between the fair value of the modified or exchanged instrument and the fair value of that instrument immediately before the modification or exchange):
  - Is included in determining the effective borrowing rate of the restructured debt for assessing whether a concession has been granted under the TDR guidance in ASC 470-60.
  - Is treated as debt fees between the debtor and the creditor and included as a day-one cash inflow or outflow when performing the 10% cashflow test under ASC 470-50.
- If the option counterparty is a third party (for example, an underwriter or law firm), any increase in fair value (any excess of the fair value of the modified or exchanged instrument over the fair value of that instrument immediately before the modification or exchange) is recognized as a debt issuance cost.

Other types of transactions

When the modification or exchange is not related to equity or debt financings and is not in the scope of other U.S. GAAP:

- Any increase in fair value (any excess of the fair value of the modified or exchanged instrument over the fair value of that instrument immediately before the modification or exchange) is recognized as a dividend.
  - If the entity presents EPS in accordance with ASC 260, the dividend is treated as a reduction of income available to common stockholders in computing basic EPS.

An entity may need to account for other modifications, such as those related to an agreement by the warrant holder to abandon acquisition plans, forgo other planned transactions, settle litigation, settle employment contracts, restrict share purchases, or as compensation for services in accordance with ASC 718, as a cost based on the transaction's substance rather than as a dividend. For example, if an entity modifies a warrant issued to a third party in exchange for its services as an underwriter related to a debt issuance or modification, the entity recognizes any increase in fair value (any excess of the fair value of the modified warrant over the fair value of that warrant immediately before the modification) as a debt issuance cost.

In a multiple-element arrangement (for example, involving both an equity and debt financing), the entity must allocate the total effect of the modification or exchange to the respective elements of the transaction on a rational basis.

EXAMPLE 4-31 (ADAPTED FROM ASC 815-40-55-49 THROUGH 55-50): WARRANT MODIFICATION RECOGNIZED AS AN EQUITY ISSUANCE COST

FACTS

Entity A issues warrants for shares of its common stock with the following terms:

- Allow the holder to buy 100 common shares for $10 per share
- Have 10-year terms and are exercisable at any time.

Entity A accounts for the warrants as equity.

Subsequently, to induce the outstanding warrants' exercise in contemplation of an equity offering (that is, to induce the imminent exercise of the warrants and raise equity), Entity A reduces the exercise price to $9 per share for 60 days. Entity A continues to account for the warrants as equity after the modification.

CONCLUSION AND ANALYSIS

Entity A determines that the incremental fair value of the modified warrants is an incremental cost directly attributable to a proposed equity offering; the modification relates to a financing transaction to raise equity. Therefore, Entity A:

- Recognizes any increase in fair value (any excess of the fair value of the modified warrants over their fair value immediately before the modification) as an equity issuance cost.
- Recognizes at the modification date the equity issuance cost as deferred cost in accordance with ASC 340-10-S99-1 and charges it against the gross proceeds of the actual offering when it occurs and the proceeds are received.

EXAMPLE 4-32 (ADAPTED FROM ASC 815-40-55-51): WARRANT MODIFICATION RECOGNIZED AS A DIVIDEND

FACTS

Entity A issues warrants to a nonemployee investor with which it has no other business relationship. Subsequently, it extends the warrants' terms. The modification causes the fair value of the warrants to increase.

Entity A determines that the modification of the warrants is not related to a debt or equity financing, is not compensation for goods or services, and is not in the scope of other U.S. GAAP. Further, Entity A determines that the modification's circumstances do not indicate other transactions entered contemporaneously or in contemplation of the modification or that other rights and privileges are exchanged to achieve an overall economic effect.

Entity A accounts for the warrants as equity before and after the modification.

CONCLUSION AND ANALYSIS

The modification is not related to equity or debt financings and any other transactions in the scope of other U.S. GAAP. Therefore, Entity A accounts for the effect of the modification as follows:

- The increase in fair value (the excess of the modified warrants' fair value over their fair value immediately before the modification) is recognized as a dividend.
- If Entity A presents EPS in accordance with ASC 260, the dividend reduces net income available to common stockholders in computing basic EPS.

EXAMPLE 4-33 (ADAPTED FROM ASC 815-40-55-49 AND 55-52): WARRANT MODIFICATION RECOGNIZED AS COMPENSATION

FACTS

Entity A issues warrants for shares of its common stock with the following terms:

- Allow the holder to buy 100 common shares for $10 per share
- Have 10-year terms and are exercisable at any time

Entity A accounts for the warrants as equity.

Subsequently, in exchange for some services received from the warrant holder, Entity A reduces the exercise price to $8 per share for the warrants' remaining term. The warrants' modification is a compensation for services under a share-based payment arrangement.

Entity A continues to account for the warrants as equity after the modification.

CONCLUSION AND ANALYSIS

Entity A modified the warrants to compensate the warrant holder for its services. Therefore, Entity A accounts for the effect of the modification under ASC 718.

4.9.2 Modification or Exchange of Other Freestanding Equity-Linked Instruments

FASB REFERENCES

ASC 815-40-35-4 and ASC 815-40-35-9 through 35-10

ASC 815-40 includes accounting guidance for modifications of equity-classified freestanding written call options (such as warrants) that remain equity classified after modification (see Section 4.9.1). However, ASC 815-40 does not explicitly address how to account for modifications of other forms of equity-linked instruments. Further, it does not explicitly address how to account for modifications of freestanding written call options that cause changes in classification.

BDO INSIGHTS — CONTRACT MODIFICATION

In the absence of direct guidance for modifications or exchanges of equity-linked instruments in ASC 815-40 (other than for equity-classified written call options that remain equity classified after a modification or exchange (see Section 4.9.1)), we believe entities should consider other guidance in U.S. GAAP, such as the guidance on contract reclassifications (see Section 4.8) and modifications of equity-classified written call options (see Section 4.9.1) in ASC 815-40 and the guidance on modifications of equity awards in ASC 718. We believe the following may be acceptable approaches to account for modifications of freestanding equity-linked instruments when there is no U.S. GAAP guidance on point, based on the facts and circumstances:

TYPE OF INSTRUMENT	CLASSIFICATION BEFORE MODIFICATION	CLASSIFICATION AFTER MODIFICATION	ANALYSIS
Equity-linked instruments other than written call options	Equity	Equity	We believe an entity may analogize to the guidance on modifications of equity-classified written call options in ASC 815-40. Any effect of the modification is recognized based on the substance of the transaction (for example, as deemed dividends). Consistent with the guidance in ASC 815-40 and ASC 718, we believe an entity should generally recognize only modifications or exchanges that are economically detrimental (unfavorable) to it. For example, an entity may not recognize a gain on the modification or exchange of an equity-classified purchased call option that remains equity classified.[4]

[4] ASU 2021-04, BC5.

TYPE OF INSTRUMENT	CLASSIFICATION BEFORE MODIFICATION	CLASSIFICATION AFTER MODIFICATION	ANALYSIS
Equity-linked instruments (including written call options)	Equity	Asset or liability	In accordance with ASC 815-40-35-9, if a contract is reclassified from equity to an asset or liability (for example, as a result of insufficient authorized shares), an entity recognizes the change in fair value during the period that the contract was classified in equity as an adjustment to stockholders' equity. The contract is subsequently marked to fair value through earnings. However, when the reclassification of the contract from equity to an asset or liability is from a modification, there may be additional elements an entity should recognize. We believe the entity may consider the following approach: ▶ Reclassify the instrument to asset or liability at its fair value at the modification date ▶ Recognize the change in fair value of the instrument (from issuance to immediately before the modification) in stockholders' equity ▶ Recognize any other elements based on the substance of the modification or exchange. For instance, the entity may need to recognize the effect of the modification (the difference between the instrument's fair value immediately before and after the modification) as an expense or deemed dividends based on the facts and circumstances. For example, an entity modifies a warrant that has an initial carrying amount of $1,000, a fair value of $1,500 immediately before the modification, and a fair value of $1,800 immediately after the modification. The entity recognizes $500 ($1,500 - $1,000) in stockholders' equity and recognizes $300 ($1,800 - $1,500) as another element of the transaction based on its substance (for example, as an expense or a deemed dividend). The entity recognizes the warrant as a liability at $1,800, the fair value at the reclassification date.

<table>
<tr><th>TYPE OF INSTRUMENT</th><th>CLASSIFICATION BEFORE MODIFICATION</th><th>CLASSIFICATION AFTER MODIFICATION</th><th>ANALYSIS</th></tr>
<tr><td>Equity-linked instruments (including written call options)</td><td>Asset or liability</td><td>Equity</td><td>In accordance with ASC 815-40-35-10, if a contract is reclassified from an asset or liability to equity, the contract must be marked to fair value immediately before the reclassification.

However, when the reclassification of the contract from an asset or liability to equity is from a modification, there may be additional elements an entity should recognize. We believe the entity may consider the following approach:
▶ Mark the instrument to its fair value immediately before the modification (with the change in fair value recognized in earnings) and reclass the instrument to equity
▶ Recognize any other elements based on the substance of the modification or exchange. For instance, based on the facts and circumstances, the entity may need to recognize any incremental value as a debit to expense or deemed dividends and credit to equity (as a credit to the carrying amount of the equity-linked instrument).</td></tr>
<tr><td>Equity-linked instruments (including written call options)</td><td>Asset or liability</td><td>Asset or liability</td><td>ASC 815-40-35-4 requires equity-linked contracts that are classified as assets or liabilities to be measured subsequently at fair value with changes in fair value recognized in earnings. Accordingly, the effect of the instrument's modification or exchange is recognized in earnings as part of the fair value remeasurement.</td></tr>
</table>

Further, we believe the entity should disclose the nature of the modification or exchange transaction, the effect of the transaction and the manner it has been recognized, and other relevant information about the transaction.

4.10 DERECOGNITION

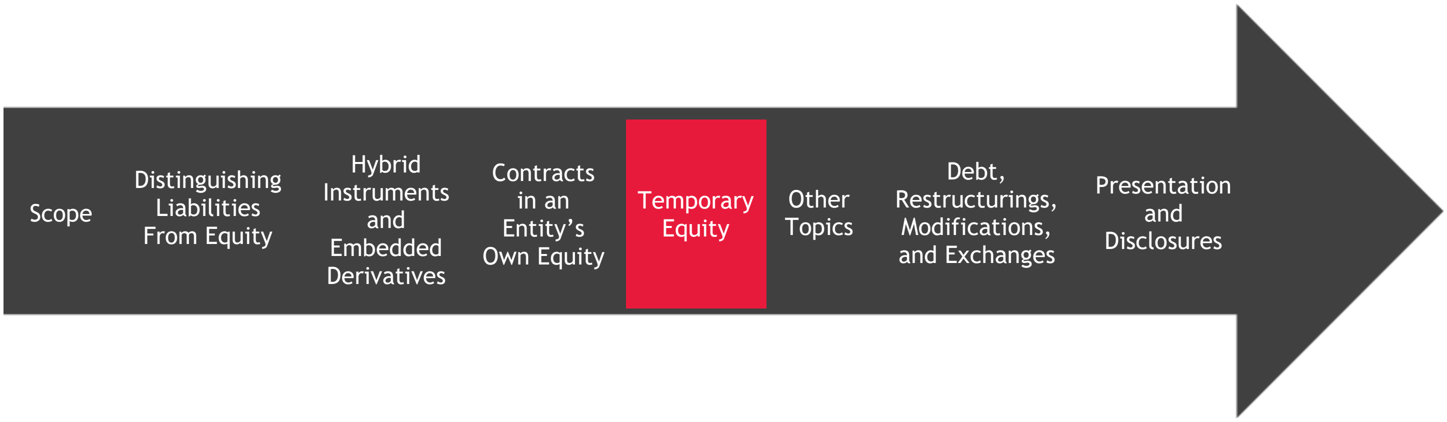
FASB REFERENCES

ASC 815-40-40-1 through 40-2

The accounting for an instrument's settlement depends on its classification and whether shares, cash, or other assets are delivered at settlement.

Equity-classified instrument	▶ If settled in cash, the entity records the cash paid (or received) as a reduction of (or an addition to) contributed capital. ▶ If settled in shares, the entity records the shares issued (or received) in equity under applicable U.S. GAAP, consistent with other equity transactions (for example, ASC 480-10-S99-3A or ASC 505).
Asset- or liability-classified instrument	▶ The entity remeasures the asset- or liability-classified instrument at its final fair value upon settlement and recognizes any gain or loss from the final remeasurement in earnings. ▶ The entity derecognizes the asset- or liability-classified instrument and recognizes the cash received (or paid). If the instrument is settled in shares, the entity records the shares issued (or received) in equity under applicable U.S. GAAP, consistent with other equity transactions (for example, ASC 480-10-S99-3A or ASC 505).

Chapter 5 — Temporary Equity



5.1 OVERVIEW

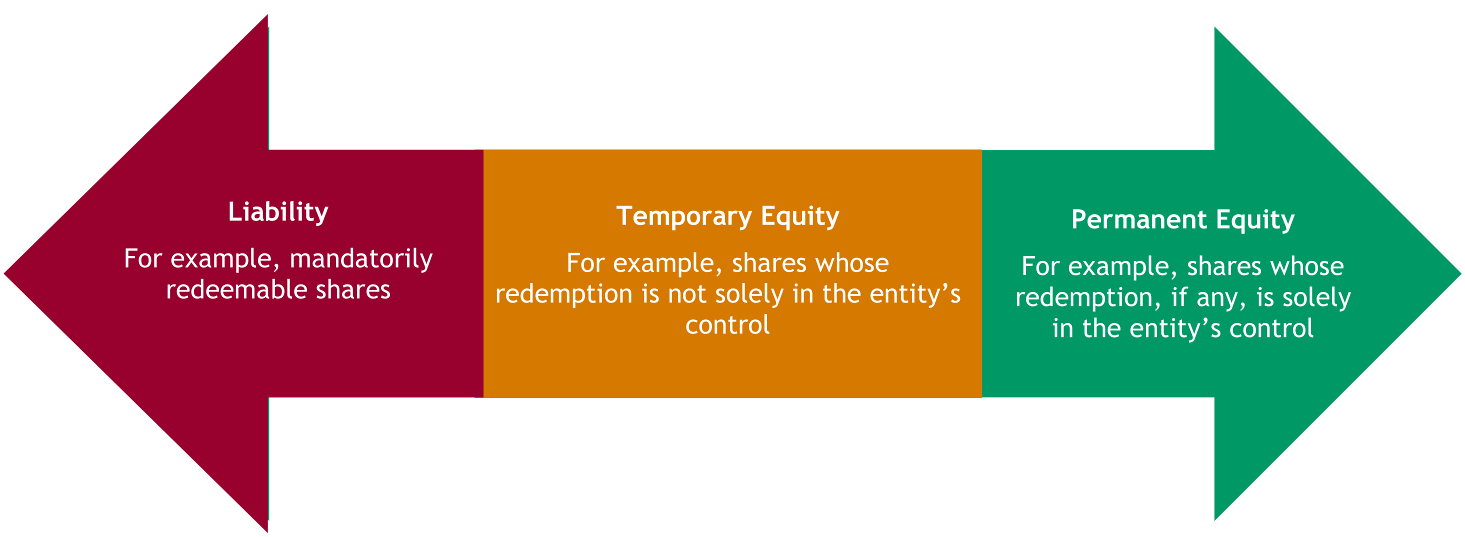
Entities that prepare financial statements in accordance with SEC Regulation S-X and other entities that elect to follow the SEC's temporary equity guidance must determine whether to classify a redeemable equity instrument as permanent or temporary equity if the instrument is not accounted for as a liability under ASC 480.

ASC 480-10-S99-3A requires classifying equity instruments in temporary equity if they are redeemable or may become redeemable for cash or other assets in **any** of the following circumstances (see Section 5.3):

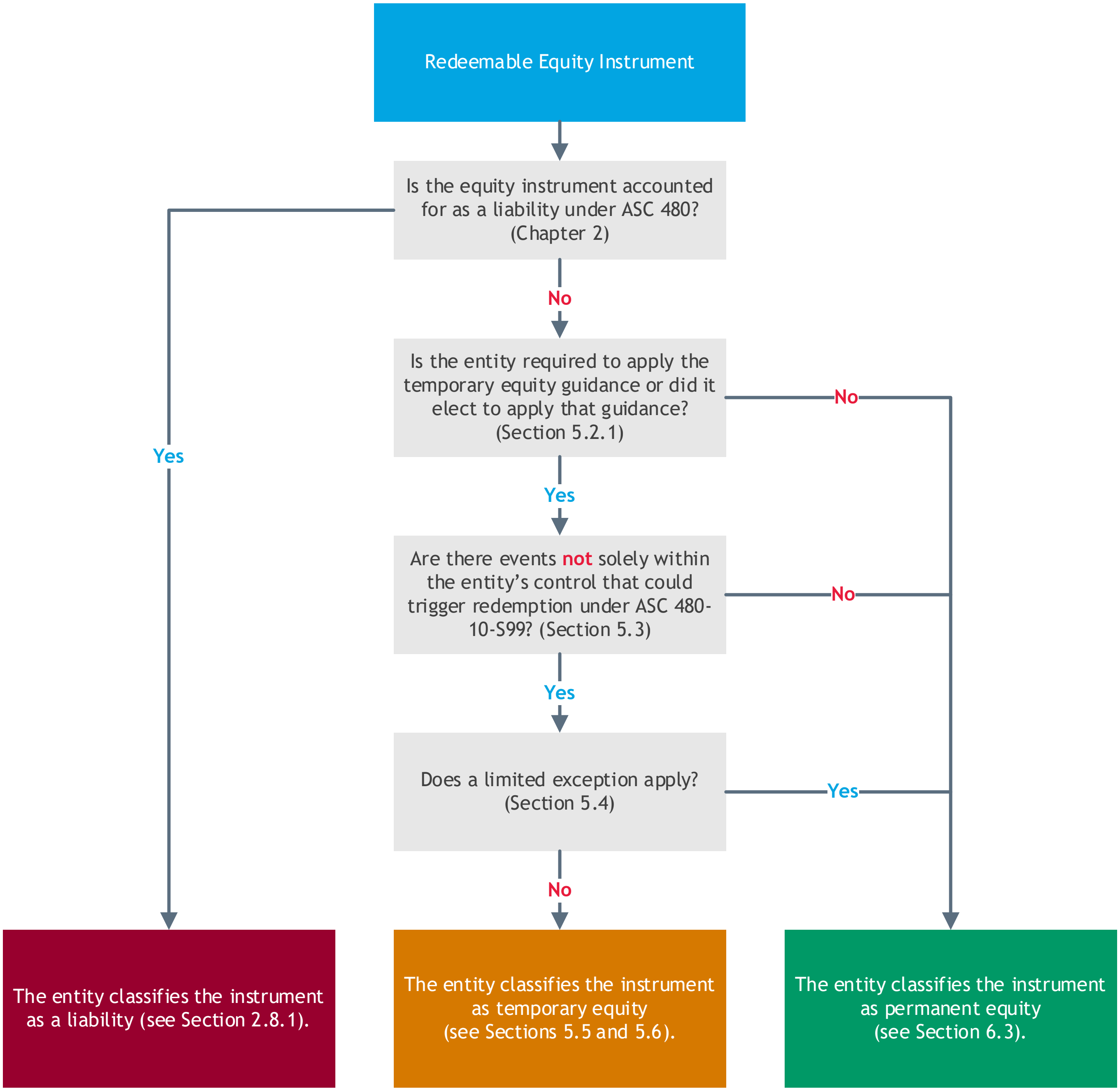
- At a fixed or determinable price on a fixed or determinable date
- At the instrument holder's option
- Upon the occurrence of an event that is not solely within the issuer's control.

An entity presents its temporary equity between liabilities and permanent equity (often referred to as "mezzanine") on the balance sheet. The temporary equity classification highlights an entity's future potential cash obligation to redeem an instrument and distinguishes it from the entity's permanent capital. See Section 5.2 for more guidance on entities and instruments within the scope of ASC 480-10-S99-3A and Section 5.4 for more guidance on specific limited exceptions.

If an instrument's redemption is solely within an entity's control, the entity presents the instrument in permanent equity. The graphic illustrates the effect of redemption provisions on an equity instrument's classification, such as a redeemable stock.



The flowchart illustrates how an entity determines the classification of a redeemable equity instrument.



Generally, entities initially measure a redeemable equity instrument classified as temporary equity at the instrument's fair value at issuance (see Section 5.5). The redeemable instrument's transaction price generally represents the issuance date fair value when the transaction is at arm's length, involves an unrelated party, and does not include unstated rights or privileges. Also, ASC 480-10-S99-3A provides initial measurement guidance for specific instruments (see Section 5.5.1).

Entities must subsequently measure temporary equity that is currently redeemable at its redemption value. If the instrument is not currently redeemable but it is probable that it will become redeemable, the entity can choose to measure the instrument at either its redemption value or accreted value (see Section 5.6). ASC 480-10-S99-3A also provides subsequent measurement guidance for specific instruments (see Section 5.6.4). If at the reporting date the instrument is not currently redeemable nor probable of becoming redeemable, the entity does not subsequently adjust the instrument's carrying amount.

If changes in facts and circumstances cause the equity instrument to no longer meet the criteria for classification in temporary equity, the entity reclassifies the instrument at its carrying amount to permanent equity on the reclassification date. If the instrument is being subsequently measured (see Sections 5.6 and 5.6.4), the entity remeasures the instrument immediately before the reclassification. On the other hand, if the entity must reclassify an equity instrument from permanent to temporary equity, the entity generally recognizes the instrument in temporary equity at its fair value on the reclassification date unless an exception from initial recognition at fair value applies (see Section 5.9).

5.2 SCOPE

ASC 480-10-S99-3A (the temporary equity guidance) includes the SEC staff's view on the application of the redeemable equity guidance in Regulation S-X (originally adopted in Accounting Series Release No. 268, *Presentation in Financial Statements of "Redeemable Preferred Stocks,"*). The SEC staff's view was originally issued as EITF Topic D-98, *Classification and Measurement of Redeemable Securities*, and later codified in ASC 480-10-S99-3A.

5.2.1 Entities

The temporary equity guidance applies to entities whose financial statements are prepared in accordance with SEC Regulation S-X. Therefore, it applies to SEC registrants (such as entities with publicly traded securities and entities conducting an IPO) and non-SEC registrants whose separate financial statements are filed with the SEC (such as for acquired or to be acquired businesses under S-X Rule 3-05[5], significant unconsolidated subsidiaries under S-X Rule 3-09, and subsidiary guarantors under S-X Rule 3-10).

The temporary equity guidance generally does not apply to nonpublic entities whose separate financial statements are not filed with the SEC. However, a nonpublic entity may elect to follow the temporary equity guidance if it plans to become an SEC registrant in the future, expects that its financial statements will be included in an SEC filing (for example, because of a potential acquisition), or determines that such presentation more faithfully represents its financial condition. An entity that did not previously apply the temporary equity guidance must account for the initial election to follow that guidance as a change in accounting policy under ASC 250, which requires retrospective application unless it is impracticable.

5.2.2 Redeemable Equity Instruments

FASB REFERENCES

ASC 480-10-S99-3A(3) through S99-3A(3)(e)

The temporary equity guidance generally applies to redeemable equity instruments and includes special considerations for specific instruments (see Section 5.7).

[5] S-X Rule 8-04 for smaller reporting companies.

MEANING OF EQUITY INSTRUMENTS

U.S. GAAP does not define equity instruments. We believe equity instruments generally refer to equity shares (for example, common and preferred stock) and equity-linked instruments. In U.S. GAAP, equity shares refer only to shares that an entity accounts for as equity.

In applying the temporary equity guidance, equity instruments also include specific instruments such as NCI, securities held by an ESOP, and share-based payment arrangements with employees.

The table includes instruments with special considerations under the temporary equity guidance.

INSTRUMENTS	SPECIAL CONSIDERATIONS
NCI	Sections 5.7.1, 5.8.3, and 5.8.4
Equity-classified share-based payment awards	Sections 5.2.2.5 and 5.7.2
Securities held by ESOPs	Section 5.7.3
Equity-classified component of convertible debt instruments	Sections 5.2.2.6 and 5.7.4
Equity-classified hybrid instruments	Sections 5.2.2.3 and 5.7.5

The temporary equity guidance does not apply to the following instruments:

Instruments out of Scope

- Freestanding financial instruments classified as assets or liabilities in accordance with ASC 480*, ASC 815-40, or other U.S. GAAP (see Section 5.2.2.1)
- Freestanding derivative instruments classified in stockholders' equity in accordance with ASC 815-40 (see Section 5.2.2.2 for some exceptions)
- Registration payment arrangements accounted for in accordance with ASC 825-20 (see Section 5.2.2.4)

*The temporary equity guidance applies to equity instruments that are not classified as liabilities under ASC 480 in accordance with that guidance's scope exceptions (for example, some mandatorily redeemable shares and NCI that are exempt from the ASC 480 classification and measurement requirements) (see Sections 2.2.4 and 5.4.2).

5.2.2.1 Freestanding Financial Instruments Classified as Assets or Liabilities

FASB REFERENCES

ASC 480-10-S99-3A(3)(a) through S99-3A(3)(b)

The temporary equity guidance does not apply to the following instruments:

- Freestanding financial instruments classified as assets or liabilities under ASC 480 (see Chapter 2) or other applicable U.S. GAAP, including those with separated derivative assets or liabilities.

- Freestanding contracts on an entity's own equity accounted for as assets or liabilities under ASC 815-40 (see Chapter 4). For instance, a derivative financial instrument that an entity must or may be required to redeem for cash or other assets (on a specified date or upon an event outside the entity's control) does not meet the equity classification criteria in ASC 815-40 and is accounted for as an asset or liability.

5.2.2.2 Freestanding Derivative Instruments Classified in Stockholders' Equity

FASB REFERENCES

ASC 480-10-S99-3A(3)(b)

Generally, the temporary equity guidance does not apply to freestanding derivative instruments (for example, warrants or forwards) that are classified in stockholders' equity in accordance with ASC 815-40.

BDO INSIGHTS — CLASSIFICATION OF CONTRACTS THAT REQUIRE SETTLEMENT IN REGISTERED SHARES

An entity evaluates contracts on its own equity under ASC 815-40 to determine whether to classify them as equity. In accordance with ASC 815-40, contracts that an entity must or may be required to settle in cash typically cannot be classified as equity (see Chapter 4).

In some cases, an instrument may require settlement in registered shares (by contract or otherwise, such as relevant securities laws). A requirement for cash settlement may arise when the contract does not expressly limit the holder to only net share settlement (often referred to as "cashless exercise in warrant agreements") in the absence of an effective registration statement or the contract fails to state that there is no circumstance that would require the entity to net cash settle the instrument. An entity typically does not control events or actions necessary to deliver registered shares, thereby implying a potential obligation to settle the instrument with cash. Accordingly, an entity may have historically accounted for those instruments as liabilities under ASC 815-40 with no further need to assess the temporary equity guidance. However, following the adoption of ASU 2020-06, which amended the equity classification guidance in ASC 815-40, an entity classifies the instrument outside equity (as an asset or a liability) **only if** the contract **explicitly** requires cash settlement when registered shares are unavailable (see Section 4.6.2.1). Otherwise, the contract is classified as equity (assuming all the equity classification requirements are met), even though settlement in registered shares may be required under the relevant securities laws.

The SEC's temporary equity guidance in ASC 480-10-S99-3A applies to redeemable equity-classified instruments whose redemption is outside the entity's control. However, ASC 480-10-S99-3A(3)(b) states that the SEC's temporary equity guidance does not apply to freestanding derivative instruments that are classified in stockholders' equity under ASC 815-40. It also says that "*a freestanding derivative instrument would not meet the conditions in Subtopic 815-40 to be classified as an equity instrument if it was subject to redemption for cash or other assets on a specified date or upon the occurrence of an event that is not within the control of the issuer*." That guidance predates ASU 2020-06, and the SEC did not change its temporary equity guidance in connection with the ASU.

Therefore, a question arises regarding whether contracts that require settlement in registered shares under the relevant securities laws (such as warrants issued in a public offering) that are classified as equity under ASC 815-40 after the adoption of ASU 2020-06 must be classified as temporary equity because they may potentially require cash settlement if the entity is unable to issue registered shares at settlement.

It is unclear whether the SEC will provide further guidance or amend ASC 480-10-S99-3A to address the issue. In the absence of additional guidance from the SEC, entities are encouraged to discuss their individual facts with their accounting advisors or auditors.

5.2.2.3 Hybrid Instruments and Embedded Derivatives

FASB REFERENCES

ASC 480-10-S99-3A(3)(a) through S99-3A(3)(b)

The temporary equity guidance applies to hybrid financial instruments (such as redeemable common or preferred stock) that are not classified in their entirety as an asset or liability under ASC 480 or other applicable U.S. GAAP.

SCENARIO	CONSIDERATIONS TO DETERMINE WHETHER IN SCOPE OF TEMPORARY EQUITY GUIDANCE	APPLICATION OF TEMPORARY EQUITY GUIDANCE IF IN SCOPE
Embedded derivative is not separated under ASC 815-15	Evaluate the entire instrument's terms and features.	Classify and measure the entire hybrid financial instrument under ASC 480-10-S99-3A (see Sections 5.5 and 5.6).
Embedded derivative is separated under ASC 815-15	Evaluate the entire instrument's terms and features, including the separated embedded derivative (to assess whether the temporary equity guidance applies to the equity host contract).	Classify and measure the host contract under ASC 480-10-S99-3A (see Section 5.7.5). Classify and measure the separated embedded derivative under ASC 815-15 (see Section 3.7.1.2).

In contrast, the temporary equity guidance does not apply to an equity instrument if its potential redemption is the result of a freestanding written put option. In that case, the entity accounts for the written put option liability as a separate unit of account (see Chapter 2).

5.2.2.4 Equity Instruments Subject to Registration Payment Arrangements

FASB REFERENCES

ASC 480-10-S99-3A(3)(c)

An entity evaluates whether an equity instrument that is subject to a registration payment arrangement must be classified as temporary equity independently of the registration payment arrangement. In other words, the registration payment arrangement is accounted for as a separate unit of account (see Section 6.4.1). The entity cannot apply that guidance by analogy to other arrangements that do not meet the definition of a registration payment arrangement in ASC 825-20.

5.2.2.5 Share-Based Payment Awards

FASB REFERENCES

ASC 480-10-S99-3A(3)(d)

When evaluating an equity-classified share-based payment arrangement accounted for under ASC 718, an entity must consider temporary equity classification if the award includes a redemption feature. However, the following features, on their own, do not cause temporary equity classification:

- Requirement to deliver registered shares, resulting in an assumption of net cash settlement
- Requirement to repurchase shares (directly or indirectly) solely to satisfy the employer's minimum statutory tax withholding requirements.

When an award is no longer within the scope of ASC 718 (for example, because of the award's modification after a grantee vests in the award and no longer provides goods or services), the entity must reassess the award's classification, including temporary equity classification (see Section 5.7.2).

5.2.2.6 Convertible Debt Instruments That Contain a Separately Classified Equity Component

FASB REFERENCES

ASC 480-10-S99-3A(3)(e)

Other applicable U.S. GAAP may require separating a convertible debt instrument into its liability and equity components, such as:

- A convertible debt with a substantial premium recorded in equity (see Section 3.6.1.2)
- A convertible debt with a conversion feature reclassified from liability to equity because the conversion feature no longer requires bifurcation (see Section 4.8.2)
- A convertible debt modified or exchanged in a transaction that does not require extinguishment accounting but results in an increase in the embedded conversion option's fair value, with the increase recorded in equity (see BDO's publication, **Troubled Debt Restructuring, Debt Modification, and Extinguishment**).

An entity presents the convertible debt's equity component in temporary equity if, at the balance sheet date, the convertible debt is currently redeemable or convertible for cash or other assets (see Section 5.7.4).

In contrast, the entity presents the convertible debt's equity component in permanent equity if the convertible debt is not redeemable (or convertible for cash or other assets) at the balance sheet date. That presentation applies even if the instrument could become redeemable (or convertible) in the future based on the passage of time or the occurrence of a contingent event.

5.3 CLASSIFICATION

FASB REFERENCES

ASC 480-10-S99-3A(2) and ASC 480-10-S99-3A(5)

The temporary equity guidance applies to equity instruments that are redeemable or may become redeemable for cash or other assets in **any** of the following circumstances:

- Redeemable at a fixed or determinable price on a fixed or determinable date (see Section 5.3.1)
- Redeemable at the instrument holder's option (see Section 5.3.2)
- Redeemable upon the occurrence of an event that is not solely within the issuer's control (see Section 5.3.3).

All the individual facts and circumstances surrounding events that could require an issuer to redeem the instrument for cash or other assets must be evaluated separately. The possibility that any triggering event not solely within its control could occur requires the issuer to classify the instrument in temporary equity. The probability of the triggering event is irrelevant to the determination.

IDENTIFYING FEATURES THAT CAN TRIGGER REDEMPTION

An entity must evaluate an instrument's contractual terms to identify all features that can trigger redemption, which might not be explicitly labeled as redemption features. For example, an equity instrument may include any of the following features:

- A redemption feature within the instrument's liquidation terms.
  - As discussed in Section 5.3.3.2, the entity must assess an instrument that it must, or may be required to, redeem upon deemed liquidation events for temporary equity classification.
- A feature that is legally referred to as a conversion feature but results in settling the instrument for a variable number of shares at a fixed amount.
  - As discussed in Section 5.3.3.1, an entity must assess whether it can issue the required shares at settlement in determining whether an instrument must be classified in temporary equity. If it does not control settlement by delivery of its shares (for example, because there is no cap on the maximum number of shares potentially issuable upon redemption), cash settlement of the instrument would be presumed, and the instrument would be classified as temporary equity.
- A feature that is a call option in legal form (exercisable by the holder) but is in substance a put option (for example, because the holder controls the issuer's decisions).
  - As discussed in Section 5.3.3.4, an entity must assess whether the instrument holder controls the decision to redeem the instrument in determining whether the instrument must be classified in temporary equity.

Further, we believe the temporary equity guidance applies only when an instrument includes contractual terms that can trigger the instrument's redemption for cash or other assets. For instance, an equity instrument is not considered a redeemable instrument just because the instrument holder controls the issuer's board and can amend the instrument's contractual terms to add a redemption feature.

Identifying features that can trigger redemption requires the use of professional judgment based on the facts and circumstances.

5.3.1 Redeemable at a Fixed or Determinable Price on a Fixed or Determinable Date

FASB REFERENCES

ASC 480-10-S99-3A(2)

An entity must present an equity instrument as temporary equity if it is redeemable at a fixed or determinable price on a fixed or determinable date and it is not accounted for as a liability under ASC 480. For example, preferred stock that the entity must redeem at a fixed price on a fixed date that has a substantive conversion option is not a liability under ASC 480. Therefore, the temporary equity guidance applies to that instrument.

5.3.2 Redeemable at the Instrument Holder's Option

FASB REFERENCES

ASC 480-10-S99-3A(2) through S99-3A(3)

An equity instrument that includes a put option exercisable by the holder is redeemable outside the issuer's control, so the issuer classifies that instrument in temporary equity. Further, as discussed in Section 5.3.3.4, a legal form call option may in substance be a put option when the instrument holder controls the issuer's decision. Therefore, the issuer also classifies that instrument in temporary equity.

Further, a redeemable NCI is subject to the temporary equity guidance if it is not accounted for under ASC 480 and the redemption feature is not a freestanding option within the scope of ASC 480.

5.3.3 Redeemable Upon the Occurrence of an Event That Is Not Solely Within the Issuer's Control

FASB REFERENCES

ASC 480-10-S99-3A(2), ASC 480-10-S99-3A(4) through S99-3A(5), and ASC 480-10-S99-3A(7)

An entity must classify an equity instrument in temporary equity if it is redeemable for cash or other assets outside its control. In determining how to classify a redeemable equity instrument, an entity assesses the events that trigger redemption and whether those events are solely within its control.

For a redeemable equity instrument to qualify as permanent equity, the entity must be able to avoid the instrument's redemption for cash or other assets by having control over the actions and events that can trigger that redemption. For example, a redemption that can be triggered by the entity's failure to complete an action that involves other parties or requires approval by a regulator is outside the entity's control (for example, an equity instrument that will become redeemable if the entity does not complete a merger or IPO by a specified date).

Also, if the triggering event requires shareholder approval, it is not solely within the entity's control because the entity cannot control its shareholders' decisions. In contrast, if the triggering event requires an affirmative vote by the majority of the entity's board of directors and the instrument holder does not control the board's vote through direct representation or other rights, that event may be within the entity's control.

BDO INSIGHTS — DETERMINING WHO CONTROLS AN ENTITY'S DECISIONS

An instrument holder may be part of the entity's board of directors and executive management. If so, it is unclear whether the instrument holder's decision must be analyzed based on the individual's role as an executive member, instrument holder, or shareholder. While directors and officers have fiduciary duties to act in good faith and in the entity's best interests, we believe such fiduciary obligation is insufficient to conclude that the individual would act based on its capacity as an executive member. Rather, we believe the entity must assess control over the instrument's redemption based on the assumption that the instrument holder could act based on its rights and obligations as an instrument holder or shareholder.

For example, if a preferred stock instrument is redeemable upon a change in control, the entity evaluates who can trigger a change in control. In some closely held structures in pre-IPO entities, an individual or small group of founders typically holds a majority of the entity's voting stock whose sale would trigger a change in control. Those stockholders often hold positions within the entity; for instance, as board members or executive officers. In those cases, we believe a change in control is outside the entity's control absent any contractual or governance mechanism restricting those individuals' ability to sell the stock in their capacity as shareholders.

Determining whether an action or event is solely within an entity's control requires the application of professional judgment based on the facts and circumstances.

5.3.3.1 Instruments That May Be Settled in Shares

FASB REFERENCES

ASC 480-10-S99-3A(6)

If an entity issues an equity instrument that is redeemable at the holder's option or upon the occurrence of an event that is not solely within the entity's control — and upon redemption, the entity can choose to pay the redemption amount in cash or a variable number its own shares with an equivalent value — it must assess whether it controls the actions or events that trigger redemption. If there is no limit to the number of shares the entity must issue **and** the entity does not control the actions or events that trigger redemption, the entity must assume cash redemption and classify the equity instrument as temporary equity. The entity must consider the requirements in ASC 815-40-25 to determine whether it controls the actions necessary to issue shares (see Section 4.6.2.2).

APPLICATION TO CONVERTIBLE INSTRUMENTS

For convertible equity instruments (such as a convertible preferred stock), the entity must determine if it controls the actions required to issue the shares when the holder exercises the conversion option. For example, if shareholders must approve the issuance of the shares upon conversion, the entity does not control the action required to issue the shares. Further, if the entity does not have sufficient available shares and an increase in authorized shares requires shareholder approval (or it requires board approval, but the instrument holder controls the board), issuing shares upon conversion is not within the entity's control. In those cases, the instrument's conversion presumably requires (or may require) the entity to settle the instrument in cash. The entity must therefore classify the convertible instrument in temporary equity, even if it does not otherwise have a redemption feature. In performing that assessment, the entity must consider the requirements in ASC 815-40-25 (see Section 4.6.2.2).

5.3.3.2 Redeemable Upon Deemed Liquidation Events

FASB REFERENCES

ASC 480-10-S99-3A(3)(f) and ASC 480-10-S99-3A(7)

An ordinary liquidation event involves an entity's termination or final liquidation of all its equity for cash or other assets. An entity does not present an equity instrument that is redeemable only when an ordinary liquidation event occurs as temporary equity.

On the other hand, the entity must present an equity instrument as temporary equity if it is redeemable for cash or other assets when a deemed liquidation event occurs, the event is not solely within the entity's control, and the limited exception discussed in Section 5.4.1 does not apply. A contract might not explicitly use the term "deemed liquidation." However, generally, a deemed liquidation event requires the entity (automatically or at the holder's option) to redeem (or liquidate) one or more particular class of its equity when that event occurs but does not result in the entity's termination or final liquidation. Examples of typical deemed liquidation events include:

- A violation of a debt covenant
- A delisting of the entity's securities from an exchange
- A change in control of the entity (see Section 5.3.3.3)
- A merger or consolidation (see Section 5.3.3.4)
- A sale of substantially all the entity's assets (see Section 5.3.3.4).

Some deemed liquidation events, such as a change in control of the entity and delisting of its securities, are generally outside the entity's control. Compliance with a debt covenant, such as meeting a specified financial covenant, might also be outside the entity's control.

Further, if the transaction or event triggering redemption requires board approval (for instance, an entity's governing documents or state laws require that the entity's board approve the transaction), the entity must evaluate if it can avoid redemption by controlling the decision over the transaction or event (for example, the decision to merge with another entity or sell the entity's assets). In most corporate structures, that generally requires assessing whether the instrument holder controls the majority vote of the entity's board of directors. If the instrument holder controls how the board votes, the entity does not solely control the action and events that would trigger the instrument's redemption (see Section 5.3.3.4).

However, under a limited exception, a deemed liquidation event does not cause temporary equity classification for a particular class of equity instrument if **all** the entity's equally and more subordinated equity holders would **always** be entitled to receive **the same form of consideration** (for example, cash or shares) when the redemption event occurs (that is, all subordinated classes would also be entitled to redeem for the same form of consideration) (see Section 5.4.1).

5.3.3.3 Redeemable Upon a Change in Control

FASB REFERENCES

ASC 480-10-S99-3A(8)

An equity instrument may include a deemed liquidation clause that requires the entity to redeem the instrument if it undergoes a change in control. For example, preferred stock may become redeemable if the entity's voting securities (those immediately before a merger or consolidation) hold less than a majority of the voting power of the surviving entity's outstanding equity immediately after the merger or consolidation. If that transaction is outside the entity's control (for instance, because a purchaser can acquire a majority of the voting power of the entity's outstanding equity without the entity's approval), the entity must classify the preferred stock in temporary equity. If the transaction requires the approval of the entity's board, the entity must evaluate whether the instrument holders control the board's vote to determine whether the event that triggers redemption is outside its control (see Section 5.3.3.4).

A change in control may occur in various ways, including via a sale of shares by shareholders. For example, a change in control may occur when an acquirer makes a tender offer that is accepted by a majority of the entity's shareholders. Generally, such a takeover is outside an entity's control (unless the entity's governance structure can prevent it from occurring). Accordingly, if the entity must redeem its equity instruments upon the takeover, the entity must classify those instruments in temporary equity unless the limited exception is met (see Section 5.4.1).

5.3.3.4 Holder Controls the Issuer's Decision or Events Triggering Redemption

FASB REFERENCES

ASC 480-10-S99-3A(7) and ASC 480-10-S99-3A(10) through S99-3A(11)

Generally, an entity's (issuer's) decision is within its control if the decision requires approval by its board of directors. However, if the instrument holder controls the vote of the issuer's board through direct representation or other rights, the issuer's decisions over that instrument (such as whether to exercise the instrument's redemption (call) feature or approve an action that will cause the instrument's redemption) is considered outside the issuer's control. In those cases, the issuer classifies the instrument in temporary equity. All relevant facts and circumstances must be considered and any provision that requires board approval cannot be assumed to be within the issuer's control.

The table illustrates how an instrument holder's control over the issuer's decisions affects an instrument's classification.

IF THE INSTRUMENT IS REDEEMABLE:	PERMANENT EQUITY CLASSIFICATION IS APPROPRIATE WHEN:	TEMPORARY EQUITY CLASSIFICATION IS APPROPRIATE WHEN:
At the issuer's option	The instrument holder does not control the board's (or other governing body's) vote	The instrument holder controls the issuer's decisions through board representation or other rights
Upon sale of substantially all an entity's assets	The instrument holder cannot trigger or otherwise require the sale of the assets through board representation or other rights **or** the limited exception discussed in Section 5.4.1 applies	The instrument holder controls the issuer's decision through board representation or other rights **and** the limited exception discussed in Section 5.4.1 does not apply
Upon merger or consolidation	State law requires board approval before any merger or consolidation can occur **and** the instrument holder does not control the board's (or other governing body's) votes through direct representation or other rights, **or** the limited exception discussed in Section 5.4.1 applies	State law requires shareholder approval for any merger or consolidation **or** state law requires board approval, the instrument holder controls the issuer's decision through board representation or other rights, **and** the limited exception discussed in Section 5.4.1 does not apply

The issuer does not consider whether the preferred stockholder could obtain control of the issuer's board by purchasing common stock or other equity interest when evaluating the instrument for temporary equity classification. However, even if the instrument holder does not currently control the issuer's board, the issuer must evaluate its governance structure and the instrument's contractual requirements to determine whether the instrument holder can take over the board through other rights. For instance, if the instrument grants the holder board control when specified events outside the issuer's control occur (such as failure to pay dividends, violation of debt covenants, or delisting of the issuer's shares), the instrument's redemption is outside the issuer's control if redemption is controlled by the board's vote.

The concepts are discussed in the SEC staff speech below.

SEC STAFF GUIDANCE

[Remarks before the 2009 AICPA Conference on Current SEC and PCAOB Developments]

Brian W. Fields, Professional Accounting Fellow, Office of the Chief Accountant

December 7, 2009

Contracts on Own Stock and Redeemable Equity Shares

> *The SEC staff guidance on redeemable shares also notes that there may be situations in which control by the governance structure of an entity, such as the Board of Directors, may be insufficient to demonstrate that a settlement option is within the company's control. These are often situations in which specific shareholders have the ability to seize control of the governance structure and require redemption of their interests in a preferential manner using another feature of the instrument. A typical example is a provision whereby a class of preferred shareholders can take control of the Board upon failure to pay dividends and thereby exercise a preexisting embedded call option on their preferred stock. Unless there were a third provision that makes the call inoperable when the preferred shareholders are in control, the shares would be classified in temporary equity because the combination of the contingent control right and the call could be used in the same manner as a put option by the preferred shareholder. Of course, whenever the analysis becomes this involved a healthy attention to appropriate disclosure is probably in order.*

BDO INSIGHTS — DETERMINING WHETHER THE INSTRUMENT HOLDER CONTROLS THE ENTITY'S BOARD OF DIRECTORS

Determining who controls an entity's board of directors is often complex and requires the entity to consider its governance structure and documents. When determining who controls the board, the entity must consider the instrument's board representation rights (including the right to appoint and remove directors), regardless of who currently sits on the board. It also must determine whether a redemption feature applies to a particular class of stock (that is, all shares of a particular class are redeemable) or more than one class of stock.

When the entity's board controls the action or event that triggers the instrument's redemption, an entity's analysis of the redeemable equity instrument (using redeemable preferred stock as an example) may include the considerations summarized in the table.

SCENARIO	ANALYSIS OF WHETHER THE INSTRUMENT HOLDER CONTROLS THE ENTITY'S BOARD OF DIRECTORS
An entity has one class of preferred stock. The preferred stock investors do not hold common stock.	The entity's considerations include: ▶ How many seats make up the board? ▶ How many seats do the preferred stock investors control? ▶ Can the preferred stock investors increase the size of the board and designate new directors (for example, through an existing voting agreement)? The analysis will depend on the facts and circumstances. For instance, if the preferred stock investors do not control the board (for example, they control one of three board seats), the decision that would trigger the preferred stock's redemption is within the entity's control. Conversely, if the preferred stock investors control the majority of board seats, the entity's decisions over the preferred stock is outside the entity's control.

SCENARIO	ANALYSIS OF WHETHER THE INSTRUMENT HOLDER CONTROLS THE ENTITY'S BOARD OF DIRECTORS
An entity has one class of preferred stock. The preferred stock investors also hold common stock.	The entity's considerations include: ▶ How many seats make up the board? ▶ How many seats do the preferred stock investors control through preferred stock? ▶ How many seats do the preferred stock investors control through other classes of stock they own? ▶ Can the preferred stock investors, through their preferred or common stock (or both), increase the size of the board and designate new directors (for example, through an existing voting agreement)? The analysis will depend on the facts and circumstances. For instance, if the preferred stock investors do not control the board through their preferred stock investment because they control one of three seats as preferred stockholders, but the investors control the board through a combination of their preferred and common shares (for example, the holders control another seat through their common shares), the entity's decisions over the preferred stock are outside the entity's control.
An entity has multiple classes of preferred stock.	The entity's considerations include: ▶ How many seats make up the board? ▶ How many seats do the preferred stock investors of the class being evaluated control through preferred stock? ▶ How many seats do the preferred stock investors of the class being evaluated control through any other classes of stock they own? ▶ Are there classes other than the class being evaluated that are redeemable and, if so, under what circumstances? ▶ Do the preferred stock investors of the different classes of preferred stock collectively control the board? ▶ Who is authorized to increase the size of the board and designate new directors? The analysis will depend on the facts and circumstances. For example, deemed liquidation events often require entities to redeem more than one class of preferred stock. In those cases, the analysis may be complex and requires considering the entity's governance structure and documents.
Independent directors hold board seats.	The entity's considerations include: ▶ Who appoints the independent directors? ▶ Who can remove an independent director? ▶ How does the entity's governance define the term "independent director"? The analysis will depend on the facts and circumstances. If the preferred stock investors have the right to appoint and remove the independent director, we believe those investors would generally control that board seat in determining whether the preferred stock controls the board.

Determining who controls the entity's board of directors requires the application of professional judgment based on the facts and circumstances.

5.3.3.5 Other Events Not Solely Within the Issuer's Control

FASB REFERENCES

ASC 480-10-S99-3A(2) and ASC 480-10-S99-3A(9)

As discussed in Section 5.3.3.4, if an instrument's redemption for cash or other assets is within the holder's control, redemption is not solely within the issuer's control and the issuer classifies the instrument in temporary equity. However, a redemption might not be solely within the issuer's control even if the control over the events triggering redemption does not rest with the holder. For example, a redemption feature triggered by any of the following is not solely within the issuer's control (therefore, the instrument generally must be classified in temporary equity):

- Failure to have a registration statement declared effective by the SEC by a designated date
- Failure to comply with debt covenants (such as specified financial covenants)
- Failure to achieve specified earnings targets
- A decrease in the issuer's credit rating.

5.4 LIMITED EXCEPTIONS

An entity does not classify a redeemable equity instrument in temporary equity if it meets any of the following limited exceptions:

- Redemptions upon deemed liquidation events (see Section 5.4.1)
- Redemptions covered by insurance (see Section 5.4.2).

5.4.1 Redemptions Upon Deemed Liquidation Events

FASB REFERENCES

ASC 480-10-S99-3A(3)(f)

As discussed in Section 5.3.3.2, deemed liquidation events that require (or allow at the holder's option) the redemption of one or more particular class of an entity's equity instrument for cash or other assets cause those instruments to be classified in temporary equity. However, as a narrow and limited exception, a deemed liquidation event does not cause a particular class of equity instrument to be classified in temporary equity if **all** holders of the entity's equally and more subordinated equity instruments would **always** be entitled to receive the **same form of consideration** (for example, cash or shares) that the particular class of equity instrument is entitled to receive. In other words, all subordinated classes would also be entitled to redeem for the same form of consideration upon a deemed liquidation event.

BDO INSIGHTS — MEETING THE LIMITED EXCEPTION FOR DEEMED LIQUIDATION REDEMPTIONS

Entities must evaluate whether the agreements or governing documents allow for all equally and more subordinated equity holders to always receive the same form of consideration that the holders of the equity instrument being evaluated are entitled to receive. However, in our experience, equity instruments that are redeemable upon deemed liquidation events infrequently meet the limited exception.

We believe the agreements or governing documents must explicitly state that all equal and more subordinated classes are entitled to receive the same form of consideration in all cases to meet the limited exception. That exception focuses on the same **form** of consideration rather than the same amount. For example, preferred stock meets the limited exception if the holders of the preferred stock have a right to receive the form of consideration that they would receive as if the preferred stock converted into common stock immediately before a transaction and the common stock is the only subordinated equity (that is, the holders of the common stock would always be entitled to also receive the same form of consideration received by the holders of the preferred stock upon the event giving rise to redemption). In that case, both the preferred stock and the subordinated common stock would always receive the same form of consideration.

Generally, we believe specified waterfall distributions (for example, when liquidation preferences exist) that do not explicitly state that all classes of shares are entitled to the same form of consideration do **not** meet the limited exception. Similarly, an investor rights agreement may provide for all preferred stockholders within a class to receive the same form of consideration without addressing other equally or more subordinate classes of stock. The limited exception would not be met in that case either.

Determining whether an equity instrument meets the limited exception requires the application of professional judgment based on the facts and circumstances.

5.4.2 Redemptions Covered by Insurance Proceeds

FASB REFERENCES

ASC 480-10-S99-3A(3)(g)

If an entity must redeem an equity instrument upon the holder's death for cash or other assets, the instrument must be classified as a liability under ASC 480 even when redemption is funded by an insurance policy. For instance, an SEC registrant must account for an outstanding share that it must redeem for cash or other assets upon the holder's death as a liability even if an insurance contract would cover the cost of redemption (see Section 2.4.3).

If an instrument is not subject to ASC 480 — for example, an outstanding share is mandatorily redeemable upon the holder's death, but the entity is a non-SEC registrant or the share is mandatorily redeemable upon the holder's disability — the temporary equity guidance generally applies. However, unlike the guidance in ASC 480, the entity does not classify the equity instrument in temporary equity if it becomes redeemable upon the holder's disability or death (at the holder's heir's or estate's option) **and** the redemption will be funded by proceeds of an insurance policy that is currently in force and the entity can and intend to maintain in force. An entity cannot apply that limited exception by analogy to other transactions.

5.5 INITIAL MEASUREMENT

FASB REFERENCES

ASC 340-10-S99-1, ASC 480-10-S99-3A(12), and ASC 480-10-S99-3A(12)(e)

Entities initially recognize redeemable equity instruments classified as temporary equity at fair value at issuance (except instruments with specific measurement guidance under ASC 480-10-S99-3A as discussed in Section 5.5.1).

Accordingly, redeemable shares (such as redeemable common and preferred stock) classified as temporary equity are initially recognized at **fair value**. Generally, the transaction price represents the fair value at issuance when the transaction is at arm's length, involves an unrelated party, and there are no unstated rights or privileges. The redeemable shares' initial carrying amount is reduced by specific incremental costs directly attributable to their issuance (see Section 6.3), the portion of the proceeds allocated to any other instruments issued with the shares (such as warrants), and the fair value of any bifurcated derivatives (see Section 5.7.5).

5.5.1 Initial Measurement for Specific Instruments

FASB REFERENCES

ASC 480-10-S99-3A(12) through S99-3A(12)(e), and ASC 815-15-30-2

As discussed in Section 5.5, generally, redeemable equity instruments that are classified in temporary equity are initially recognized at their fair value at issuance. However, ASC 480-10-S99-3A requires specific measurement (rather than fair value) for some instruments, as summarized in the table.

EQUITY INSTRUMENT	INITIAL MEASUREMENT IS BASED ON	GUIDANCE
NCI	The guidance in ASC 805-20-30 or ASC 810-10	Section 5.7.1
Share-based payment arrangements with employees	The award's redemption amount, adjusted for the proportional employee service received at the award's initial recognition	Section 5.7.2
Securities held by ESOPs	Generally, the maximum cash obligation. However, if the cash redemption obligation relates only to a market value guarantee, either: ▶ The entity's maximum cash obligation based on the equity securities' fair value at the balance sheet date ▶ The entire guaranteed market value of the equity securities.	Section 5.7.3
Equity-classified component of convertible debt instruments that are **currently redeemable** (or currently convertible for cash or other assets)	At the issuance date, the excess of: ▶ The redemption or conversion payable over ▶ The liability component's carrying amount.	Section 5.7.4
Hybrid equity instrument with bifurcated derivative	The difference between: ▶ The proceeds allocated to the hybrid instrument (see Section 3.7.1.2) and ▶ The embedded derivative's fair value.	Section 5.7.5

5.6 SUBSEQUENT MEASUREMENT

FASB REFERENCES

ASC 480-10-S99-3A(13) through S99-3A(17) and ASC 825-10-15-5(f)

ASC 480-10-S99-3A requires specific measurement for some instruments that are classified as temporary equity (see Section 5.6.4). For all other instruments classified as temporary equity, an entity must subsequently measure them as follows:

Instrument is currently redeemable	Current Redemption Value Method — Adjust the carrying amount to the instrument's current maximum redemption value at the balance sheet date (see Section 5.6.1).
Instrument is not currently redeemable but is probable of becoming redeemable	Use either of the following methods consistently (see Section 5.6.2): ▶ Accreted Value Method — Accrete any changes in the redemption value from the issuance date to the instrument's earliest possible redemption date using an appropriate method (typically, the effective interest method). ▶ Current Redemption Value Method — Recognize any redemption value changes immediately as they occur and adjust the carrying amount to equal the redemption value at each reporting period.
Instrument is not currently redeemable and not probable of becoming redeemable	No subsequent adjustment to the carrying amount is made (see Section 5.6.3).

An entity cannot subsequently reduce temporary equity to less than its initial carrying amount. In other words, reductions in the carrying amount of the redeemable equity instrument are appropriate only to the extent that the entity has previously recorded increases in the instrument's carrying amount.

Further, an entity cannot elect the fair value option on instruments in temporary equity because ASC 825-10-15 excludes instruments that are partly or entirely classified in equity.

BDO INSIGHTS — INSTRUMENTS WITH MULTIPLE REDEMPTION FEATURES

An instrument classified in temporary equity may include more than one redemption feature (with different redemption amounts), with some or all redemption features triggering subsequent measurement for the instrument. In that case, the entity must determine the appropriate measurement amount for each redemption feature that requires subsequent measurement under the temporary equity guidance and adjust the instrument's carrying amount based on the highest amount. We believe the following do not affect subsequent measurement of the redeemable instrument under the temporary equity guidance:

- Redemption features that are solely within the entity's control
- Redemption features that are not currently redeemable nor probable of becoming redeemable (for instance, because the redemption feature is based on an event not probable of occurring).

5.6.1 Instruments That Are Currently Redeemable

FASB REFERENCES

ASC 480-10-S99-3A(14) through S99-3A(15) and ASC 480-10-S99-3A(16)(e)

As discussed in Section 5.6, if an instrument classified in temporary equity is currently redeemable, an entity must adjust the instrument's carrying amount to its current redemption value (that is, the maximum redemption amount (see Section 5.6.1.1)) at the balance sheet date (except for financial instruments discussed in Section 5.6.4).

The amount presented in temporary equity cannot be less than the initial carrying amount (even if the maximum redemption amount is less than the instrument's initial carrying amount). In other words, reductions in the redeemable instrument's carrying amount are made only to the extent of previously recorded increases in it.

See Section 5.7 for special considerations for specific instruments.

DETERMINING WHETHER AN INSTRUMENT IS CURRENTLY REDEEMABLE

An instrument is currently redeemable when the holder can currently exercise a redemption feature (that is, the instrument's redemption is not subject to any unmet conditions other than the holder electing to redeem). For example, an instrument that is redeemable at issuance or at any time at the holder's option is currently redeemable. Further, we believe an instrument that an entity must redeem at any time upon the instrument holders' majority vote is in substance redeemable at the holder's option and is currently redeemable.

In contrast, an instrument with a redemption option that a holder can exercise only at a future date (for example, a preferred stock instrument redeemable five years after issuance) is not currently redeemable. However, that instrument is probable of becoming redeemable because redemption is based only on the passage of time.

A redemption option that a holder can exercise only upon meeting a specified condition (and the condition is not met at the balance sheet date) is also not currently redeemable. An entity must assess whether it is probable that the instrument will become redeemable (see Section 5.6.2). Determining whether an instrument is currently redeemable requires the use of professional judgment based on the facts and circumstances.

5.6.1.1 Instrument's Current Redemption Value

FASB REFERENCES

ASC 480-10-S99-3A(14)

An entity determines an instrument's current redemption value based on its maximum redemption amount as if redemption were to occur as of the balance sheet date. If the maximum redemption amount varies, it is computed based on the conditions existing as of the balance sheet date. For instance:

- If the redemption amount is contingent on an index or other similar variable — for example, the instrument's fair value or historical EBITDA — the entity determines the maximum redemption amount based on the value or measure as of the balance sheet date.
- If the entity must pay undeclared and unpaid dividends at the instrument's redemption or when the ultimate payment of dividends is not solely within the entity's control (such as dividends that must be paid out of future earnings), the entity must include those dividends in computing the maximum redemption amount.

5.6.2 Instruments That Are Not Currently Redeemable but Probable of Becoming Redeemable

FASB REFERENCES

ASC 450-20-20: Probable and ASC 480-10-S99-3A(15)

As discussed in Section 5.6, there are two methods for subsequent measurement when an equity instrument is not currently redeemable, but it is probable it will become redeemable. **Either** of the following methods is acceptable, but must be applied consistently:

- Accreted Value Method: Accrete the changes in the redemption value from the issuance date to the earliest possible redemption date using an appropriate methodology, which is typically the interest method. Any changes in the redemption value are accounted for as changes in accounting estimates.
- Current Redemption Value Method: Recognize changes in the redemption value immediately as they occur and adjust the instrument's carrying amount to equal the redemption value at the end of each reporting period (see Section 5.6.1.1). This method views the end of the reporting period as the instrument's redemption date.

See Section 5.7 for special considerations for specific instruments.

SUBSEQUENT MEASUREMENT USING THE ACCRETED VALUE METHOD

When an entity uses the accreted value method to subsequently measure temporary equity, adjustments to the instrument's carrying amount are made through periodic accretions of the difference between the instrument's initial carrying amount and its future redemption amount over the period from the issuance date (or the date the instrument becomes probable of becoming redeemable, if later) to the earliest redemption date. The computation of the future redemption amount includes undeclared or unpaid dividends that are payable upon redemption.

The entity computes the periodic accretion using an appropriate method, which is usually the effective interest method. The entity updates the accretion schedule if the earliest redemption date changes or when the future redemption amount varies, such as when the redemption amount is based on an index or other variable, for example, EBITDA (or the instrument's fair value). In that case, the future redemption amount is determined based on the most recent EBITDA measure (or the instrument's current fair value) as of the balance sheet date. When the redemption date or amount varies, measuring the instrument at its current redemption value (immediately recognizing the change in redemption value as it occurs), rather than at accreted value, is generally more practical.

Determining whether it is probable that an instrument will become redeemable is consistent with the assessment under ASC 450, which defines probable as "the future event or events are likely to occur."

An instrument that will become redeemable based solely on the passage of time (for example, a preferred stock instrument redeemable five years after issuance) is considered probable of becoming redeemable. In contrast, an instrument that will become redeemable only if specified conditions or events occur may or may not be probable of becoming redeemable based on the facts and circumstances. The entity must consider the instrument's contractual terms and the events triggering redemption in performing its analysis, including assessing whether any triggering events are probable to occur. The entity must perform its probability assessment every reporting period and when relevant events occur. If an instrument was probable of becoming redeemable and circumstances occur that cause it to no longer be probable of becoming redeemable, the entity must no longer adjust the instrument's carrying amount nor reverse previous measurement adjustments.

PROBABLE OF BECOMING REDEEMABLE VERSUS PROBABLE OF BEING REDEEMED

An entity must evaluate the probability an instrument will become redeemable. That assessment does not consider if the entity believes the redemption will occur. In other words, the assessment is not about whether it is probable that the instrument will be redeemed.

For example, an equity instrument that will become redeemable at the holder's option based solely on the passage of time is probable of becoming redeemable. Whether the holder will exercise the redemption option (that is, whether it is probable the instrument will be redeemed) is irrelevant to the analysis.

When a redeemable equity instrument has both a conversion and redemption feature that the holder can exercise, an entity must not consider the likelihood of which options may be exercised first, even if the features are mutually exclusive. The SEC staff addresses that scenario in the following speech.

SEC STAFF GUIDANCE

Remarks before the 2005 AICPA Conference on Current SEC and PCAOB Developments

Mark Northan, Professional Accounting Fellow, Office of the Chief Accountant

December 5, 2005

Redeemable Equity Securities

> *The question that I will address today concerns preferred securities that include multiple mutually exclusive options that are exercisable by the holder. In one example, the first option is a conversion option that is currently exercisable. This option gives the holder the right to convert the security into a fixed number of common shares. The second option, which is not currently exercisable, is a redemption option that gives the holder the right to redeem the shares for cash. The second option would become exercisable following the passage of a specified period of time.*

*****

> *When applying this guidance to a security with both a conversion option and a redemption option like the one described earlier, some have argued that it is not probable that the security will become currently redeemable because of the likelihood that the holder will exercise the conversion option first. We have objected to this view because the exercise of the conversion option was controlled entirely by the holder. Absent that action by the holder, the security will become redeemable following only the passage of time. The probability assessment that is required by [ASC 480-10-S99-3A] would not factor in the likelihood that other options held by the holder may or may not be exercised first. Thus, the instrument that I have described would be considered to be probable of becoming currently redeemable regardless of the likelihood of earlier conversion. As a result, the changes in the redemption values for this instrument would be recognized over the period from the date of issuance to the earliest possible redemption date using either of the two methods specified in [ASC 480-10-S99-3A].*

BDO INSIGHTS — ASSESSING THE PROBABILITY OF DEEMED LIQUIDATION EVENTS

Many instruments subject to the temporary equity guidance include deemed liquidation clauses requiring an entity to redeem the instrument when a deemed liquidation event (such as change in control, merger, or sale of substantially all the entity's assets) occurs. Because consummating the transaction involves significant uncertainties (for example, the involvement of a willing third party, regulatory approval, and substantive terms and conditions to closing), we believe it is acceptable to conclude that a deemed liquidation event is not probable until it occurs (regardless of whether the instrument holders control the entity's board). In that case, an entity does not adjust the temporary equity's carrying amount because the instrument is not probable of becoming redeemable.

Determining the probability of redemption events requires the application of professional judgment based on the facts and circumstances.

5.6.3 Instruments That Are Not Currently Redeemable and Not Probable of Becoming Redeemable

FASB REFERENCES

ASC 480-10-S99-3A(15) and ASC 480-10-S99-3A(24)(c)

An entity does not adjust the carrying amount of a redeemable equity instrument classified in temporary equity if the instrument is not currently redeemable and not probable of becoming redeemable. The entity must disclose why it is not probable the instrument will become redeemable (see Section 8.4.6.4). The instrument's carrying amount is adjusted if circumstances change and the instrument becomes currently redeemable (see Section 5.6.1) or probable of becoming redeemable (see Section 5.6.2).

5.6.4 Subsequent Measurement for Specific Instruments

FASB REFERENCES

ASC 480-10-S99-3A(13) and ASC 480-10-S99-3A(16)(a) through S99-3A(16)(e)

The table summarizes the required measurement for specific financial instruments that are classified in temporary equity and are either currently redeemable or probable of becoming redeemable.

EQUITY INSTRUMENT	SUBSEQUENT MEASUREMENT IS BASED ON	GUIDANCE
NCI	A two-step method: ▶ Step 1: Apply the guidance in ASC 810-10 on attribution of net income or loss of the subsidiary. ▶ Step 2: Apply the guidance in ASC 480-10-S99-3A (see Section 5.6). Reductions in the carrying amount of those redeemable equity instrument under Step 2 are appropriate only to the extent that the entity has previously recorded increases under Step 2 in their carrying amount.	Section 5.7.1

EQUITY INSTRUMENT	SUBSEQUENT MEASUREMENT IS BASED ON	GUIDANCE
Share-based payment arrangements with employees	The award's redemption amount, adjusted for the proportional employee service received to date	Section 5.7.2
Securities held by ESOPs	Generally, the maximum cash obligation. However, if the cash redemption obligation relates only to a market value guarantee, either of the following: ▶ The entity's maximum cash obligation based on the equity securities' fair value at the balance sheet date ▶ The entire guaranteed market value of the equity securities.	Section 5.7.3
Equity-classified component of convertible debt instruments that are **currently redeemable** (or currently convertible for cash or other assets)	At the balance sheet date, the excess of: ▶ The redemption or conversion payable at the balance sheet date over ▶ The liability component's carrying amount.	Section 5.7.4

ASC 480-10-S99-3A does not explicitly address how to measure a host contract that is classified in temporary equity, is currently redeemable or probable of becoming redeemable, and has a bifurcated derivative (see BDO Insights in Section 5.7.5).

5.7 SPECIAL CONSIDERATIONS FOR SPECIFIC INSTRUMENTS

The SEC's temporary equity guidance provides special considerations for the initial and subsequent measurement for specific instruments discussed in this section. This section also discusses the SEC staff's view on increasing-rate preferred stock and redeemable shares issued by SPACs.

5.7.1 Noncontrolling Interest

FASB REFERENCES

ASC 480-10-S99-3A(12)(c), ASC 480-10-S99-3A(16)(c), ASC 480-10-S99-3A(16)(e), and ASC 480-10-S99-3A(22)

An entity recognizes the NCI's initial carrying amount in accordance with applicable U.S. GAAP (typically ASC 805 or ASC 810).

At each balance sheet date, an entity remeasures redeemable NCI using a two-step method:

- Step 1: The entity applies the measurement guidance in ASC 810-10, allocating a portion of the subsidiary's net income or loss to the NCI.
- Step 2: If needed, the entity adjusts the carrying amount of redeemable NCI to the higher of:
  - The carrying amount as determined in Step 1
  - The redemption value as determined in accordance with ASC 480-10—S99-3(A) (see Section 5.6).

The entity must not make the additional adjustments in Step 2 if it would reduce the NCI's carrying amount below its initial carrying amount. In other words, reductions in the carrying amount of redeemable NCI from the application of the guidance in Section 5.6 are appropriate only to the extent that the entity has previously recorded increases in the carrying amount of redeemable NCI under that guidance.

Adjustments to a redeemable NCI's carrying amount in Step 2 are akin to repurchasing an NCI but may be recognized in retained earnings instead of APIC. They do not affect the entity's consolidated net income or comprehensive income. See Sections 5.8.3 and 5.8.4 for the effect of those adjustments on EPS.

5.7.1.1 Deconsolidation of a Subsidiary

FASB REFERENCES

ASC 480-10-S99-3A(19)

When a parent deconsolidates a subsidiary with a redeemable NCI, it reverses any previous temporary equity adjustments to the NCI's carrying amount (see Section 5.7.1) against its equity because those adjustments do not initially affect net income. The parent computes the deconsolidation gains or losses under ASC 810 using the carrying amount of the NCI after eliminating the NCI's previous temporary equity measurement adjustments.

5.7.2 Share-Based Payment Arrangements

FASB REFERENCES

ASC 480-10-S99-3A(12)(a), ASC 480-10-S99-3A(16)(a), and ASC 718-10-S99-1

An entity initially recognizes a share-based payment arrangement that is classified in temporary equity at its redemption amount, adjusted for the proportional employee service received at the award's initial recognition. For example, an entity that grants a fully vested share-based payment award that the employee can put back to the entity at intrinsic value upon a change in control must initially account for the award's entire intrinsic value in temporary equity.

Then, an entity remeasures temporary equity based on the redemption amount, proportionately adjusted for the service the employee has rendered to date. In determining the proportion of employee service rendered to date, the entity must consider the guidance in ASC 718. The entity recognizes any difference between the ASC 718 expense and the temporary equity measurement adjustment in APIC.

5.7.3 Employee Stock Ownership Plans

FASB REFERENCES

ASC 480-10-S99-3A(3), ASC 480-10-S99-3A(12)(b), ASC 480-10-S99-3A(16)(b), and ASC 480-10-S99-4

The temporary equity guidance applies to equity securities held by ESOPs — whether or not allocated — if they include terms that require the entity (the sponsor) to redeem the equity securities for cash or other assets at the holder's option or upon events not solely within the entity's control (regardless of their probability of occurrence). An entity must reflect the maximum cash obligation for those redeemable securities in temporary equity.

If an ESOP's cash redemption obligation relates only to a market value guarantee feature, an entity may elect one of two methods in determining the amount recognized in temporary equity:

- Recognize the entity's maximum cash obligation based on the underlying equity securities' fair value as of the balance sheet date (that is, the excess of guaranteed value over the equity securities' market value) in temporary equity. That will require reclassification of amounts between permanent and temporary equity based on the equity securities' fair value.

- Recognize the equity securities' entire guaranteed market value in temporary equity because the ultimate cash obligation is uncertain because of the equity securities' possible market value decline.

Those methods are applicable for both initial and subsequent measurement and must be applied consistently.

5.7.4 Convertible Instruments That Contain a Separately Classified Equity Component

FASB REFERENCES

ASC 480-10-S99-3A(12)(d), ASC 480-10-S99-3A(16)(d), and ASC 480-10-S99-3A(23)

As discussed in Section 5.2.2.6, an entity classifies a convertible debt's equity component in temporary equity only if the debt is **currently redeemable** (or **currently convertible** for cash or other assets). In determining the equity component's classification (temporary or permanent equity), the entity does not assess whether it will become redeemable (or convertible for cash or other assets) in the future.

For initial and subsequent measurement, the equity component that the entity recognizes in temporary equity is equal to:

- The cash or amount of other assets payable to the holder upon the debt's redemption or conversion at the issuance date (for initial recognition) or at the balance sheet date (for subsequent measurement) less
- The liability component's current carrying amount.

For example, an entity recognizes $25 in temporary equity for a convertible debt's equity-classified component if the convertible debt is currently redeemable at $100 and has a liability component of $75.

The subsequent measurement discussed above for a convertible debt's equity-classified component does not have an incremental effect on EPS. Rather, an entity applies ASC 260 for the effect of the convertible debt on EPS.

5.7.5 Hybrid Equity Instrument With Bifurcated Derivative

FASB REFERENCES

ASC 480-10-S99-3A(12)(e) and ASC 815-15-30-2

For hybrid instruments with a bifurcated embedded derivative, an entity evaluates the entire instrument's terms and features, including the separated embedded feature, to determine whether the temporary equity guidance applies to the equity host contract (see Section 5.2.2.3).

If the temporary equity guidance applies, the difference between the proceeds allocated to the hybrid instrument and the fair value of the bifurcated embedded derivative is recognized in temporary equity as the host contract's initial carrying amount (see Section 3.7.1.2).

BDO INSIGHTS — MEASURING A REDEEMABLE EQUITY INSTRUMENT WITH A BIFURCATED DERIVATIVE

ASC 480-10-S99-3A does not explicitly address how a host contract classified in temporary equity that is currently redeemable or probable of becoming redeemable and has a bifurcated derivative must be subsequently measured.

We believe one acceptable approach is to adjust the host instrument to an amount that equals the redemption amount of the hybrid instrument less the fair value of the bifurcated derivative. For example, if the redemption amount of a currently redeemable hybrid equity instrument increases from $110 to $125, and a bifurcated redemption feature has a fair value of $10 at the balance sheet date, the host instrument would be adjusted from its prior carrying amount to $115 ($125 - $10). Other approaches may also be acceptable. Regardless of the approach used, the amount presented in temporary equity cannot be less than the instrument's initial carrying amount (see Section 5.6).

Reaching a conclusion about the appropriate subsequent measurement approach requires the application of professional judgment based on the facts and circumstances.

5.7.6 Increasing-Rate Preferred Stock

FASB REFERENCES

ASC 480-10-S99-3A(15)

As discussed in Section 5.6.2, an entity must choose between two methods of measuring adjustments to redeemable preferred stock that is not currently redeemable but is probable of becoming redeemable. However, the entity must use the effective yield method if the instrument is an increasing-rate preferred stock that is also subject to ASC 505-10-S99-7 (the Staff Accounting Bulletin (SAB) Topic 5.Q, *Increasing Rate Preferred Stock*). Under that guidance, immediately recognizing the discount between the instrument's issuance price and liquidation preference is not appropriate (see Section 6.3.3.3).

5.7.7 Redeemable Common Stock Issued by Special Purpose Acquisition Companies

FASB REFERENCES

ASC 480-10-S99-3A(15)

In its IPO, a SPAC typically issues to investors units consisting of a redeemable common stock (public common share) and a public warrant (or fraction thereof) for common stock (public warrant). The SPAC's governance requires the SPAC to place the IPO proceeds in a trust account. The common stock is typically redeemable at a fixed price (typically, $10 a share), adjusted for the trust account's interest income and specific expenses.

The SPAC's redeemable common stock generally does not meet the criteria for liability classification under ASC 480. Typically, the redemption provisions provide that:

- If the SPAC is unable to consummate a transaction by a specified date (typically within 18-24 months from the IPO), the SPAC dissolves and must redeem the public common shares.
- If the SPAC consummates a business combination, the holder has the right to require it to redeem the public common shares. However, the SPAC's governing documents often restrict the SPAC from redeeming the public common shares if it causes the SPAC's minimum net tangible assets to be less than $5 million.

As such, the shares will either be redeemed on a specific date or will be redeemable at the holder's option if a business combination occurs, thereby requiring temporary equity classification for the SPAC's redeemable common shares. Further, each public common share is equally subject to redemption, so all redeemable common shares must be classified in temporary equity, irrespective of limits in the entity's charter or other governance documents (consistent with an SEC staff comment made at the 2021 AICPA and CIMA Conference on Current SEC and PCAOB Developments). The redeemable common shares are probable of becoming redeemable because they will become redeemable by a specified date.

The SPAC must allocate the IPO proceeds between the public common shares and public warrants and initially recognize the redeemable public common shares at their allocated amount. As discussed in Section 5.6.2, there are two acceptable methods to subsequently measure instruments classified in temporary equity and that are probable of becoming redeemable:

- Remeasuring the instrument based on its accreted value: The SPAC computes periodic accretions that adjust the initial carrying amount to the redemption value from the issuance date to the earliest redemption date. Therefore, the SPAC must estimate the date the business combination is expected to occur when using this method.
- Remeasuring the instrument at its current redemption value (typically, $10 a share, adjusted for the trust's interest income and specific expenses). This method views the end of the reporting period as the instrument's redemption date.

The SPAC must also apply ASC 480-10-S99-3A(21) in accounting for the redeemable common stock's measurement adjustments and in computing EPS (see Section 5.8.2).

5.8 EPS CONSIDERATIONS

Adjustments to the carrying amount of equity instruments classified in temporary equity affect EPS except for adjustments to the carrying amount of share-based payment arrangements (see Section 5.7.2), equity securities held by ESOPs (see Section 5.7.3), and the equity component of convertible debt (see Section 5.7.4).

5.8.1 Redeemable Preferred Stock

FASB REFERENCES

ASC 480-10-S99-3A(20)

As discussed in Sections 5.6, an entity must subsequently adjust the carrying amount of temporary equity that is currently redeemable or probable of becoming redeemable. For redeemable preferred stock or any redeemable instrument other than common stock (issued by a parent or single reporting entity) that is classified in temporary equity, increases (or decreases) to the carrying amount are typically referred to as "deemed dividends." Those items must be treated in the same manner as dividends on nonredeemable stock as both:

- Charges against retained earnings or APIC (in the absence of retained earnings)
- Adjustments to income available to common stockholders in computing EPS.

BDO INSIGHTS — RECOGNIZING DEEMED DIVIDENDS WHEN AN ENTITY HAS AN ACCUMULATED DEFICIT

An entity recognizes deemed dividends as charges against APIC when it has an accumulated deficit. Once APIC is exhausted (that is, zero), we believe the entity may recognize deemed dividends as charges against accumulated deficit. Regardless of how the deemed dividend is recognized, the entity must include it as an adjustment to income available to common stockholders in computing EPS.

Determining the appropriate treatment for deemed dividends requires the application of professional judgment based on the facts and circumstances, including applicable state laws and the entity's corporate charter, bylaws, and other governing documents.

Amendments to, or exchanges of, preferred stock can cause either its modification or extinguishment and may also result in recognizing deemed dividends (see Section 6.3.3.5).

Further, the accounting for derecognition of preferred stock depends on how it is settled (for example, redeemed or converted), which may also result in recognizing deemed dividends (see Section 6.3.3.6).

5.8.2 Redeemable Common Stock

FASB REFERENCES

ASC 480-10-S99-3A(21)

For redeemable common stock (issued by a parent or single reporting entity), temporary equity adjustments to the stock's carrying amount (see Sections 5.6.1 and 5.6.2) are accounted for as charges against retained earnings (or APIC in the absence of retained earnings); like dividends on nonredeemable stock. However, they do not affect income available to common stockholders in computing EPS. Instead, the entity must consider whether the EPS two-class method discussed in ASC 260-10-45-60B applies.

In computing EPS, an entity uses the two-class method if it has multiple classes of common stock and, without prior or senior rights, at least one class has a dividend rate (or distribution right) different from that of another class of common stock. When a class of common stock is redeemable at other than its fair value, in substance, that class of common stock is entitled to receive a distribution different from other classes of common stock, and the entity must use the two-class method in computing EPS. Conversely, if common stock is redeemable at fair value, it does not result in a distribution different from other classes of common stock, so the two-class method does not apply. If common stock is redeemable at a specified formula designed to equal or reasonably approximate fair value, it is considered to be redeemable at fair value. However, a formula based solely on a fixed multiple of earnings (or other similar measure) is not considered to be designed to equal or reasonably approximate fair value.

The graphic summarizes how the temporary equity adjustments to the redeemable common stock's carrying amount affect EPS.

If the common stock is redeemable at other than fair value…	…the two-class method applies. That includes redemption at a fixed price or a formula price not directly related to the common stock's fair value (for example, a fixed multiple of earnings or EBITDA).
If common stock is redeemable at fair value…	…the two-class method does not apply (adjustments to the carrying amount do not affect EPS). That includes redemption at a formula price based on the common stock's average trading price over a reasonable short period immediately before the redemption.

See ASC 260-10-45-59 through 45-70 for more guidance on EPS and the two-class method. When the two-class method applies, an entity may include the temporary equity measurement adjustments in the EPS computation using one of two methods:

- Treat the entire periodic adjustment like a dividend.
- Treat only the portion of the periodic adjustment that reflects a redemption in excess of fair value like a dividend.

Under either approach, decreases in the common stock's carrying amount affect EPS only if they represent recoveries of amounts previously reflected in the entity's EPS.

5.8.3 Noncontrolling Interest in the Form of Preferred Stock

FASB REFERENCES

ASC 480-10-S99-3A(22)(a)

If the NCI is in the form of preferred stock, the temporary equity adjustments to the NCI's carrying amount (discussed in Step 2 in Section 5.7.1) affect EPS based on who issued the redemption feature or whether the parent guarantees the instrument's redemption.

- If the parent issued the redemption feature (or guarantees the instrument's redemption), the entire adjustment reduces or increases income available to the parent's common stockholders.
- If the subsidiary issued the redemption feature and the parent does not guarantee the instrument's redemption, the adjustment is allocated between the parent and the NCI, as illustrated in ASC 260-10-55-64 through 55-67.

5.8.4 Noncontrolling Interest in the Form of Common Stock

FASB REFERENCES

ASC 480-10-S99-3A(21) and ASC 480-10-S99-3A(22)(b)

The temporary equity measurement adjustments (discussed in Step 2 in Section 5.7.1) of NCI in the form of common stock may affect EPS depending on whether the NCI's potential redemption is at fair value or other than fair value.

If the NCI's potential redemption is at fair value, the temporary equity adjustments to the NCI's carrying amount do not affect EPS.

In contrast, if the NCI's potential redemption is at other than fair value, the temporary equity measurement adjustments affect how an entity computes EPS.

BDO INSIGHTS — TREATMENT OF NON-FAIR-VALUE REDEMPTION FEATURE IN COMPUTING EPS

When the NCI's potential redemption is at other than fair value, we believe that consistent with footnote 17 of ASC 480-10-S99-3A(21), an entity may choose one of two methods in computing EPS, which it must apply consistently:

- Treat the entire temporary equity adjustment to the NCI's carrying amount like a dividend.
- Treat only the portion of the temporary equity adjustment to the NCI's carrying amount that reflects a redemption in excess of fair value like a dividend.

Under either approach, decreases in the NCI's carrying amount (because of temporary equity measurement adjustments) affect EPS only if they represent recoveries of amounts previously reflected in the entity's EPS.

Further, ASC 810-10 does not have detailed guidance on attribution of net income to the parent and NCI. When NCI is redeemable at other than fair value, some entities consider the redemption feature's terms in the determination of net income attributable to the parent (that is, as reported on the face of the income statement), while others consider the redemption feature's impact in the calculation of income available to common stockholders of the parent (that is, the control number for EPS purposes).

Accordingly, an entity's EPS treatment of NCI redeemable at other than fair value depends on its policy.

If the redemption feature's terms are fully considered in the attribution of net income under ASC 810-10…	…the two-class method is not necessary.
If the redemption feature's terms are not fully considered in the attribution of income under ASC 810-10…	…the entity applies the two-class method at the subsidiary level to determine net income available to the parent's common stockholders.

5.9 RECLASSIFICATION

FASB REFERENCES

ASC 480-10-S99-3A(18)

An entity must reclassify a redeemable instrument from temporary equity to permanent equity at its carrying amount on the date the instrument ceases to qualify as temporary equity (for example, the date a redemption feature lapses or the entity modifies the instrument's terms). If the instrument is being subsequently measured (see Sections 5.6 and 5.6.4), the entity must remeasure the instrument immediately before the reclassification. The change is prospective; the entity cannot reverse any previous adjustments made to the carrying amount. Further, the entity cannot adjust previous financial statements for the change in classification.

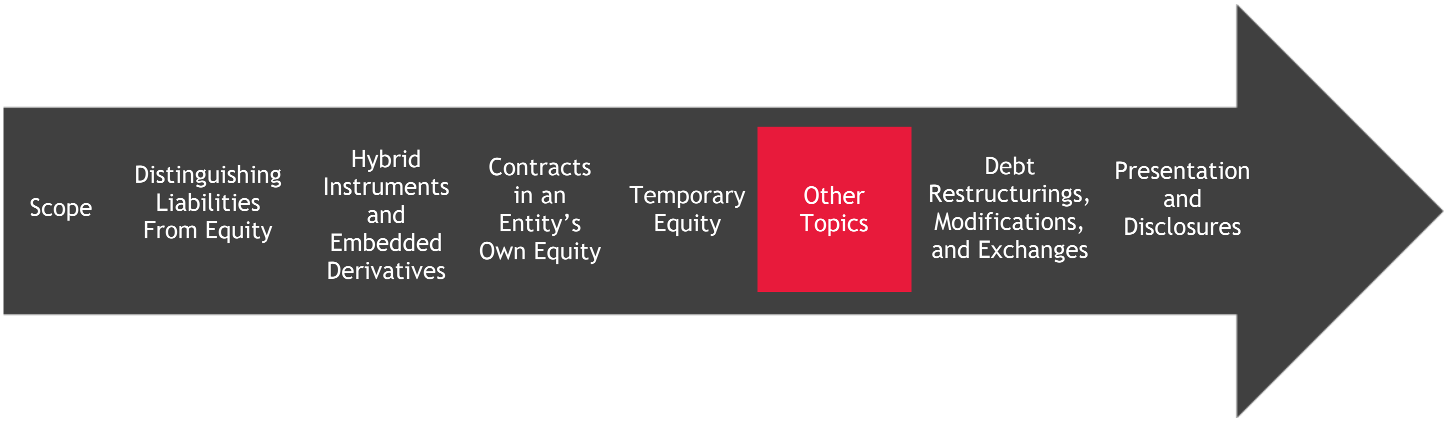
BDO INSIGHTS — RECLASSIFICATION FROM PERMANENT TO TEMPORARY EQUITY

ASC 480-10-S99-3A does not explicitly address how to account for reclassifications from permanent to temporary equity.

By analogy to ASC 815-40-35-9, we believe an entity may initially recognize the instrument in temporary equity at fair value on the reclassification date unless an exception applies (see Section 5.5.1), with the adjustment (the difference between the instrument's fair value and previous carrying amount) charged to APIC (or retained earnings if the entity does not have APIC).

See Section 6.3.3.5 for reclassifications of preferred stock caused by modifications to its terms.

Chapter 6 — Other Topics



6.1 OVERVIEW

Entities commonly raise capital to finance their operations and strategic activities (such as acquisitions) through debt and equity offerings. Debt and equity instruments may include terms, such as conversion, redemption, and interest or dividend features that can add complexity to the accounting.

Generally, an entity must first evaluate whether a financial instrument is subject to ASC 480 (see Chapter 2). The entity must also determine whether the instrument includes embedded derivatives that must be bifurcated (see Chapter 3), including evaluating the embedded derivatives for the derivative scope exception for contracts in an entity's own equity in ASC 815-10-15-74(a) (see Chapter 4).

If the instrument is not accounted for at fair value and is not subject to ASC 480, the entity accounts for the entire instrument (if no embedded derivatives require bifurcation) or the host contract (if embedded derivatives require bifurcation) under other U.S. GAAP (such as ASC 470 and ASC 505). The entity may also elect the fair value option for eligible instruments. This chapter discusses the accounting for specific debt and equity instruments and related transactions.

Also, a public entity (or a private entity that elects to apply the SEC temporary equity guidance) must consider whether redeemable equity instruments must be classified as temporary equity under ASC 480-10-S99-3 (see Chapter 5).

6.2 DEBT

FASB REFERENCES

ASC 470-20-20: Convertible Security and ASC 470-50-20: Line-of-Credit Arrangement

Although not defined in U.S. GAAP, the term "debt" generally refers to a contractual obligation to pay cash or other assets on a specified date for amounts borrowed, and it may or may not have a stated interest rate. An entity generally recognizes debt at its issuance date at an amount equal to the proceeds less the amount allocated to other instruments or to other elements of the transaction (see Section 6.2.1). The difference between the debt's initial carrying amount and the amount repayable at maturity results in a debt discount or premium that is amortized in accordance with ASC 835-30 (see Section 6.2.2.1) along with capitalized debt issuance costs (see Section 6.2.5). However, if an entity elects the fair value option, it initially and subsequently measures the debt at fair value and recognizes any upfront costs and fees immediately in earnings (see Sections 6.2.1.6 and 6.2.2.2).

Debt takes many different forms, such as term debt, line-of-credit arrangements, convertible debt, and share-settled debt. It can include senior or subordinated rights to an entity's assets in a liquidation. Senior debt has the highest priority and must be repaid before subordinated debt; however, debt of any type generally has a higher liquidation preference than equity. A debt instrument may also include PIK interest feature that either requires or allows interest payments to be settled by adding the accrued interest to the loan balance or issuing additional debt instruments with the same terms as the original instrument (see Section 6.2.6).

In practice, term debt generally refers to a nonconvertible loan, which may require either repayment at the maturity date or amortizing payments, such as monthly, quarterly, or annually, sometimes with a balloon payment at maturity. The total repayment amount is generally the amount initially borrowed plus interest, except when the debt includes a discount or premium. The debt instrument may also include embedded features that must be evaluated in accordance with ASC 815-15 for potential bifurcation as derivatives (see Chapter 3).

A line-of-credit arrangement (also known as a revolver) allows an entity to make multiple borrowings up to a specified amount, repay portions of previous borrowings, and then reborrow under the same credit agreement. The arrangement includes a debt instrument (the drawn amount) and the creditor's commitment to make additional funds available up to the specified amount under predefined terms (a loan commitment) (see Section 6.2.5.1).

Some debt instruments contain embedded conversion features that allow or require the holder to convert the debt into shares of the entity's stock at a specified rate. The conversion may be at the option of the holder or automatic on a specific date or upon the occurrence or nonoccurrence of a contingent event (see Section 6.2.4).

Other debt instruments may or must be settled with a variable number of shares (rather than a fixed number of shares) based on a fixed monetary amount. In those cases, the entity evaluates the instrument under ASC 480 (see Section 2.6.3.1).

Debt is also often issued with other instruments, such as warrants (see Section 6.2.1.3). In some cases, the debt arrangement requires the entity to issue warrants whenever debt is drawn (see Section 6.2.1.3.1).

In addition, U.S. GAAP includes guidance for specific debt instruments:

- Sales of future revenues (see Section 6.2.7.1)
- Indexed debt (see Section 6.2.7.2)
- Increasing-rate debt (see Section 6.2.7.3).

An entity derecognizes debt only if it has been extinguished (see Section 6.2.3).

6.2.1 Initial Measurement of Debt

FASB REFERENCES

ASC 835-30-10-1 and ASC 835-30-15-2 through 15-3

Debt instruments are most often issued in exchange for cash (see Section 6.2.1.1); however, debt may sometimes be issued in exchange for property, goods, or services (see Section 6.2.1.2). An entity generally recognizes debt when it is issued (at the transaction closing date) at an amount equal to the proceeds (for example, cash or fair value of consideration received) less the amount allocated to other instruments or other elements of the transaction (such as bifurcated features of the debt). The difference between the debt's initial carrying amount and the amount repayable at maturity results in a debt discount or premium that is accounted for in accordance with ASC 835-30 (see Section 6.2.2.1).

ASC 835-30 SCOPE EXCEPTION FROM IMPUTATION OF INTEREST

ASC 835-30 requires entities to impute interest for a debt instrument issued in exchange for property, goods, or services (or if debt issued in exchange for cash includes other rights and privileges) to approximate the prevailing rate of interest to maturity. That guidance applies to any receivables and payables that represent contractual rights

ASC 835-30 SCOPE EXCEPTION FROM IMPUTATION OF INTEREST

to receive money or contractual obligations to pay money on fixed or determinable dates, regardless of whether they include stated interest. However, it does **not** apply to:

- Payables from transactions with suppliers in the normal course of business that are due in customary trade terms not exceeding approximately one year
- Amounts that do not require repayment in the future but rather will be applied to the purchase price of the property, goods, or service involved (for example, deposits or progress payments on construction contracts, advance payments for acquisition of resources and raw materials, and advances to encourage exploration in the extractive industries (see ASC 932-835-25-2))
- Amounts intended to provide security for one party to an agreement (for example, security deposits and retainages on contracts)
- Customary cash-lending activities and demand or savings deposit activities of financial institutions whose primary business is lending money
- Transactions in which interest rates are affected by the tax attributes or legal restrictions prescribed by a governmental agency (for example, industrial revenue bonds, tax exempt obligations, government guaranteed obligations, and income tax settlements)
- Transactions between parent and subsidiaries and between subsidiaries of a common parent
- The application of the present value measurement (valuation) technique to estimates of contractual or other obligations assumed in connection with sales of property, goods, or service (for example, a warranty for product performance)
- Receivables, contract assets, and contract liabilities in contracts with customers (see ASC 606-10-32-15 through 32-20 for guidance on identifying a significant financing component in a contract with a customer).

However, if an entity elects the fair value option for the debt instrument, it initially and subsequently measures the debt at fair value and recognizes any upfront costs and fees in earnings (see Sections 6.2.1.6 and 6.2.2.2).

6.2.1.1 Debt Exchanged for Cash or for Cash and Rights or Privileges

FASB REFERENCES

ASC 835-30-25-4 through 25-6 and ASC 835-30-55-4 through 55-6

Debt is often issued for cash equal to its face amount less lender fees (the net cash proceeds). If an entity issues debt for cash and no other rights or privileges are exchanged, the debt instrument is presumed to have a present value equal to the net cash proceeds the entity received. The entity determines the effective interest rate by equating the initial carrying amount of the debt to the debt's contractual cash flows.

In some cases, the debt's face or principal amount differs from the net cash proceeds, such as when the stated rate differs from the market interest rate at issuance. The difference between the debt's face amount and the net cash proceeds upon issuance results in either a debt discount or premium. The entity amortizes the debt discount or premium over the debt's term in accordance with ASC 835-30 (see Section 6.2.2.1). For example, the net proceeds from the issuance of a long-term zero-coupon note are ordinarily less than its face amount and the note's stated interest rate (0%) differs from its effective interest rate. In that case, the difference between the face amount and net proceeds is recognized as a debt discount, which is amortized over the note's term.

The debt's total interest cost during its term is measured by the difference between its initial carrying amount and the total amount the entity agrees to repay the lender.

EXAMPLE 6-1 (ADAPTED FROM ASC 835-30-55-4 THROUGH 55-5): ILLUSTRATION OF PRESENT VALUE CONCEPTS

FACTS

Entity A issues a 20-year bond of $1,000 with a stated interest rate of 10% in exchange for cash. There are no unstated (or stated) rights or privileges issued with the bond. The table illustrates how the market rate typically affects the bond proceeds and the determination of the bond's present value under different scenarios.

	10% MARKET RATE	12% MARKET RATE	8% MARKET RATE
Present value of annual interest of $100 (10% coupon X $1,000) for 20 years	$ 851	$ 747	$ 982
Present value of principal of $1,000 at the end of Year 20	149	104	215
Present value and proceeds at issuance date	$ 1,000	$ 851	$ 1,197

CONCLUSION AND ANALYSIS

Upon issuance, Entity A recognizes the bond at the proceeds received, which is the present value of the future coupon interest payments plus the present value of the future principal payments.

When the market rate is 10% and the coupon rate is also 10%, the bond would ordinarily be issued for proceeds of $1,000. Entity A recognizes the $1,000 proceeds from the bond, which also represents the amount repayable at maturity. However, if Entity A issues the same bond when the market rate is greater or less than 10%, the proceeds would ordinarily be different than the face amount of $1,000, creating a discount ($149 assuming a 12% market rate) or premium ($197 assuming an 8% market rate).

EXAMPLE 6-2 (ADAPTED FROM ASC 835-30-55-4 THROUGH 55-6): PRESENT VALUE OF A ZERO-COUPON BOND ISSUED FOR CASH

FACTS

Entity A issues a 20-year noninterest-bearing bond of $1,000 in exchange for cash when the prevailing market rate for comparable credit risk is 10%. There are no unstated (or stated) rights or privileges issued with the bond. The table illustrates how the market rate typically affects the proceeds and the determination of the present value for a noninterest-bearing bond.

	10% MARKET RATE
Present value of no annual interest payments	$ —
Present value of principal of $1,000 at the end of Year 20	149
Present value and proceeds at issuance date	$ 149

CONCLUSION AND ANALYSIS

Upon issuance, Entity A recognizes the bond at the proceeds received, which is the present value of the future coupon interest payments ($0) plus the present value of the future principal payments.

When the market rate is 10% and the coupon rate is 0%, the bond would ordinarily be issued for proceeds of $149. Entity A recognizes the difference between the proceeds ($149) and face amount ($1,000) as a debt discount.

DEBT ISSUED FOR CASH AND UNSTATED (OR STATED) RIGHTS OR PRIVILEGES EXIST

Debt issued for cash equal to its face amount is presumed to earn the stated interest rate of that instrument. However, the instrument's stated interest rate differs from its effective interest rate if the parties also exchanged unstated (or stated) rights or privileges that must be recognized.

If an entity issues debt interest free or with a below-market interest rate in exchange for cash, it must determine whether the transaction includes other elements that must be recognized. However, the requirement to impute interest does not always apply (see Section 6.2.1).

6.2.1.2 Debt Exchanged for Property, Goods, or Services

FASB REFERENCES

ASC 835-30-05-2 and ASC 835-30-25-7 through 25-11

When debt is issued in exchange for property, goods, or services, the entity recognizes the debt at the present value of the consideration exchanged by the parties on the transaction date, similar to a cash transaction. Debt issued in exchange for property, goods, or services represents two elements (which may or may not be stipulated in the agreement):

- The principal, which is equal to the bargained exchange price of the property, goods, or services established by the contracting parties
- The interest, which compensates the supplier over the life of the debt for the use of funds that would have been received in a cash transaction at the time of the exchange.

The difference between the debt's face amount and present value at issuance creates a discount or premium, which the entity amortizes over the life of the debt in accordance with ASC 835-30 (see Section 6.2.2.1).

THE GENERAL PRESUMPTION AND CIRCUMSTANCES WHEN IT DOES NOT APPLY

When debt is exchanged for property, goods, or services in a bargained transaction entered at arm's length, there is a general presumption that the interest rate stipulated by the parties represents fair and adequate compensation to the supplier for the use of the related funds. However, that presumption must not cause the transaction's form to prevail over its economic substance. Therefore, the general presumption does not apply in **any** of the following circumstances:

- Interest is not stated.
- The stated interest rate is unreasonable.
- The stated face amount of the debt is materially different from the current cash sales price for the same or similar items or from the debt's fair value at the transaction date.

In those circumstances, the debt (and the cost of the property, goods, or services) must be recognized based on whichever is more clearly determinable between the following two amounts:

- The fair value of the property, goods, or services received
- An amount that reasonably approximates the debt's fair value.

If there are no established exchange prices for the property, goods, or services or the fair value of debt, the entity must determine the debt's present value by discounting all future payments using an imputed rate of interest at the time the debt is issued, assumed, or acquired; any subsequent changes in prevailing interest rates are ignored (see Section 6.2.1.2.1).

The difference between the debt's face amount and its initially recorded amount results in a debt discount or premium, which the entity amortizes over the life of the debt in accordance with ASC 835-30 (see Section 6.2.2.1). However, the requirement to impute interest does not always apply (see Section 6.2.1).

6.2.1.2.1 Determining Present Value and Imputed Interest Rate

FASB REFERENCES

ASC 835-30-10-1, ASC 835-30-25-2 through 25-3, and ASC 835-30-25-12 through 25-13

The methods of establishing the debt's present value that use the following information are preferable:

- If determinable, the established exchange price (which presumably is the same as the cash sales price) of property, goods, or services acquired or sold in consideration for the debt
- When the debt is traded in an open market, the market rate of interest and quoted prices of the debt.

When there is no established exchange price or the debt has no ready market, the entity must estimate the debt's present value using an interest rate that approximates prevailing interest rates, which might not be the same as the stated or coupon rate. The process is known as imputation of interest. Failure to recognize a small difference between the stated rate and an interest rate that approximates the prevailing rate can have a material effect if the debt is long term or has a large principal.

The objective of interest imputation is to approximate an interest rate for a debt as if two independent parties negotiated a similar transaction with comparable terms and conditions with the option to either pay the cash price or issue a note with the prevailing market interest rate to maturity. There is no specific interest rate that applies in all circumstances. However, an entity must consider the following guidelines:

- The entity's credit standing; the restrictive covenants, collateral, payments, and other debt terms; and, if appropriate, the tax consequences to the buyer and seller may affect the choice of rate.
- The prevailing rates for similar instruments issued by entities with similar credit ratings will normally help determine the appropriate interest rate for determining the debt's present value.
- In any event, the rate used for present value purposes must be the rate the entity can obtain for similar financing from other sources on the transaction date.

Further, the choice of a rate may be influenced by:

- An approximation of the prevailing market rates for the source of credit that provides a market for sale or assignment of the debt
- The prime or higher rate for notes that are discounted with banks (giving due weight to the maker's credit standing)
- Published market rates for bonds with similar quality
- Current rates for debt with substantially identical terms and risks that are traded in open markets
- The current rate charged by investors for first or second mortgage loans on similar property.

EXAMPLE 6-3: PRESENT VALUE OF A NOTE ISSUED FOR EQUIPMENT

FACTS

Issuer A issues a note with a face amount of $1 million and a 2% coupon rate that matures in 10 years in exchange for equipment when the prevailing market rate for comparable credit risk is 12%. Interest is payable annually and no principal payments are required until maturity. There are no unstated (or stated) rights or privileges issued with the note. There are no established exchange prices for the equipment and the note is not traded in an open market.

CONCLUSION AND ANALYSIS

Upon issuance, Issuer A recognizes the note at its present value, which is (1) the present value of the future coupon interest payments, plus (2) the present value of the future principal payments.

In accordance with ASC 835-30-25-12(c), the rate used for valuation must be the rate at which the entity can obtain financing of a similar nature, Issuer A therefore uses the prevailing market rate of 12% to value the note. Issuer A recognizes the difference between the note's present value ($434,978) and face amount ($1 million) as a debt discount. The table shows how the entity determines the present value for the note.

	12% MARKET RATE
Present value of annual interest payments	$ 113,005
Present value of principal of $1 million at the end of Year 10	321,973
Present value at issuance date	$ 434,978

6.2.1.3 Debt With Detachable Warrants

FASB REFERENCES

ASC 470-20-25-2 and ASC 470-20-30-2

Entities may issue debt with other freestanding financial instruments, such as detachable warrants. Detachable warrants are freestanding instruments because they are legally detachable and separately exercisable from the debt instrument (see Section 2.3.1). Therefore, the debt and the warrants are accounted for separately.

An entity must allocate the proceeds between the debt instrument and detachable warrants. The allocation of proceeds to the warrants could cause a debt discount (or in some cases, a reduced premium), which the entity amortizes over the life of the debt in accordance with ASC 835-30 (see Section 6.2.2.1). From the entity's perspective, the debt instrument with detachable warrants typically results in a lower cash interest cost than would otherwise be available to the entity, but the effective interest rate is higher than the coupon rate because of the warrants.

BDO INSIGHTS — ALLOCATING PROCEEDS BETWEEN DEBT AND DETACHABLE WARRANTS

The table summarizes how an entity allocates the proceeds to a debt instrument and detachable warrant (issued together in a financing transaction) in accordance with ASC 470-20-25-2 and by analogy to the allocation method described in ASC 815-15-30-2. The method of allocating proceeds depends on whether the warrant is classified as a liability or equity (see Section 2.8.2).

WARRANT CLASSIFICATION	DEBT IS SUBSEQUENTLY MEASURED AT AMORTIZED COST	DEBT IS SUBSEQUENTLY MEASURED AT FAIR VALUE (SUCH AS WHEN FAIR VALUE OPTION IS ELECTED)
Warrant is classified as equity	Allocate the proceeds to the debt and warrant on a relative fair value basis.	Recognize the debt at fair value and allocate the residual proceeds to the warrant.
Warrant is classified as liability	Recognize the warrant at fair value and allocate the residual proceeds to the debt.	Recognize the debt and warrant at their fair values at issuance.

When the debt, warrant, or both are subsequently measured at fair value and the fair values exceed the proceeds received by the entity, the entity must consider whether there are any other elements that must be recognized from the transaction (see Section 2.8.2).

WARRANTS AND DEBT ISSUED AS CONSIDERATION FOR PURCHASE TRANSACTIONS

When detachable warrants are issued with a debt instrument as consideration in purchase transactions (such as in business combinations or asset acquisitions), each instrument is typically recognized at fair value at the time of issuance. The debt's discount or premium is determined by comparing the value attributed to the debt instrument with its face amount.

Section 5.4 and Section C.3 in Appendix C of our Blueprint, Business Combinations Under ASC 805, provide more guidance on consideration transferred in a business combination and cost of an asset acquisition.

6.2.1.3.1 Credit Facilities for Term Loan and Warrant

FASB REFERENCES

ASC 815-10-15-69, ASC 815-10-S99-4, and ASC 815-40-15-6

Entities may enter credit facilities to fund their liquidity needs. Some credit facilities allow an entity to borrow loans on a delayed basis (a delayed-draw facility) and may require the entity to issue a warrant on its own equity at either the outset of the arrangement or whenever debt is drawn down. Those arrangements often consist of four elements:

- Term loan
- Warrant (issued at inception or contingently issuable as debt is drawn down)
- Loan commitment
- Loan commitment fee.

The entity must identify all the freestanding financial instruments that must be recognized (see Section 2.3.1). Typically, both the debt and warrant that are legally issued at the outset of the arrangement are freestanding instruments because one or both can usually be transferred separately and the settlement of the warrant does not cause the settlement of the debt and vice versa. Further, a contingently issuable warrant may also be a freestanding instrument if it is deemed issued for accounting purposes (see Section 4.2.3). However, if the warrant is determined to be embedded in the debt, the entity must evaluate the warrant for bifurcation (see Chapter 3).

For a freestanding warrant, the entity must first evaluate the unit of account. If the warrant issued at the outset of the arrangement is a single unit of account and the number of shares issuable varies based on the amount of debt drawn, the warrant is not indexed to the entity's own stock because the amount of debt drawn is not an input to the pricing of a fixed-for-fixed option on equity shares (see Section 4.5.2). Similarly, a contingently issuable warrant that is deemed issued for accounting purposes (see Section 4.2.3) and determined to be a single unit of account would not be indexed to the entity's own stock if the number of shares issuable varies based on the amount of debt drawn. Those warrants would be liability classified.

In addition to the debt and warrant, a delayed-draw facility includes a loan commitment. The entity must assess whether the loan commitment is freestanding or embedded in the debt. The loan commitment is generally freestanding from the debt when both:

- The lender can transfer to another party either the debt without the loan commitment or the loan commitment without the debt
- The exercise of the loan commitment does not terminate the debt.

As discussed in Section 3.2.3.2, a loan commitment that gives a potential borrower a right to originate a loan is excluded from the scope of derivative accounting in ASC 815-10. Therefore, if the entity has the right to borrow (even if the right is conditional), it does not account for a freestanding loan commitment and accounts only for the loan when it is issued.

The loan commitment exception does not apply if the lender can require the entity to issue additional debt. In that case, we believe the entity must account for the written option to issue debt at fair value, with changes in fair value recognized in earnings, consistent with the SEC staff's longstanding position on written options (see Section 3.2.3.2).

If the loan commitment is embedded in the debt, the entity does not bifurcate the embedded loan commitment if it does not meet the definition of a derivative instrument (such as if the underlying debt instrument does not publicly trade in an active market) or if it meets the derivative scope exception in ASC 815-10-15-69 (see Section 3.6.5).

BDO INSIGHTS — ACCOUNTING FOR LOAN COMMITMENT FEES

A loan commitment that provides a borrower with the right to access funds from the lender for a specified period typically qualifies for a derivative scope exception; thus, no accounting is required for the loan commitment. However, if an entity pays a fee (either in cash or by issuing a warrant) to the lender for the loan commitment, we believe the fee meets the definition of an asset because it provides the borrower with the right to access funds from the lender.

The accounting for a loan commitment fee for a delayed-draw facility depends on the facts and circumstances. If the entity entered into the delayed-draw facility fully expecting to draw down the debt, it may be appropriate to keep the loan commitment fee on the balance sheet until the draw down occurs. At that point, the debt would be recognized and the loan commitment fee would be reclassified as a debt discount, which the entity would amortize over the life of the debt in accordance with ASC 835-30 (see Section 6.2.2.1). If only a portion of the loan commitment is drawn, a proportionate amount of the loan commitment fee would be reclassified as a debt discount from that day forward.

Alternatively, if the entity entered the delayed draw facility just to have access to capital, as needed, but is uncertain whether it will draw down the debt, we believe it would be appropriate to amortize the loan commitment fee on a straight-line basis over the commitment period, similar to issuance costs for a line of credit (see Section 6.2.5.1).

If the loan commitment is terminated, any remaining loan commitment fees must be expensed. Similarly, if it is probable that the entity will not qualify to draw down the commitment, or if the creditor is no longer capable of honoring the commitment, the remaining commitment fees must be expensed.

6.2.1.4 Debt With Bifurcated Derivatives

FASB REFERENCES

ASC 815-15-30-2 through 30-3

When a debt instrument contains an embedded derivative that requires separation from the host contract, an entity initially recognizes the bifurcated embedded derivative at fair value determined in accordance with ASC 820 (see Section 3.7.1.1) and allocates the residual proceeds to the debt host instrument (see Section 3.7.1.2). The approach separates the fair value of the derivative components (that meet the bifurcation criteria) from the nonderivative components of the contract. The allocation results in a debt discount (or in some cases, a reduced premium), which the entity amortizes over the life of the debt in accordance with ASC 835-30 (see Section 6.2.2.1).

6.2.1.5 Debt Discounts and Premiums

FASB REFERENCES

ASC 835-30-20: Discount and Premium and ASC 835-30-45-1A

Debt discounts or premiums can arise for many reasons. A debt discount results when the net proceeds an entity receives after expenses are less than the amount repayable at maturity. In contrast, a debt premium results when the net proceeds after expenses are more than the amount repayable at maturity.

An entity initially recognizes discounts or premiums as a direct reduction or addition to the face amount of the debt and cannot classify them as separate liabilities (deferred credit) or assets (deferred charge). The entity amortizes the discounts and premiums over the life of the debt in accordance with ASC 835-30 (see Section 6.2.2.1).

The table summarizes common reasons for debt discounts and premiums.

REASON	DISCOUNT OR PREMIUM	SECTION
Lender fees	Lender fees reduce the cash proceeds and are recognized as a debt discount.	Section 6.2.1.1
Stated interest rate differs from market rate	Debt instruments with a stated interest rate that differs from the market rate are ordinarily issued for cash proceeds that differ from the debt's face amount, resulting in a discount or premium.	Section 6.2.1.1
Exchange of unstated (or stated) rights or privileges	When debt is issued with unstated (or stated) rights or privileges that require separate accounting recognition, the allocation of proceeds to the other elements results in a discount or premium.	Section 6.2.1.1
Debt exchanged for property, goods, or services	The difference in the debt's face amount and present value caused by imputation of interest creates a discount.	Section 6.2.1.2
Debt issued with other instruments (such as warrants)	When debt is issued with other instruments, the allocation of proceeds to those other instruments often results in a discount.	Section 6.2.1.3
Bifurcated derivatives	The fair value of a bifurcated derivative creates a discount.	Sections 3.7.1 and 6.2.1.4

6.2.1.6 Initial Measurement of Debt Under the Fair Value Option

FASB REFERENCES

ASC 825-10-15-5(f) and ASC 825-10-25-2 through 25-3, ASC 825-10-25-4(a), ASC 825-10-25-4(e), ASC 825-10-25-5(a), and ASC 825-10-25-5(c)

Entities may elect the fair value option for debt on an instrument-by-instrument basis. However, an entity may not elect the fair value option if the debt has an equity-classified component (for example, convertible debt with a substantial premium recognized in equity). Further, the fair value option can be elected only at the debt instrument's initial recognition or when a previously recognized instrument becomes subject to a remeasurement event (such as a business combination or a debt amendment accounted for as an extinguishment under ASC 470-50). If an entity elects the fair value option, the debt is measured at fair value and any upfront costs and fees are recognized in earnings and not deferred. If elected, the fair value option is irrevocable and must be applied to an entire instrument (it cannot be applied to only specific risks or cash flows or to portions of the instrument). See Section 3.4.2.1 for more guidance on the fair value option.

6.2.2 Subsequent Measurement of Debt

Entities that do not elect the fair value option must subsequently measure debt at amortized cost using the interest method in accordance with ASC 835-30 (see Section 6.2.2.1). Each period, the amortization of a discount or premium brings the debt's net carrying amount closer to the amount the entity must repay at maturity. If the entity elects the fair value option, it remeasures the debt at fair value each period (see Section 6.2.2.2).

6.2.2.1 Amortization of Debt Discounts and Premiums

FASB REFERENCES

ASC 835-30-20: Interest Method, ASC 835-30-35-2 through 35-4, ASC 835-30-45-3, and ASC 835-30-55-2

Debt discounts or premiums must be amortized over the life of the debt using the interest method (also commonly known as the effective interest method). The interest method calculates the periodic interest cost by applying a constant interest rate (the effective interest rate) to the debt's carrying amount (outstanding principal plus or minus the unamortized discount or premium) at the beginning of each period. The difference between the periodic interest cost and the coupon interest (outstanding principal times the stated interest rate) is the periodic amortization for the debt discount and premium. Amortization of the discount or premium is reported as interest expense. See Section 6.2.5 for discussion of debt issuance costs.

Other amortization methods (such as the rule of 78, sum of the years' digits, and straight-line) may be used only if they result in an amortization that is not materially different from the one that would result from the interest method.

BDO INSIGHTS — ESTIMATING THE AMORTIZATION PERIOD

U.S. GAAP requires an entity to amortize discounts and premiums using the interest method over the life of the debt. In practice, entities often use the contractual term for the amortization period for traditional debt with a clearly defined term.

However, debt instruments with embedded puts are not necessarily outstanding for the entire term. For those instruments, we believe an amortization period based on the contractual term is acceptable. A shorter amortization period based on the facts and circumstances may also be appropriate. For example, if the lender has a put option to require the entity to redeem the debt on a specific date, an amortization period from the issuance date to the first put date would be acceptable. Further, whether the debt's redemption feature is contingent may affect an entity's determination of an appropriate amortization period. For example, an entity may consider the likelihood that the redemption feature will become exercisable and will be exercised.

An entity may need to reassess the amortization period when events occur that affect the debt's estimated life (for example, upon occurrence of a contingent event triggering the exercisability of a put option or upon violation of debt covenants causing the debt to be puttable). An entity must disclose its amortization policy and apply it consistently.

We believe an issuer's prepayment option should generally not affect the amortization period. In other words, an issuer should generally not amortize debt discounts and premiums over the period ending on the earliest date the entity can prepay the debt.

In some circumstances, such as when the debt is partially extinguished, it may be appropriate to proportionately write off the related discount or premium.

Determining the appropriate amortization period for debt discounts and premiums requires the application of professional judgment based on the facts and circumstances.

6.2.2.2 Subsequent Measurement of Debt Under the Fair Value Option

FASB REFERENCES

ASC 825-10-45-5

If an entity elects the fair value option for a debt instrument, it remeasures the debt at fair value, with changes in fair value recognized through earnings. That is so except for the portion of the change in fair value that is a result of a change in the instrument-specific credit risk (which is recognized in other comprehensive income, as discussed in Section 3.7.2).

6.2.3 Extinguishment of Debt

FASB REFERENCES

ASC 405-20-40-1, ASC 470-50-20: Net Carrying Amount of Debt and Reacquisition Price of Debt, ASC 470-50-40-1 through 40-3, ASC 470-50-40-6, and ASC 825-10-45-6

An entity derecognizes a liability (such as debt) if and only if it has been extinguished, which is when either of the following conditions is met:

- The entity (debtor) pays the creditor and is relieved of its obligation. Payment may be by any of the following:
  - Paying cash
  - Delivering other financial assets
  - Delivering goods or services
  - Reacquiring its outstanding debt securities (whether the securities are canceled or held as treasury bonds)
- The entity is legally released, either judicially or by the creditor, from the liability as primary obligor.

Further, an amendment or exchange of a term loan with the same creditor is accounted for as an extinguishment if the restructured loan is substantially different from the original term loan. See BDO's publication, Troubled Debt Restructuring, Debt Modification, and Extinguishment for more guidance on modifications (or exchanges) and extinguishments of debt instruments.

U.S. GAAP defines the following terms:

Reacquisition price of debt	*The amount paid on extinguishment, including a call premium and miscellaneous costs of reacquisition. If extinguishment is achieved by a direct exchange of new securities, the reacquisition price is the total present value of the new securities.*
Net carrying amount of debt	*The amount due at maturity, adjusted for unamortized premium, discount, and cost of issuance.*

When accounting for a debt extinguishment, an entity recognizes the difference between the reacquisition price and the net carrying amount of the extinguished debt as a gain or loss in the income statement. If debt is extinguished early by exchanging it for common or preferred stock, the entity determines the reacquisition price using the value of the common or preferred stock or the value of the debt, whichever is more clearly evident.

If in accordance with the debt's contractual terms, an entity issues a variable number of shares equal to a fixed monetary amount to settle a debt instrument, it accounts for that settlement as an extinguishment and recognizes a gain or loss for the difference between the fixed monetary amount (the debt's reacquisition price) and the debt's net carrying amount. However, if that variable share-settled obligation computes the number of shares based on an average share price during a period (such as 30 days before settlement) instead of the share price on the settlement date, the entity does not recognize any gain or loss for the difference in the average and ending stock prices (see Section 2.6.3.1).

The debt extinguishment gain or loss must be recognized in the period of extinguishment and identified as a separate item either on the face of the income statement or in the notes (see Section 8.3.9.4). The entity cannot defer the recognition to a future period. Further, the entity must recognize any unstated (or stated) rights or privileges exchanged at extinguishment by allocating a portion of the consideration to those elements.

BDO INSIGHTS — RELATED PARTY DEBT EXTINGUISHMENT AS A CAPITAL TRANSACTION

When the entity and creditor are related parties (for example, the creditor is also a principal stockholder), the entity must determine if the debt extinguishment is in essence a capital transaction. If so, the entity recognizes any debt extinguishment gain in APIC (rather than in income). A loss on debt extinguishment generally should be recognized in income, regardless of whether the parties are related.

Reaching a conclusion on whether a debt extinguishment is in essence a capital transaction requires the application of professional judgment based on the facts and circumstances.

EXTINGUISHMENT OF DEBT UNDER THE FAIR VALUE OPTION

When debt accounted for under the fair value option is extinguished, the entity remeasures the debt at fair value before derecognition and recognizes in net income the cumulative amount of the gain or loss previously recognized in other comprehensive income related to the changes in instrument-specific credit risk.

6.2.4 Debt With Conversion Options

FASB REFERENCES

ASC 470-20-05-5 through 05-8A and ASC 470-20-20: Contingently Convertible Instruments

Convertible debt either requires or allows the holder to convert the debt into shares of the issuer's stock at a specified rate. From the issuer's perspective, convertible debt generally has a lower interest rate than nonconvertible debt, and the issuer may view convertible debt as essentially raising equity capital. The issuer benefits from borrowing at a relatively low cash interest cost regardless of the future stock price movement. If the stock price increases above the conversion price, the holder is economically motivated to exercise the conversion option, thereby eliminating debt and raising equity.

From the investor's perspective, convertible debt provides the holder an option to receive either the debt's face or redemption amount or the underlying shares. The investor benefits when the conversion option is in-the-money and receives the protection of a debt security (principal and interest) when the conversion option is out-of-the-money.

Conversion features are often exercisable at any time at a fixed conversion rate (for example, 10 shares of common stock for every $1,000 of principal) and are settled by issuing the underlying shares. However, in other cases, conversion features may include terms such as:

- Exercisable at the lower of a fixed conversion rate or specified discount to the stock price at the conversion date
- Exercisable only upon the occurrence of a future event that is outside the issuer or holder's control
- Must or may be settled in cash (or other assets) upon conversion, including partial cash settlement (commonly referred to as "cash conversion features")
- A conversion price that is variable based on future events (a contingently adjustable conversion ratio) such as:
  - An entity's liquidation or change in control
  - A next round of financing at a price lower than the convertible debt's original conversion price
  - An IPO at a share price lower than an agreed amount.
- A contingent conversion feature (commonly referred to as "CoCo") that is exercisable based on either of:
  - A market price trigger (a market condition based at least in part on the entity's own stock price)
  - Multiple contingencies, if one contingency is a market price trigger and the instrument can be converted or share settled upon meeting the specified market condition.

Convertible debt often includes characteristics of term debt, such as a principal amount and a maturity date and can include additional embedded features such as puts or calls. Entities must analyze all features of a convertible debt instrument to determine if any embedded features require bifurcation (see Section 3.6).

6.2.4.1 Accounting Models for Convertible Debt

FASB REFERENCES

ASC 470-20-15-2A through 15-2D, ASC 470-20-25-12 through 25-15, ASC 470-20-55-1A, ASC 470-20-55-19, ASC 815-15-30-2, and ASC 825-10-15-5(f)

At issuance, an entity generally recognizes convertible debt at the allocated proceeds (see Section 2.8.2). If the convertible debt also includes other unstated (or stated) rights or privileges, the entity must allocate a portion of the proceeds to the rights and privileges if required by U.S. GAAP (see Section 6.2.1). Further, convertible debt is typically accounted for under one of three accounting models:

- Embedded derivative model
- Substantial premium model
- Traditional debt model.

Alternatively, an entity may elect the fair value option if the convertible debt qualifies. The fair value option cannot be elected for financial instruments that are, in whole or in part, classified as a component of shareholders' equity, so an entity cannot elect the fair value option for debt with a substantial premium recognized in APIC (see Section 3.4.2.1).

If the entity does not elect (or qualify for) the fair value option, it must evaluate the debt's embedded conversion option and other features for potential bifurcation in accordance with ASC 815-15 (see Section 3.6). If the conversion feature meets the criteria for bifurcation, the entity recognizes the debt instrument under the embedded derivative model. If ASC 815 does not require an embedded conversion feature to be bifurcated from the debt instrument, the entity evaluates whether the debt is issued at a substantial premium and, if so, it recognizes the substantial premium in APIC. If the conversion feature does not meet the bifurcation criteria and the debt is not issued at a substantial premium, the entity recognizes the convertible debt as a liability in its entirety as traditional debt, in which there is no separate accounting for the conversion feature.

The table summarizes those models and the debt instrument's initial recognition under each model.

MODEL	DESCRIPTION	INITIAL RECOGNITION
Embedded derivative model	If the conversion feature meets the criteria for bifurcation, it is separated from the debt instrument in accordance with ASC 815-15 (see Section 3.6.1).	Recognize the conversion feature as a liability at fair value with the remaining proceeds allocated to the debt (see Section 3.7.1.2).
Substantial premium model	If the conversion feature does not meet the criteria for bifurcation and the debt is issued at a substantial premium, there is a presumption that the premium represents paid-in capital (see Section 3.6.1.2).	Recognize the premium in APIC with the remaining proceeds allocated to the debt (see Section 3.6.1.2).
Traditional debt model	If the conversion feature does not meet the criteria for bifurcation and the debt is not issued at a substantial premium, the traditional debt model is applied.	Recognize the convertible debt in its entirety as a liability (no portion of the proceeds is allocated to the conversion feature).

APPLICATION TO CONVERTIBLE PREFERRED STOCK

The guidance in ASC 470-20 also applies to convertible preferred stock that is mandatorily redeemable and classified as a liability under ASC 480-10. For example, if an entity issues convertible preferred stock that has a stated redemption date and requires the entity to settle the face amount of the instrument in cash upon exercise of the conversion option, that instrument is mandatorily redeemable and is classified as a liability in ASC 480-10 because it embodies an unconditional obligation to redeem the preferred stock by transferring assets at a specified or determinable date (or dates). If the conversion option does not meet the bifurcation criteria in ASC 815-15, the entity must assess whether the convertible preferred stock is issued at a substantial premium and, if so, it must recognize the substantial premium in APIC.

APPLICATION TO SHARE-SETTLED DEBT

A debt instrument with a conversion option that continuously resets as the underlying stock price increases or decreases to provide a fixed value of common stock to the holder at any conversion date is share-settled debt, which is evaluated under other applicable U.S. GAAP (such as ASC 480, ASC 718-10, ASC 815-15, or ASC 825-10) rather than ASC 470. That is so unless the share-settled debt also includes a substantive conversion feature, in which case, the entity considers the guidance in ASC 470 in addition to other applicable U.S. GAAP.

For example, if an entity issues a note with a face value of $1 million that is convertible into common stock by dividing the face amount by the common stock price at the conversion date, the note is accounted for as share-settled debt (see Section 2.6.3.1) rather than as convertible debt because the conversion rate continuously resets, guaranteeing the holder $1 million in value upon conversion.

APPLICATION TO CONVERTIBLE DEBT SUBJECT TO ASC 718

ASC 470 does not apply to a convertible debt instrument award issued to a grantee that is subject to ASC 718 unless the instrument is modified and no longer subject to ASC 718.

6.2.4.2 Conversion Accounting

FASB REFERENCES

ASC 470-20-05-9, ASC 470-20-35-11, ASC 470-20-40-4, and ASC 470-20-40-11

If convertible debt accounted for under either the substantial premium or traditional debt model is converted pursuant to the conversion privileges included in the debt's terms, the entity reduces the carrying amount of the debt by any cash or other assets transferred and then reclassifies the debt (including any unamortized debt discount or premium and debt issuance costs) to equity to reflect the shares issued. The entity does not recognize any gain or loss.

Conversion accounting applies even if, pursuant to the debt's original conversion privileges, the conversion is settled in exchange for cash (or other assets) or a combination of shares and cash or other assets (such as in a conversion of a cash convertible debt).

BDO INSIGHTS — CONVERSION OF DEBT ACCOUNTED FOR UNDER THE EMBEDDED DERIVATIVE MODEL

U.S. GAAP does not specify how an entity must account for a conversion of debt with a bifurcated conversion option. We believe when the conversion option has been bifurcated from the convertible debt, no equity conversion feature remains in the debt instrument. The liabilities for the debt and conversion feature are extinguished in exchange for shares of stock, and the entity must recognize the difference between the liabilities' carrying amount (after the final remeasurement of the conversion feature to fair value) and the shares' fair value as a gain or loss in the income statement.

See Section 3.7.3.2 for the accounting for the conversion of debt with a previously bifurcated conversion option that is reclassified to stockholders' equity because it no longer required bifurcation.

INTEREST FORFEITURE

Sometimes an instrument's conversion terms provide that any accrued but unpaid interest at the conversion date is forfeited by the former debt holder. That interest forfeiture may occur when the conversion date falls between the interest payment dates or there are no specified interest payment dates (such as in a zero-coupon convertible debt instrument). In that case, interest must be accrued or imputed to the date of the instrument's conversion. Upon conversion, the accrued interest (from the last interest payment date to the date of conversion, net of any related income tax effects) is credited to equity as part of the cost of shares issued at conversion. In other words, the debt's net carrying amount (the principal and any unamortized premium or discount and issuance costs) and the related accrual for interest to the date of conversion (less any tax effects) are accounted for in the same way — as a credit to equity.

6.2.4.3 Conversion Upon Issuer's Exercise of Call Option

FASB REFERENCES

ASC 470-20-05-11, ASC 470-20-20: Time of Issuance and Substantive Conversion Feature, ASC 470-20-40-5 through 40-9, and ASC 470-20-55-68

Convertible debt that is not otherwise currently convertible may become convertible upon the entity's exercise of a call option. For example, an entity may issue debt that (1) is contingently convertible by the holder when the entity's share price exceeds a specified price (a market price trigger) and (2) includes an option for the entity to call the debt at any time before maturity. As specified in the instrument's terms, if the entity calls the debt, the holder can choose to receive cash (for the call amount) or the fixed number of shares stated in the original conversion terms even if the market trigger is not met. In that case, the accounting for the conversion pursuant to the instrument's original conversion terms depends on whether the conversion feature was substantive at the debt's time of issuance, which is the date when the parties have reached and announced the agreement terms, even though the agreement may be subject to certain further actions, such as directors' or stockholders' approval.

The table summarizes the accounting for the issuance of shares to settle a debt instrument (pursuant to the instrument's original conversion terms) that became convertible upon the entity's exercise of a call option.

IF THE CONVERSION FEATURE IS	ACCOUNTING	SECTION
Substantive	Apply conversion accounting with no gain or loss recognized.	Section 6.2.4.2
Not substantive	Include the fair value of the shares in the debt's reacquisition price and apply extinguishment accounting.	Section 6.2.3

A conversion feature is substantive if its exercise is **at least reasonably possible** (that is, more than remote) of being exercised in the future. In determining whether a conversion feature is reasonably possible of being exercised, an entity does not need to assess the holder's intent. However, in accordance with ASC 470-20-40-7, if an instrument's conversion price at issuance is extremely high so that conversion of the instrument is not at least reasonably possible at the time of issuance, the conversion feature would not be considered substantive. Therefore, even if that conversion feature is based solely on the passage of time (for example, the instrument will become convertible before maturity), it would not be considered substantive.

Further, a conversion feature that is exercisable **only** when the issuer exercises a call option is not substantive.

An entity can assess whether a conversion feature is substantive after the issuance date, but the assessment must consider only assumptions, considerations, and marketplace information available as of the issuance date.

The following methods may provide evidence about whether a conversion feature is substantive.

Relative Fair Values	Compare the fair value of the conversion option to the fair value of the entire debt instrument. The higher the relative percentage, the more likely the conversion option is substantive.
Effective Annual Interest Rate	Compare the convertible debt's effective interest rate to the estimated effective rate of a nonconvertible debt instrument with the same expected term and credit risk. The lower the relative percentage, the more likely the conversion option is substantive.
Isolating the Effect of Contingencies	If the debt instrument is contingently convertible, compare the debt's fair value to the fair value of an identical instrument with a noncontingent conversion option to isolate the effect of the contingencies. A similar fair value may indicate the conversion option is substantive. This approach may not be appropriate unless it is clear that the conversion option is substantive regardless of the contingencies.
Qualitative Evaluation	Qualitatively assess the conversion provisions. For example, if the instrument is convertible upon the occurrence of a specific event, the likelihood the event will occur before the debt matures may indicate the conversion feature is substantive. This approach may not be appropriate unless it is clear that the conversion feature is substantive regardless of the contingencies.

6.2.4.4 Induced Conversion

FASB REFERENCES

ASC 470-20-05-10, ASC 470-20-40-13 through 40-17, ASC 470-20-55-3 to 55-9, and 470-50-15-3(a)

Convertible debt is typically exercisable for an extended period (often up to the debt's maturity date). The debt may be convertible (or will become convertible after a specified date) at any time at the holder's option. During the period when the debt is convertible, even though the conversion option may be in-the-money, debt holders often do not exercise the option until the entity calls the debt or the conversion privileges are otherwise about to expire.

An entity may seek to induce the early conversion of its outstanding convertible debt instruments for various reasons (for example, it plans to replace the existing debt with new debt instruments with a lower interest rate or reduce its outstanding borrowings to improve its leverage ratio). To induce the debt's prompt conversion, the entity may offer additional consideration to debt holders that agree to convert by a specified date.

To qualify as an induced conversion, the conversion to equity securities must reflect changes to the debt's original conversion privileges (including payment of additional consideration) that are made to induce prompt conversion. That could involve any of the following:

- Temporary reduction of the original conversion price (resulting in the issuance of additional shares)
- Issuance of warrants or other securities not provided in the original conversion terms
- Payment of cash or other consideration to debt holders that convert during the specified period.

Induced conversion accounting does not apply to changes in conversion privileges or debt terms that are different from those discussed above.

Conditions for Induced Conversion

Further, to be an induced conversion, the conversion must meet **both** conditions:

- Conversion occurs pursuant to changed conversion privileges that are exercisable only for a limited time (for example, within 30 or 60 days). Offers without a restrictive time limit on their exercisability are not changes made to induce prompt conversion. For example, a conversion pursuant to a changed conversion privilege that is exercisable for the debt's remaining term is not an induced conversion.
- Includes issuing all the equity securities issuable under the debt's original conversion privileges for each converted instrument, regardless of which party initiates the offer. This condition may be met regardless of whether the offer relates to all debt holders or only some debt holders accept the offer.

Some convertible debt instruments include provisions that allow the entity to modify the terms of the debt to the benefit of the debt holders. The provisions may be general in nature, allowing the entity to take actions to protect the debt holders' interests, or they may be specific (for example, authorizing the entity to temporarily reduce the conversion price to induce conversion). Conversions pursuant to amended or altered conversion privileges on those instruments may qualify for an induced conversion (if the conditions above are met), even though they are literally provided in the debt's terms at issuance. In other words, the existence of provisions allowing changes to the conversion privileges does not preclude meeting the conditions for induced conversion.

INDUCED CONVERSION COMPARED TO OTHER FORMS OF SETTLEMENT

The accounting for induced conversion applies **only to conversions** of convertible debt to equity securities pursuant to the **changed conversion privileges**. Therefore, an induced conversion differs from debt extinguishment and contractual conversion based on the debt's original terms even though those settlements may also involve issuing equity securities to settle the debt.

For instance, if an entity has traditional convertible debt for which the conversion feature can be contractually settled only by issuing 1,000 common shares, but the entity settled by paying cash equal to the value of the shares at settlement, the entity accounts for that settlement as a debt extinguishment, recognizing a gain or loss based on the difference between the reacquisition price and the debt's net carrying amount (see Section 6.2.4.5). In contrast, if the entity settles the convertible debt by issuing 1,000 common shares, it accounts for that settlement as a conversion and does not recognize any gain or loss (see Section 6.2.4.2).

To qualify as an induced conversion, the settlement must be a conversion (albeit based on changed conversion privileges). Therefore, the entity does not recognize any gain or loss for the value of the shares issuable pursuant to the original conversion privileges. Rather, the entity recognizes an inducement expense for the fair value of the **additional** securities or assets transferred to the debt holder to induce the debt's prompt conversion.

In accordance with ASC 470-20-40, an exchange of a convertible debt instrument for equity securities or a combination of equity securities and other consideration is considered a conversion regardless of whether the exchange involves legal exercise of the contractual conversion privileges included in the debt's terms. For instance, based on the facts and circumstances, a repurchase of convertible notes in the open market or a repurchase of convertible bonds through a tender offer may be an induced conversion if the conditions in ASC 470-20-40-13 are met.

Further, when an entity exchanges one convertible debt instrument for another debt instrument with the same lender, it must first evaluate whether the exchange is an induced conversion before assessing whether the transaction is accounted for as a debt extinguishment or a modification under ASC 470-50. That is because induced conversions are outside the scope of ASC 470-50.

When induced conversion accounting applies, an entity recognizes an inducement expense calculated as of the **offer acceptance date** as follows:

The fair value of all securities and other consideration transferred in the transaction	−	The fair value of the securities issuable pursuant to the original conversion terms	=	Inducement Expense

An entity measures the fair value of the securities or other consideration as of the date the inducement offer is accepted by the debt holder. That is because no exchange has been made between the entity and debt holder until the holder accepts the offer. The offer acceptance date is normally the conversion date or the date the debt holder enters the binding agreement to convert.

ASU 2024-04, *INDUCED CONVERSIONS OF CONVERTIBLE DEBT*

Under U.S. GAAP, to be an induced conversion, the conversion must require the entity to issue all the equity securities issuable under the debt's original conversion privileges for each converted instrument. However, it was often not clear how that criterion applies to debt instruments with cash conversion features because those instruments do not require the entity to issue shares at conversion. Also, it was unclear (1) how to apply that criterion when the conversion privileges are changed to incorporate, eliminate, or modify a VWAP formula in the instrument's conversion terms and (2) whether the induced conversion guidance applies to convertible debt that is not currently convertible. The absence of guidance in those specific areas has led to diversity in practice.

In November 2024, the FASB issued ASU 2024-04, which clarifies that:

- The induced conversion guidance can apply to a convertible instrument that is not currently convertible so long as it had a substantive conversion feature as of the issuance date and the offer acceptance date.
- To qualify for induced conversion accounting, an inducement offer must preserve the consideration in form and amount. That means that the inducement offer must provide the holder with, at a minimum, consideration in the same form and amount that was issuable under the conversion privileges provided in the terms of the existing debt instrument (the existing conversion privileges). The criterion is assessed **as of the offer acceptance date**.
  - To determine whether the inducement offer preserves the consideration in form and amount, an entity compares the amount of cash (or other assets) and the number of shares issuable under the existing conversion privileges with those to be issued under the inducement offer. For example, if the existing conversion privileges require settlement of the principal in cash and the conversion premium in any combination of cash and shares, but the inducement offer does not include cash consideration, the settlement does not qualify for induced conversion.
  - The ASU also clarifies how to assess this criterion in specific situations:

SCENARIO	ACCOUNTING CONSIDERATIONS
Settlement terms under either the existing conversion privileges or the inducement offer are based on a future share price or average of future share prices (such as VWAP)	Use the share price **as of the offer acceptance date** to compute the amount of cash payable and shares issuable under the existing conversion privileges. For example, if the existing conversion terms include a VWAP formula based on future share prices*, then incorporating, eliminating, or modifying that formula in the inducement offer** does not affect the determination of the amount of cash or number of shares issuable for the induced conversion assessment because the fair value of the shares on the offer acceptance date would be used instead of the future VWAP. * To illustrate, assume the convertible debt allows the entity to settle the principal and conversion premium in any combination of cash and shares with a total value equal to a fixed number of shares times VWAP. Under the existing conversion privileges, the VWAP is computed using a 40-day period beginning the day after the holder notifies the entity that it will convert the debt. ** For example, the existing conversion terms require the total consideration to be computed using a 40-day VWAP while the inducement offer requires a 15-day VWAP.

ASU 2024-04, *INDUCED CONVERSIONS OF CONVERTIBLE DEBT*

SCENARIO	ACCOUNTING CONSIDERATIONS
Changed terms cause the amount of cash (or other assets) or the number of shares to be indexed to something other than the future price of the issuer's shares (such as the fair value of a commodity)	Those changes are a change in the form of settlement, so induced conversion does not apply.
The existing debt was exchanged or modified within the one before the offer acceptance date and was not an extinguishment under ASC 470-50	The conversion privileges that existed one year before the offer acceptance date are used in the induced conversion assessment, instead of the conversion privileges existing immediately before the inducement offer.

Two common types of cash convertible instruments are referred to as "Instrument C" and "Instrument X." The table summarizes the induced conversion assessment for those instruments under the proposed ASU, assuming the conversion occurs based on changed conversion privileges that are exercisable for only a limited time.

CASH CONVERTIBLE INSTRUMENT	DESCRIPTION	INDUCED CONVERSION ASSESSMENT
Instrument C	Requires the entity to settle the debt's principal in cash and allows the entity to settle the conversion premium in cash or shares	▶ Induced conversion applies if the settlement under the inducement offer is fully in cash and the cash offered is sufficient to satisfy both the principal and the conversion premium under the existing conversion privileges. ▶ Induced conversion applies if the settlement under the inducement offer is for a combination of cash and shares and both of the following are met: • The cash offered is sufficient to satisfy the principal under the existing conversion privileges. • The amount offered (cash or shares) is sufficient to also satisfy the conversion premium (together with the principal) under the existing conversion privileges. ▶ Induced conversion does not apply (the transaction is accounted for as an extinguishment) if the settlement under the inducement offer is fully in shares because the form of the consideration under the existing conversion privileges would not be preserved by the offer.
Instrument X	Allows the entity to settle the if-converted value (principal plus conversion premium) in cash, shares, or any combination of cash and shares	▶ We believe induced conversion applies if the total amount offered (cash or shares) is sufficient to satisfy both the principal and conversion premium under the existing conversion privileges.

ASU 2024-04, *INDUCED CONVERSIONS OF CONVERTIBLE DEBT*

The table summarizes the transition for the ASU.

	ALL ENTITIES
Effective Date	Fiscal years and interim periods within fiscal years beginning after December 15, 2025.
Early adoption	Allowed for entities that have adopted ASU 2020-06. If an entity adopts the ASU in an interim period, it must adopt the amendments as of the beginning of the annual period that includes that interim period.
Transition	Prospective to settlements of convertible debt instruments that occur on or after the date of adoption (including interim periods). Disclosure requirements include the nature of and reason for the change in accounting principle. Entities may elect to adopt the ASU retrospectively as of the beginning of the first reporting period in accordance with ASC 250-10-45-5 through 45-10. That method can be applied only to settlements of convertible debt that occur after adopting ASU 2020-06. Disclosure requirements include: ▶ The nature of and reason for the change in accounting principle ▶ The chosen method of adoption ▶ The cumulative effect on retained earnings or other components of equity as of the beginning of the first reporting period ▶ The effect on income from continuing operations, net income, and any other affected financial statement line item (including earnings per share, if presented)

EXAMPLE 6-4 (ADAPTED FROM ASC 470-20-55-3 THROUGH 55-5): ENTITY REDUCES CONVERSION PRICE TO INDUCE CONVERSION — INCREASE IN DEBT FAIR VALUE

FACTS

On January 1, 19X4, Entity A issues $1,000 of 10% convertible debt at par (there is no original issue premium or discount) with the following terms:

- Matures on December 31, 20X3
- Convertible into Entity A's common shares at a conversion price of $25.

On January 1, 19X6, when the convertible debt's fair value is $1,700, Entity A reduces the conversion price to $20 for 60 days (until February 29, 19X6) to induce the debtholders to convert their debt promptly. The debt immediately converts on the date the debtholders accept the inducement offer. The fair value of Entity A's common stock on the offer acceptance date (which, in this case, is the same as the conversion date) is $40 per share.

CONCLUSION

Entity A must account for the conversion as an induced conversion, recognizing an inducement expense for the fair value of incremental consideration.

ANALYSIS

Entity A accounts for the conversion as an induced conversion because it meets the following two conditions:

- It occurs pursuant to changed conversion privileges that are exercisable only for a limited time.
  - The changed conversion price is exercisable only for 60 days, which is a limited time; therefore, the first condition is met.
- It includes issuing all the equity securities issuable under the debt's original conversion privileges for each converted instrument.
  - The changed conversion privileges require Entity A to issue 50 shares of its common stock. Therefore, it includes the issuance of all 40 shares of common stock issuable pursuant to the original conversion terms; the second condition is met.

Entity A calculates the induced conversion expense as follows:

Value of securities issued[(a)]	$	2,000
Less value of securities issuable pursuant to original conversion privileges[(b)]		1,600
Fair value of incremental consideration[(c)]	$	400

[(a)] Value of securities issued to the debtholders:		
Par amount	$	1,000
Divided by the new conversion price per share	$	20
Shares issued in induced conversion		50
Multiplied by the fair value per common share on conversion date	$	40
Value of securities issued	$	2,000
[(b)] Value of securities issuable under the original conversion terms:		
Par amount	$	1,000
Divided by the original conversion price per share	$	25
Shares issuable pursuant to the original conversion terms		40
Multiplied by the fair value per common share on conversion date	$	40
Value of securities issuable under the original conversion terms	$	1,600

Entity A records the following journal entry to recognize the incremental consideration paid for the inducement (inducement expense):

Debit	Convertible debt	$	1,000		
Debit	Debt conversion expense[(c)]		400		
Credit	Common stock			$	1,400

EXAMPLE 6-5 (ADAPTED FROM ASC 470-20-55-6 THROUGH 55-9): ENTITY REDUCES CONVERSION PRICE TO INDUCE CONVERSION — DECREASE IN DEBT FAIR VALUE

FACTS

On January 1, 19X1, Entity B issues $1,000 of 4% convertible debt at par (there is no original issue premium or discount) with the following terms:

- Matures on December 31, 20X0
- Convertible into Entity B's shares of common stock at a conversion price of $25.

On June 1, 19X4, when the convertible debt's fair value is $500, Entity B reduces the conversion price to $20 for 30 days (until July 1, 19X4) to induce the debtholders to convert their debt promptly. The debt immediately converts on the date the debtholders accept the inducement offer. The fair value of Entity B's common stock on the offer acceptance date (which, in this case, is the same as the conversion date) is $12 per share.

CONCLUSION

Entity B must account for the conversion as an induced conversion, recognizing an inducement expense for the fair value of incremental consideration.

ANALYSIS

Entity B accounts for the conversion as an induced conversion because it meets the following two conditions:

- It occurs pursuant to changed conversion privileges that are exercisable for only a limited time.
  - The changed conversion price is exercisable only for 30 days, which is a limited time; therefore, the first condition is met.
- It includes issuing all the equity securities issuable under the debt's original conversion privileges for each converted instrument.
  - The changed conversion privileges require Entity B to issue 50 shares of its common stock. Therefore, it includes the issuance of all 40 shares of common stock issuable pursuant to the original conversion terms; the second condition is met.

Entity B calculates the incremental induced conversion expense as follows:

Value of securities issued[a]	$	600
Less value of securities issuable pursuant to original conversion privileges[b]		480
Fair value of incremental consideration[c]	$	120

[a] Value of securities issued to the debtholders:		
Par amount	$	1,000
Divided by the new conversion price per share	$	20
Shares issued in induced conversion		50
Multiplied by the fair value per common share on conversion date	$	12
Value of securities issued	$	600

[b] Value of securities issuable under the original conversion terms:		
Par amount	$	1,000
Divided by the original conversion price ratio per share	$	25
Shares issuable pursuant to the original conversion terms		40
Multiplied by the fair value per common share on conversion date	$	12
Value of securities issuable under the original conversion terms	$	480

Entity B records the following journal entry to recognize the incremental consideration paid for the inducement (inducement expense):

Debit	Convertible debt	$	1,000		
Debit	Debt conversion expense[(c)]		120		
Credit	Common stock			$	1,120

The same accounting applies if instead of reducing the conversion price, Entity B issued 50 shares of its common stock in a tender offer in exchange for each $1,000 of convertible debt surrendered by July 1, 19X4.

6.2.4.5 Extinguishment of Convertible Debt

FASB REFERENCES

ASC 470-50-40-3 through 40-5

When convertible debt is extinguished in a manner not contemplated in the contract's original terms (such as through the debt's negotiated redemption), the entity recognizes the difference between the debt's reacquisition price and net carrying amount in earnings (as a gain or loss) in the period of extinguishment (see Section 6.2.3). If the debt is extinguished through exchange for the entity's shares and the settlement is not a conversion, the debt's reacquisition price is determined by the fair value of the shares issued or the debt's fair value, whichever is more clearly evident.

On the other hand, if the debt is settled pursuant to the original terms of the conversion feature, the entity accounts for the settlement as a conversion (see Section 6.2.4.2). A debt instrument that is tendered to exercise detachable warrants that were originally issued with that debt and for which the agreement allows the debt to be tendered towards the warrant's exercise is also accounted for as a conversion.

See Section 3.7.3.2 for the accounting for the extinguishment of debt with a previously bifurcated conversion option that is reclassified to stockholders' equity because it no longer required bifurcation.

6.2.4.6 Own Share-Lending Arrangements in Contemplation of Convertible Debt Issuance

FASB REFERENCES

ASC 470-20-05-12A through 05-12C, ASC 470-20-25-20A, ASC 470-20-30-26A, and ASC 470-20-35-11A

An entity may enter a share-lending arrangement with an investment bank in connection with a convertible debt issuance. That may occur when borrowing the entity's shares is cost prohibitive to the investment bank or third-party investors; for instance, because of a lack of liquidity or extensive open short position in the entity's shares. The share-lending arrangement is executed between the entity (share lender) and the investment bank (share borrower) and is entered separately from (but in connection with) the convertible debt, which is issued to the investor. The arrangement is intended to facilitate the investor's ability to hedge the conversion option in the convertible debt.

A share-lending arrangement requires an entity to issue loaned shares to an investment bank in exchange for a nominal loan processing fee that is usually equal to the par value of the loaned stock and significantly less than the stock's fair value. The loaned shares are legally outstanding during the arrangement's term, and the investment bank must return the loaned shares to the entity at the arrangement's maturity or conversion of the debt, generally for no additional consideration.

A share-lending arrangement also typically requires the investment bank to reimburse the entity for any dividends paid by the entity on the loaned shares during the arrangement's term. The loaned shares typically do not have voting rights.

The entity must first evaluate whether a share-lending arrangement is subject to ASC 480 (see Chapter 2). Typically, that arrangement does not embody an entity's obligation to repurchase shares in exchange for assets or to issue a variable number of its own shares. Therefore, it is typically outside the scope of ASC 480, in which case the entity evaluates whether the arrangement meets the requirements for equity classification in ASC 815-40. If it meets the requirements for equity classification, it is initially recognized at fair value in accordance with ASC 820 as a debt issuance cost with an offset to APIC (see Section 6.2.5).

After initial recognition, the entity continuously assesses the probability that the investment bank will default on the share-lending arrangement. If default is probable, the entity recognizes an expense equal to the fair value of the unreturned shares net of the fair value of any probable recoveries with an offsetting entry to APIC. Each period, the entity remeasures the fair value of the unreturned shares, including changes in the fair value of probable recoveries, through earnings until the arrangement consideration payable by the counterparty becomes fixed.

6.2.5 Debt Issuance Costs

FASB REFERENCES

ASC 340-10-S99-1, ASC 470-20-45-1A, ASC 825-10-25-3, ASC 835-30-45-1A, and ASC 835-30-45-3

Debt issuance costs incurred with parties other than the lender that are directly attributable to the debt financing are accounted for in accordance with ASC 835-30 similar to debt discounts. In other words, debt issuance costs are recognized as a direct deduction from the debt's face amount and amortized to interest expense using the interest method (see Section 6.2.2.1). When an entity elects the fair value option to measure debt, any upfront costs and fees are expensed immediately.

By analogy to the guidance on equity offerings in ASC 340-10-S99-1, costs that are not incremental or directly attributable to the debt issuance, such as management salaries or other general and administrative expenses, are not included as debt issuance costs.

Include as Debt Issuance Costs	▶ Document preparation and printing costs ▶ Registration and listing fees ▶ Underwriting fees and expenses ▶ Roadshow and travel costs ▶ Accountant, advisors, and attorney fees that directly relate to the debt issuance
Exclude From Debt Issuance Costs	▶ Internal legal and accounting costs ▶ General and administrative expenses ▶ Management salaries and bonuses ▶ Insurance policy premiums for directors and officers ▶ Fees not essential to the financing ▶ Costs related to aborted offerings

DEBT ISSUANCE COSTS EXCLUDE LENDER FEES

While lender fees and debt issuance costs are both presented in the balance sheet as direct deductions from the face amount of the debt and amortized using the interest method, lender fees reduce the debt's proceeds (as a debt discount) and are not included as debt issuance costs. The distinction plays an important role in some accounting analyses, including:

- Embedded derivative analysis (call and put options) — When evaluating whether a call or put option is clearly and closely related to its debt host, entities must determine whether a substantial premium or discount exists. The calculation includes lender fees but excludes debt issuance costs (see Section 3.6.3.1).
- Debt modifications — When debt is modified or exchanged with the same lender, lender fees are included in the 10% change in cash flow test in ASC 470-50, while debt issuance costs are excluded. Further, the accounting treatment (capitalize versus expense) for lender fees and debt issuance costs differs in ASC 470-50. See BDO's publication, Troubled Debt Restructuring, Debt Modification, and Extinguishment for more guidance on debt modifications.

6.2.5.1 Line-of-Credit Debt Issuance Costs

FASB REFERENCES

ASC 835-30-S45-1

Line-of-credit arrangements or revolving debt arrangements do not always have outstanding balances. The balances depend on draws and repayments and can fluctuate from period to period.

ASC 835-30 includes guidance for debt issuance costs on debt instruments but it does not discuss debt issuance costs and other fees related to revolving credit agreements. The SEC staff has said it would not object to an entity presenting debt issuance costs related to line-of-credit arrangements as a deferred asset and amortizing them ratably over the term of the arrangement, regardless of whether there are any outstanding amounts under the agreement. When there are outstanding borrowings under the arrangement, there might be acceptable alternative presentations (see Section 8.3.9.2.1).

6.2.6 Paid-in-Kind Interest

A debt instrument with PIK interest either requires or allows the entity to make the coupon interest payments at each interest date in cash or by payment in kind (by adding the accrued interest to the loan balance or issuing additional debt instruments with the same terms as the original instrument) (see Section 3.6.5).

BDO INSIGHTS — RECOGNIZING PIK INTEREST

U.S. GAAP does not specify how an entity must recognize PIK interest. In practice, the accounting depends on whether the PIK interest is nondiscretionary or discretionary. We believe the methods summarized below are acceptable but there may be other acceptable methods. The entity must choose a reasonable approach based on the facts and circumstances and apply that approach consistently.

PIK INTEREST IS	DESCRIPTION	MEASUREMENT
Nondiscretionary	The issuer and holder cannot elect the form of payment for the interest (for example, it must always be settled as PIK interest).	▶ The entity computes the effective interest rate of the debt instrument assuming that all nondiscretionary PIK interest will be paid at the maturity date. ▶ The entity recognizes interest expense using the effective interest rate computed above in the same manner as a zero-coupon bond with compounding interest.
Discretionary	The issuer or holder of the instrument can choose to settle the interest in cash or as PIK interest.	▶ The entity computes the effective interest rate of the debt instrument based on the assumption that the debtor will settle the interest either (1) entirely in cash or as PIK interest (at the contractual rate), or (2) with a mixture of cash and PIK interest, in which case the entity must estimate the amount and timing of the interest payments. ▶ The entity recognizes interest expense using the effective interest rate computed above in accordance with ASC 835-30 but adjusts the interest expense recognized at each interest accrual date for any differences between the estimated and actual settlement choices using one of the following methods: • Adjust interest expense based on the actual settlement method using the appropriate **contractual** interest rate (if different than the contractual rate used to compute the estimated effective interest rate). • Adjust interest expense based on the actual settlement method to reflect the **fair value** of the incremental PIK instruments issued, consistent with the accounting for stock dividends under ASC 505-20-30-3.

Determining the appropriate recognition of PIK interest requires the application of professional judgment based on the facts and circumstances.

6.2.7 Special Debt Topics Under U.S. GAAP

6.2.7.1 Sales of Future Revenues

FASB REFERENCES

ASC 470-10-20: Units-of-Revenue Method, ASC 470-10-25-1 through 25-2, ASC 470-10-35-3, and ASC 815-10-15-59(d)

An entity may enter an arrangement in which it receives cash from an investor in exchange for an obligation to pay the investor a specified amount or a percentage of future revenues or other measure of income (such as gross margin, operating income, or pretax income) of a particular product line, business segment, trademark, patent, or contractual right for a defined period.

Typically, those arrangements qualify for the derivative scope exception for nonexchange-traded contracts that have settlements based on the specified sales volumes or service revenues of one of the parties to the contract. Therefore, they are generally not accounted for as derivative instruments.

Further, the entity typically cannot immediately recognize the upfront payment as revenue because the earnings process often is not complete when the cash is received. Rather, the upfront payment is classified as either debt or deferred income depending on the facts and circumstances.

The presence of **any one** of the following factors independently creates a rebuttable presumption that the upfront payment must be classified as debt:

- The form of the transaction is debt (the transaction does not purport to be a sale).
- The entity has significant continuing involvement in generating the cashflows that are due to the investor (for example, the entity is actively involved in generating the operating revenues of a product line, subsidiary, or business segment).
- Either the entity or investor can cancel the arrangement through a lump sum payment or transfer of other assets by the entity.
- The transaction terms implicitly or explicitly limit the investor's rate of return.
- Fluctuations in the entity's revenue or income underlying the transaction have only a trifling effect on the investor's rate of return.
- The investor has recourse against the entity for payments the entity owes the investor under the arrangement.

An entity can overcome the debt classification presumption and classify the upfront payment as deferred income if none of the factors listed above are present; however, in practice, accounting for the proceeds as deferred income is rare.

The graphic summarizes the accounting treatment for the upfront payment depending on the classification.

Debt Classification	Initial recognition: The entity debits the cash or consideration received and credits debt. Subsequent accounting: Amortize the upfront payment using the interest method (see Section 6.2.2.1) over the term of the arrangement. Recognize interest expense based on the effective interest rate of the debt.

Deferred Income Classification	Initial recognition: The entity debits the cash or consideration received and credits deferred income. Subsequent accounting: Amortize the upfront payment using the units-of-revenue method, which calculates a ratio of the proceeds received from the investor to the total payments expected to be made to the investor over the term of the arrangement, and then apply that ratio to the period's cash payment. The entity does not recognize an interest expense.

BDO INSIGHTS — CHANGE IN ESTIMATED CASH FLOWS FOR SALES OF FUTURE REVENUES CLASSIFIED AS DEBT

U.S. GAAP does not require an approach for accounting for changes in estimated cash flows for sales of future revenues. For arrangements classified as debt, we believe an entity may choose one of the following methods, which it must apply consistently in similar facts and circumstances:

METHOD	DESCRIPTION	ACCOUNTING FOR THE CHANGE
Prospective	Determine the new effective interest rate using the revised estimated cash flows from the date of the change to the end of the arrangement's term. The debt's carrying amount is not immediately adjusted.	▶ Recognize the change prospectively through interest expense using the new effective interest rate.
Cumulative catch-up	Immediately adjust the debt's carrying amount to the present value of the revised estimated cash flows using the original effective interest rate.	▶ Recognize the adjustment immediately in earnings. ▶ Continue to amortize the debt using the original effective interest rate.
Retrospective	Determine the revised effective interest rate from inception of the arrangement to the end of the arrangement's term. The revised effective interest rate is calculated using the original carrying amount, actual cash flows to date, and the revised remaining cash flows. Immediately adjust the debt's carrying amount to the present value of the revised estimated cash flows using the revised effective interest rate.	▶ Recognize the adjustment immediately in earnings. ▶ Amortize the debt using the revised effective interest rate.

We believe an entity may not adjust the debt's carrying amount below the original carrying amount unless the conditions for derecognition in ASC 405-20-40-1 are met (see Section 6.2.3). Accounting for a change in estimated cash flows for sales of future revenues requires the application of professional judgment based on the facts and circumstances.

6.2.7.2 Indexed Debt

FASB REFERENCES

ASC 470-10-25-3 through 25-4, ASC 470-10-35-4, ASC 815-10-35-1, ASC 815-15-30-2, ASC 815-15-35-2A, and ASC 835-30-45-3

A debt instrument may require an entity to make both fixed payments (such as interest or principal) and contingent payments that depend on changes to a specific index; for example, the S&P 500 or the price of a specific commodity, such as oil (an indexed feature).

The accounting for the indexed feature depends on whether it is freestanding or embedded, and if embedded, whether it requires bifurcation from the debt instrument, as summarized in the table.

SCENARIO	INITIAL RECOGNITION	SUBSEQUENT MEASUREMENT
Indexed feature is freestanding	The entity allocates the proceeds between the indexed feature liability and the debt instrument. The entity accounts for the discount that results from the allocation in accordance with ASC 835-30 (see Section 6.2.1.5).	The entity measures the indexed feature liability based on the value of the applicable index at the balance sheet date and must not include the effect of expected future changes in the index value. Changes in the value of the indexed feature liability are recognized through earnings. The entity accounts for the debt instrument separately, generally, at amortized cost (see Section 6.2.2.1).
Indexed feature is embedded and not bifurcated	The entity allocates the entire proceeds to the debt instrument.	The entity measures the indexed feature embedded in the debt based on the value of the applicable index at the balance sheet date and must not include the effect of expected future changes in the index value. Changes in the value of the embedded indexed feature are recognized through earnings and as adjustments to the debt’s carrying amount.
Indexed feature is embedded and bifurcated	The entity recognizes the bifurcated indexed feature at fair value and allocates the residual proceeds to the debt instrument. The entity accounts for the discount that results from the allocation in accordance with ASC 835-30 (see Section 6.2.1.5).	The entity subsequently measures the bifurcated indexed feature at fair value through earnings (see Chapter 3 for more guidance on embedded derivatives). The entity accounts for the debt instrument separately, generally, at amortized cost (see Section 6.2.2.1).

6.2.7.3 Increasing-Rate Debt

FASB REFERENCES

ASC 470-10-35-1 through 35-2 and ASC 470-10-45-8

Some debt instruments allow the entity (borrower) to extend the debt’s maturity until a final maturity is reached in which the debt’s interest rate increases a specified amount at each renewal or extension. Entities must analyze the term-extension provisions under ASC 815-15 to determine if they must bifurcate the feature (see Section 3.6.4).

If the term-extending option is not accounted for as a derivative under ASC 815-10, the entity must apply the interest method under ASC 835-30. The entity estimates the remaining term of the debt by considering its plans, ability, and intent to service the debt. It must amortize any debt issuance costs as interest expense over the same estimated term.

If an entity repays increasing-rate debt at its par value before its estimated maturity, the entity must derecognize any excess accrued interest as a reduction to interest expense. See Section 8.3.7 for presentation requirements for increasing-rate debt.

6.3 EQUITY

FASB REFERENCES

ASC 340-10-S99-1, ASC 480-10-S99-3A(12), ASC 505-10-05-3, and ASC 505-10-15-1

Equity is the residual interest in an entity's assets after subtracting the entity's liabilities (it is also sometimes referred to as "net assets"). The guidance on accounting for equity is found in several parts of U.S. GAAP, such as:

- ASC 505, which includes general guidance related to equity, as well as guidance on several specific elements of transactions, accounts, and financial instruments that are classified as equity (for example, treasury stock transactions, stock dividends, and stock splits). It pertains to all entities unless specifically addressed by other topics in U.S. GAAP.
- ASC 480, which includes guidance on whether a financial instrument must be classified outside equity as an asset or liability (see Chapter 2).
- ASC 815-40, which includes guidance on whether equity-linked financial instruments must be classified as equity or as an asset or liability (see Chapter 4).
- ASC 480-10-S99-3, which includes guidance on classifying equity as either permanent or temporary equity for financial statements prepared under Regulation S-X (see Chapter 5).

Equity represents the entity's ownership interests and typically consists of different components, such as capital accounts, APIC, retained earnings or accumulated deficit, accumulated other comprehensive income, and noncontrolling interests.

Generally, permanent equity issued in exchange for cash is recognized at the amount of proceeds allocated to the instrument (after allocation to other instruments issued in the transaction, as well as any bifurcated derivatives or unstated (or stated) rights or privileges) (see Section 2.8.2) and is not subsequently remeasured. Temporary equity is recognized initially at fair value (with some exceptions as noted in Section 5.5.1) and may have to be subsequently remeasured (see Chapter 5).

Equity issued in a noncash transaction is typically recognized based on the more clearly determinable of the fair value of the equity or of the consideration received. If equity is issued as consideration for a business combination, it is measured at fair value at issuance.

Further, if equity is issued in exchange for goods and services, the entity recognizes and measures the share-based compensation under ASC 718.

ACCOUNTING FOR EQUITY ISSUANCE COSTS

When an entity incurs costs that are incremental and directly attributable to an issuance of equity securities, it recognizes the costs as an offset against the total equity proceeds. However, if an entity's costs exceed the amount of proceeds received, the excess should be expensed.

If an entity incurs incremental and direct costs before the equity securities are issued, the entity defers those costs and recognizes them as an offset against the total equity proceeds when they are received. If the entity aborts the offering, any deferred equity issuance costs must be expensed immediately. The entity cannot recognize those costs against the proceeds of a future offering. Postponing the offering for a short period (up to 90 days) is not considered an aborted offering.

Also, management salaries and other general and administrative expenses must be expensed as incurred because they are not incremental and direct costs of an equity offering.

6.3.1 Common Stock

Common stock is the most usual form of ownership interest in a corporate entity. The common stockholders typically have voting and dividend rights and the most residual interest in the entity (the lowest liquidation preference). An entity's capital structure may include more than one class of common stock that have different rights to dividends or distributions. Entities that present EPS and have more than one class of common stock must calculate EPS using the two-class method.

Although rare, common stock can have redemption or conversion rights and, if those features are present, an entity must evaluate them under ASC 480, ASC 815-15, and ASC 815-40, as discussed in Chapters 2, 3, and 4, respectively. Entities that apply the temporary equity guidance must consider temporary equity classification if the common stock is redeemable (for example, a SPAC generally issues shares of redeemable common stock during its initial IPO (see Section 5.7.7)).

An entity generally recognizes common stock on the date it issues the stock and receives the agreed consideration (for example, cash, an enforceable right to receive cash, or another financial instrument). Generally, if common stock is issued for cash, the entity recognizes the common stock based on the allocated proceeds (after allocation to other instruments issued in the transaction, as well as any bifurcated derivatives or unstated (or stated) rights or privileges) (see Section 2.8.2). If common stock is issued in a noncash transaction, it is recognized based on the more clearly determinable of the fair value of the stock or of the consideration received.

Often, common stock has a par value (the minimum amount a stockholder must pay for a share of common stock) or a stated value established in an entity's corporate documents. An entity recognizes the common stock at par or stated value and credits APIC for the remaining proceeds. In some jurisdictions, entities may issue common stock without a par or stated value, in which case, an entity may recognize the entire proceeds allocated to common stock as a credit to either common stock or paid-in capital.

BDO INSIGHTS — MODIFICATION OF COMMON STOCK

Although uncommon, an entity may modify or exchange its outstanding common stock for another class of common stock as part of an equity restructuring. U.S. GAAP does not specify how an entity must account for a common stock modification, and often, there is no accounting required for such a modification. However, the entity must consider the transaction's facts and circumstances.

6.3.2 Treasury Stock

FASB REFERENCES

ASC 505-30-05-2 through 05-3, ASC 505-30-15-1 through 15-2, and ASC 505-30-25-1 through 25-2

An entity may repurchase its common stock for many reasons, such as to reduce dilution from issuing shares in another transaction, prevent a hostile takeover, or increase EPS by reducing the number of shares outstanding. An entity may repurchase its common stock for retirement (see Section 6.3.2.2) or hold it in treasury for reissuance (see Section 6.3.2.3). Common stock repurchased by the entity and not retired is known as "treasury stock" or "treasury shares." Treasury stock generally does not have the same rights as regular common stock.

An entity may pay more or less than the fair value or the original issue price to repurchase its own common stock. If an entity pays more than fair value, it must determine whether the excess is attributable to other transaction elements, such as stated or unstated rights or privileges.

ASC 505-30, *Treasury Stock,* provides guidance for all entities on the accounting and presentation for:

- Repurchase of an entity's own outstanding common stock (Sections 6.3.2.2 and 6.3.2.3)
- Retirement of repurchased stock (Section 6.3.2.2)
- Resale of repurchased stock (Section 6.3.2.3)
- Accelerated share repurchase programs (Section 6.3.2.4)

Laws determine when an entity can repurchase its stock and may require a specific accounting treatment. For example, depending on the entity's place of incorporation, state law may require an entity to immediately retire the repurchased shares or allow an entity to hold and later reissue the repurchased shares. If laws conflict with the accounting requirements in U.S. GAAP, the accounting for treasury stock transactions must conform to the legal requirements.

The guidance in this section does not apply to the repurchase of an entity's preferred stock (see Section 6.3.3.6).

6.3.2.1 Allocation of Purchase Price to Repurchased Stock and Other Elements of the Transaction

FASB REFERENCES

ASC 505-30-25-3 through 25-4 and ASC 505-30-30-3 through 30-5

An entity must consider the facts and circumstances to determine whether the purchase price relates to elements other than the repurchased common stock. If the payment also relates to additional elements, the entity must allocate the purchase price between the repurchased shares and the other elements. Factors such as the following may indicate there is another element (for example, stated or unstated rights or privileges) in the transaction:

- The entity offers to repurchase shares from only one shareholder or a subset of shareholders
- The purchase price is significantly more than the common stock price in the open market or in transactions in which the identity of the selling shareholder is not important.

REPURCHASE PRICE IN EXCESS OF THE STOCK'S FAIR VALUE

An entity may need to allocate the purchase price to other transaction elements when it repurchases its common shares at a stated price that is significantly in excess of the shares' current market price. Unstated (or stated) rights or privileges received by the entity from the shareholder, such as the following, require an allocation of the purchase price:

- Abandoning specific acquisition plans
- Forgoing other planned transactions
- Settling a lawsuit
- Settling employment contracts
- Voluntarily restricting the purchase of the shares of the entity or its affiliates within a specified period.

If the transaction includes other elements requiring separate recognition, the entity recognizes the cost of the repurchased stock at its fair value at the date the major terms of the purchase agreement are reached. The excess purchase price is attributed to the other transaction elements and accounted for according to their substance. For example, payments to a shareholder or former shareholder in exchange for not purchasing more shares (such as in a standstill agreement) are expensed as incurred and not capitalized as assets. If the fair value of other elements is more clearly evident (for instance, because the entity's shares are not publicly traded), those other elements are recognized at their fair values and the difference is allocated to the cost of repurchased stock.

If no other elements require separate recognition, the entire purchase price is accounted for as the cost of repurchased stock. For instance, transactions in which a repurchase of an entity's stock at a price other than market price do occur for business reasons (for example, in a tender offer or in a purchase of a block of shares representing a controlling interest). In those circumstances, in the absence of the receipt of other elements, the entire purchase price is accounted for as the cost of repurchased stock.

U.S. GAAP does not specify how an entity must account for costs (such as legal and accounting costs) incurred to repurchase stock. AICPA Technical Question 4110.09, *Costs Incurred to Acquire Treasury Stock*, states that an entity can treat those costs similarly to stock issuance costs (as a reduction from the gross proceeds of the stock sale). Similarly, an entity can treat the costs of acquiring repurchased stock as an addition to the repurchase price.

6.3.2.2 Purchase and Retirement of Stock

FASB REFERENCES

ASC 505-30-30-6 through 30-9 and ASC 505-30-45-1

When an entity formally retires its shares or repurchases its outstanding shares for constructive retirement (with or without an intention to formally retire the shares in accordance with applicable laws), the entity recognizes the difference between the cost of the repurchased stock (see Section 6.3.2.1) and its par or stated value (commonly referred to as the "retirement method") as follows:

- If the stock's par or stated value exceeds the cost to repurchase it, the entity recognizes the excess by crediting APIC.
- If the cost of the repurchased stock exceeds its par or stated value, the entity may allocate the excess between APIC and retained earnings using one of the following accounting methods, which must be applied consistently:

METHOD	ACCOUNTING CONSIDERATIONS
Allocate excess between APIC and retained earnings	The maximum portion allocated to APIC is the sum of: ▶ All APIC resulting from previous retirements and net gains on sales of treasury stock of the same issue ▶ The pro rata portion of APIC, voluntary transfers of retained earnings, and capitalization of stock dividends on the same issue. For this purpose, any remaining APIC applicable to issues fully retired (formal or constructive) is deemed applicable pro rata to shares of common stock.
Charge entire excess to retained earnings	The entire excess may be allocated to retained earnings in recognition of the fact that an entity can always capitalize or allocate retained earnings for such purpose.

6.3.2.3 Purchase and Resale of Treasury Stock

FASB REFERENCES

ASC 505-30-25-7, ASC 505-30-25-9, and ASC 505-30-30-10

When stock is purchased but will not be immediately retired (or if ultimate disposition has not yet been decided), the cost of the treasury stock (see Section 6.3.2.1) may be presented separately as a deduction from the total of capital stock, APIC, and retained earnings (commonly referred to as the "cost method"). Alternatively, an entity may account for the treasury stock using the retirement method discussed in Section 6.3.2.2.

After an entity purchases treasury stock it may choose to resell it at a price higher or lower than the original purchase price. While that transaction might cause the entity's net asset value to increase or decrease, it relates to the entity's capital, so no gain or loss is recognized in the income statement. Instead, the resale of treasury stock is recognized as an equity transaction in the same manner as the issuance of common stock (see Section 6.3.1) because there is no substantive difference between the following transactions:

- The repurchase and retirement of treasury stock and the subsequent issuance of new common stock
- The repurchase and resale of treasury stock.

The difference between the resale price and the cost of treasury stock (determined based on the entity's accounting policy, such as last in, first out; first in, first out; average cost; or specific identification) is recognized in equity as follows:

Gain on Resale of Treasury Stock	Recognize as a credit to APIC
Loss on Resale of Treasury Stock	Recognize as a debit: ▶ To APIC until all the previous gains from the sale or retirement recognized in APIC of the same class of stock are exhausted ▶ Otherwise, to retained earnings

BDO INSIGHTS — RECOGNIZING LOSS ON RESALE OF TREASURY STOCK WHEN AN ENTITY HAS ACCUMULATED DEFICIT

We believe that when an entity has an accumulated deficit, it should recognize the loss on resale of treasury stock in APIC by analogy to the recognition of measurement adjustments to redeemable preferred stock under ASC 480-10-S99-2 (see Section 5.8.1). Once APIC is exhausted (the balance is zero), any additional losses should be recognized by increasing the accumulated deficit.

6.3.2.4 Accelerated Share Repurchase Programs

FASB REFERENCES

ASC 505-30-25-5 through 25-6 and ASC 505-30-55-1 through 55-6

An ASR program is typically used by a public entity to buy back a large block of its outstanding shares while simultaneously entering a forward contract on its own shares with settlement at a future date (either in cash or shares) based on its VWAP over the period the forward contract is outstanding. An ASR combines the benefits of an immediate share retirement under a tender offer (an immediate EPS effect) and the market effects and the pricing advantage of a disciplined daily open market stock repurchase program (the final price of the repurchased shares is determined by an average market price over a fixed period).

An entity must recognize an ASR as two separate transactions:

- The repurchase of common stock (a treasury stock transaction) on the purchase date (see Section 6.3.2.2)
- A forward contract on its own common stock.

The forward contract is an equity-linked instrument that the entity must first analyze under ASC 480 (see Chapter 2). Often, the forward contract is not subject to ASC 480 because while the contract may involve the issuance of a variable number of shares, the monetary value of the obligation is typically not solely or predominantly based on a fixed monetary amount or a variable other than the fair value of the entity's stock, or inversely related to the changes in the fair value of the entity's stock. However, an entity must evaluate all the relevant contract terms to determine whether any settlement could cause the contract to meet the conditions in ASC 480. If the contract is not subject to ASC 480, the entity must evaluate it in accordance with ASC 815-40 (see Chapter 4). If the forward contract meets the conditions for indexation and equity classification, it is recognized in equity and is not remeasured. If the forward contract does not meet the indexation or equity classification conditions, it is recognized as a liability that is initially and subsequently measured at fair value with changes in fair value recognized through earnings.

EXAMPLE 6-6 (ADAPTED FROM ASC 505-30-55-1 THROUGH 55-6): ACCELERATED SHARE REPURCHASE PROGRAM

FACTS

On July 1, 20X4, Entity A and an investment bank enter an ASR program for 1 million shares of Entity A's outstanding common stock.

The treasury stock transaction is effectuated as follows:

- The investment bank borrows 1 million shares of Entity A's common stock from investors and becomes the owner of record for the purchased shares.
- The investment bank then short sells the shares to Entity A at the stock's fair value of $50 per share. Entity A pays the investment bank $50 million in cash in settlement of the purchase transaction.
- Entity A holds the shares in treasury and has legal title to them. No other party has the right to vote those shares.

Simultaneously, Entity A and the investment bank enter a forward contract on 1 million shares of Entity A's common stock with the following terms:

- The forward contract's settlement (or maturity) date is October 1, 20X4.
- The settlement of the forward contract at maturity is computed based on the difference between the VWAP of Entity A's common stock during the contract period (July 1, 20X4, to October 1, 20X4) and the original purchase price of $50 per share less commission fees paid to the investment bank as follows:

IF ENTITY A'S VWAP IS:	SETTLEMENT
More than $50	Entity A will pay the investment bank the price difference multiplied by 1 million shares. It has the option to pay cash or the equivalent variable number of shares of its common stock.
Less than $50	The investment bank will deliver to Entity A cash equal to the price difference multiplied by 1 million shares.

CONCLUSION AND ANALYSIS

Entity A recognizes the ASR as two transactions:

- A treasury stock transaction for $50 million, resulting in the reduction of the outstanding shares on July 1, 20X4, when calculating the weighted-average outstanding shares for basic and diluted EPS.
- A forward contract that will be settled on October 1, 20X4, which Entity A analyzes in accordance with ASC 480 (see Chapter 2). If the contract is not subject to that guidance, Entity A analyzes it under ASC 815-40 (see Chapter 4).

6.3.3 Preferred Stock

FASB REFERENCES

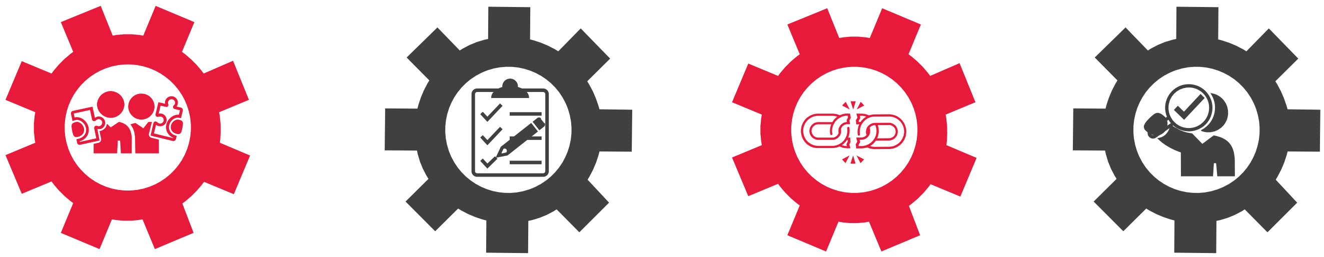
ASC 505-10-20: Preferred Stock

Preferred stock (preferred shares or units) is another typical form of ownership in an entity. Preferred stock is often issued in series financings by early-stage entities and sometimes through tranche issuances (see Section 3.5.3). It can have various features and typically has preferential rights to liquidation. It also often includes dividend rights, which may be cumulative, noncumulative, fixed, or participating (see Section 6.3.3.1). In some cases, the dividends may be paid in kind (see Section 6.3.3.2). Further, the preferred stock may be convertible into common stock at any time or based on the passage of time, or it may become convertible upon the occurrence of a contingent event (see

Section 6.3.3.4). It may be redeemable at the holder or entity's option and is often redeemable upon a deemed liquidation event. Often, preferred shareholders are also given a right to elect a specified number of board members.

An entity must first evaluate preferred stock under ASC 480 (see Chapter 2). Preferred stock that is mandatorily redeemable or that is convertible into a variable number of shares may be within the scope of ASC 480. Also, the entity must evaluate any embedded features in the preferred stock for potential bifurcation (see Chapter 3). If the entity prepares its financial statements in accordance with SEC Regulation S-X, it must determine if the preferred stock must be classified as temporary equity (see Chapter 5).

The graphic summarizes the steps to account for preferred stock.



Determine whether the preferred stock is freestanding from other financial instruments issued in the transaction (see Section 2.3.1).

Evaluate the preferred stock under ASC 480 (see Sections 2.4 and 2.6).

Determine whether the preferred stock has embedded features that require bifurcation (see Chapter 3).

Determine whether the temporary equity guidance applies (see Chapter 5).

Preferred stock classified as permanent equity under ASC 505-10 is initially recognized at an amount equal to the proceeds (for example, cash or fair value of consideration received) less the amount allocated to other instruments (if issued in a basket transaction) or other elements of the transaction (such as bifurcated derivatives). If an entity incurs costs that are incremental and directly attributable to the issuance of the preferred stock, it recognizes those costs as an offset against the total proceeds as a debit to equity (see Section 6.3).

U.S. GAAP does not require an entity to subsequently remeasure preferred stock classified in permanent equity unless its terms are modified (see Section 6.3.3.5) or it is reclassified to temporary equity (see Section 5.9). Further, an entity must consider the incremental guidance for increasing-rate preferred stock (see Section 6.3.3.3).

The derecognition via conversion or redemption of an equity-classified preferred stock does not affect an entity's earnings (see Section 6.3.3.6). However, if the entity presents EPS, the derecognition has a potential effect to the income available to common stockholders in computing basic and diluted EPS.

6.3.3.1 Preferred Stock Dividends

Preferred stock typically includes stated (contractual) dividends, which may be cumulative or noncumulative. Generally, cumulative dividends accumulate, whether declared or not, over time (or upon the occurrence of an event). When dividends are declared on preferred stock with cumulative dividends, the entity must pay the stated dividends for the current year and all the unpaid dividends from prior years. Therefore, cumulative dividends typically accrete to the preferred stock's liquidation or redemption value. In contrast, noncumulative dividends do not accrue until declared.

BDO INSIGHTS — DETERMINING WHEN TO RECOGNIZE DIVIDENDS

U.S. GAAP does not specify when an entity must recognize dividends on preferred stock. We believe an entity generally must recognize dividends payable when it has the legal obligation to pay the dividends (which is typically upon declaration by the entity's board of directors), consistent with AICPA Technical Q&A Section 4210.04.

However, in some cases, dividends may need to be recognized before they are declared, such as:

- When the preferred stock is presented in temporary equity and measured at redemption value, any unpaid cumulative dividends that must be paid upon redemption are recognized as part of the stock's redemption value regardless of whether the dividends are declared (see Section 5.6).
- When the preferred stock is accounted for as a liability under ASC 480 (see Section 2.4.5).

If the entity presents EPS and the preferred stock participates in dividends with common stock, the two-class method of computing EPS may be applicable under ASC 260 (see Section 8.4.2 for dividend disclosure requirements).

6.3.3.2 Paid-in-Kind Dividends

A PIK dividend feature requires or allows the entity to pay dividends in additional shares of preferred stock. Depending on the dividend's terms, the entity may distribute the dividend through either issuance of more preferred shares or an increase to the stock's liquidation preference.

BDO INSIGHTS — RECOGNIZING PIK DIVIDENDS

U.S. GAAP does not specify how an entity must recognize PIK dividends (see BDO Insights in Section 6.3.3.1). In practice, the accounting for PIK dividends depends on whether the dividends are nondiscretionary or discretionary. We believe the methods summarized below are acceptable but there may be other acceptable methods. The entity must choose a reasonable approach based on the facts and circumstances and apply that approach consistently.

PIK DIVIDEND IS:	DESCRIPTION	MEASUREMENT
Nondiscretionary	The issuer and holder cannot elect the form of payment for the dividend (for example, it must always be settled as PIK dividends).	▶ The entity recognizes PIK dividends based on the preferred stock's contractual dividend rate.
Discretionary	The issuer or holder of the instrument can choose to settle the dividend in cash or as PIK dividends.	▶ The entity recognizes PIK dividends based on the preferred stock's contractual dividend rate. ▶ Alternatively, we believe it would be acceptable to recognize PIK dividends based on the fair value of incremental PIK instruments issued at each dividend date by analogy to the accounting for stock dividends in ASC 505-20-30-3.

Determining the appropriate recognition of PIK dividends requires the application of professional judgment based on the facts and circumstances.

6.3.3.3 Increasing-Rate Preferred Stock

FASB REFERENCES

ASC 505-10-S99-7

Some preferred stock accrues little to no dividends in initial periods but requires the entity to pay increasing-rate dividends in later periods if the stock remains outstanding until a final stated dividend rate (the perpetual dividend rate) is reached. The purchase price (fair value) of the increasing-rate preferred stock is typically less than its stated value to reflect the difference between the market and contractual dividend rates, resulting in a discount from the stated value.

The discount represents the imputed dividend cost, computed using the market dividend rate on preferred stock with comparable terms. The entity must amortize the discount over the initial period using the interest method, recognizing the dividend cost against retained earnings and increasing the preferred stock's carrying amount by a corresponding amount.

The following SEC staff guidance illustrates the accounting for an increasing-rate preferred stock.

SEC STAFF GUIDANCE

SAB Topic 5.Q, Increasing Rate Preferred Stock

Facts: A registrant issues Class A and Class B nonredeemable preferred stock [FN19] on 1/1/X1. Class A, by its terms, will pay no dividends during the years 20X1 through 20X3. Class B, by its terms, will pay dividends at annual rates of $2, $4 and $6 per share in the years 20X1, 20X2 and 20X3, respectively. Beginning in the year 20X4 and thereafter as long as they remain outstanding, each instrument will pay dividends at an annual rate of $8 per share. In all periods, the scheduled dividends are cumulative.

[FN19] "Nonredeemable" preferred stock, as used in this SAB, refers to preferred stocks which are not redeemable or are redeemable only at the option of the issuer.

At the time of issuance, eight percent per annum was considered to be a market rate for dividend yield on Class A, given its characteristics other than scheduled cash dividend entitlements (voting rights, liquidation preference, etc.), as well as the registrant's financial condition and future economic prospects. Thus, the registrant could have expected to receive proceeds of approximately $100 per share for Class A if the dividend rate of $8 per share (the "perpetual dividend") had been in effect at date of issuance. In consideration of the dividend payment terms, however, Class A was issued for proceeds of $79 3/8 per share. The difference, $20 5/8, approximated the value of the absence of $8 per share dividends annually for three years, discounted at 8%.

The issuance price of Class B shares was determined by a similar approach, based on the terms and characteristics of the Class B shares.

Question 1: How should preferred stocks of this general type (referred to as "increasing rate preferred stocks") be reported in the balance sheet?

Interpretive Response: As is normally the case with other types of securities, increasing rate preferred stock should be recorded initially at its fair value on date of issuance. Thereafter, the carrying amount should be increased periodically as discussed in the Interpretive Response to Question 2.

Question 2: Is it acceptable to recognize the dividend costs of increasing rate preferred stocks according to their stated dividend schedules?

Interpretive Response: No. The staff believes that when consideration received for preferred stocks reflects expectations of future dividend streams, as is normally the case with cumulative preferred stocks, any discount due to an absence of dividends (as with Class A) or gradually increasing dividends (as with Class B) for an initial period represents prepaid, unstated dividend cost. [FN20] Recognizing the dividend cost of these instruments according to their stated dividend schedules would report Class A as being cost-free, and would report the cost of Class B at less than its effective cost, from the standpoint of common stock interests (i.e., for purposes of computing income applicable to common stock and earnings per common share) during the years 20X1 through 20X3.

[FN20] As described in the "Facts" section of this issue, a registrant would receive less in proceeds for a preferred stock, if the stock were to pay less than its perpetual dividend

SEC STAFF GUIDANCE

for some initial period(s), than if it were to pay the perpetual dividend from date of issuance. The staff views the discount on increasing rate preferred stock as equivalent to a prepayment of dividends by the issuer, as though the issuer had concurrently (a) issued the stock with the perpetual dividend being payable from date of issuance, and (b) returned to the investor a portion of the proceeds representing the present value of certain future dividend entitlements which the investor agreed to forgo.

Accordingly, the staff believes that discounts on increasing rate preferred stock should be amortized over the period(s) preceding commencement of the perpetual dividend, by charging imputed dividend cost against retained earnings and increasing the carrying amount of the preferred stock by a corresponding amount. The discount at time of issuance should be computed as the present value of the difference between (a) dividends that will be payable, if any, in the period(s) preceding commencement of the perpetual dividend; and (b) the perpetual dividend amount for a corresponding number of periods; discounted at a market rate for dividend yield on preferred stocks that are comparable (other than with respect to dividend payment schedules) from an investment standpoint. The amortization in each period should be the amount which, together with any stated dividend for the period (ignoring fluctuations in stated dividend amounts that might result from variable rates, [FN21] *results in a constant rate of effective cost vis-a-vis the carrying amount of the preferred stock (the market rate that was used to compute the discount).*

[FN21] *See Question 3 regarding variable increasing rate preferred stocks.*

Simplified (ignoring quarterly calculations) application of this accounting to the Class A preferred stock described in the "Facts" section of this bulletin would produce the following results on a per share basis:

Carrying amount of preferred stock

	Beginning of Year (BOY)	Imputed Dividend (8% of carrying Amount at BOY)	End of year
Year 20X1	$ 79.38	6.35	85.73
Year 20X2	85.73	6.86	92.59
Year 20X3	92.59	7.41	100.00

During 20X4 and thereafter, the stated dividend of $8 measured against the carrying amount of $100 [FN22] *would reflect dividend cost of 8%, the market rate at time of issuance.*

[FN22] *It should be noted that the $100 per share amount used in this issue is for illustrative purposes, and is not intended to imply that application of this issue will necessarily result in the carrying amount of a nonredeemable preferred stock being accreted to its par value, stated value, voluntary redemption value or involuntary liquidation value.*

The staff believes that existing authoritative literature, while not explicitly addressing increasing rate preferred stocks, implicitly calls for the accounting described in this bulletin.

The pervasive, fundamental principle of accrual accounting would, in the staff's view, preclude registrants from recognizing the dividend cost on the basis of whatever cash payment schedule

SEC STAFF GUIDANCE

might be arranged. Furthermore, recognition of the effective cost of unstated rights and privileges is well-established in accounting, and is specifically called for by FASB ASC Subtopic 835-30, Interest—Imputation of Interest, and Topic 3.C of this codification for unstated interest costs of debt capital and unstated dividend costs of redeemable preferred stock capital, respectively. The staff believes that the requirement to recognize the effective periodic cost of capital applies also to nonredeemable preferred stocks because, for that purpose, the distinction between debt capital and preferred equity capital (whether redeemable [FN23] or nonredeemable) is irrelevant from the standpoint of common stock interests.

[FN23] Application of the interest method with respect to redeemable preferred stocks pursuant to Topic 3.C results in accounting consistent with the provisions of this bulletin irrespective of whether the redeemable preferred stocks have constant or increasing stated dividend rates. The interest method, as described in FASB ASC Subtopic 835-30, produces a constant effective periodic rate of cost that is comprised of amortization of discount as well as the stated cost in each period.

When an increasing-rate preferred stock has a variable dividend rate, an entity calculates the initial discount and subsequent amortization using the applicable index at the issuance date. Future changes in the index do not affect the amortization, as discussed in the following SEC staff guidance.

SEC STAFF GUIDANCE

SAB Topic 5.Q, Increasing Rate Preferred Stock

Question 3: Would the accounting for discounts on increasing rate preferred stock be affected by variable stated dividend rates?

Interpretive Response: No. If stated dividends on an increasing rate preferred stock are variable, computations of initial discount and subsequent amortization should be based on the value of the applicable index at date of issuance and should not be affected by subsequent changes in the index.

For example, assume that a preferred stock issued 1/1/X1 is scheduled to pay dividends at annual rates, applied to the stock's par value, equal to 20% of the actual (fluctuating) market yield on a particular Treasury security in 20X1 and 20X2, and 90% of the fluctuating market yield in 20X3 and thereafter. The discount would be computed as the present value of a two-year dividend stream equal to 70% (90% less 20%) of the 1/1/X1 Treasury security yield, annually, on the stock's par value. The discount would be amortized in years 20X1 and 20X2 so that, together with 20% of the 1/1/X1 Treasury yield on the stock's par value, a constant rate of cost vis-a-vis the stock's carrying amount would result. Changes in the Treasury security yield during 20X1 and 20X2 would, of course, cause the rate of total reported preferred dividend cost (amortization of discount plus cash dividends) in those years to be more or less than the rate indicated by discount amortization plus 20% of the 1/1/X1 Treasury security yield. However, the fluctuations would be due solely to the impact of changes in the index on the stated dividends for those periods.

6.3.3.4 Convertible Preferred Stock

FASB REFERENCES

ASC 260-10-30-1 through 30-2, ASC 260-10-35-1, ASC 260-10-45-12B, ASC 260-10-S99-2, ASC 480-10-30-2, ASC 505-10-05-5 through 05-7, ASC 505-10-15-2(d), ASC 505-10-20: Contingently Convertible Instruments, Convertible Security, and Down Round Feature, and ASC 505-10-35-1

The terms of preferred stock may allow, or in some circumstances may require, the holder or entity to convert the preferred stock to shares of an entity's common stock. The preferred stock may be convertible into common stock at any time or based on the passage of time, or it may become convertible upon the occurrence of a contingent event.

An entity must first evaluate preferred stock under ASC 480 (see Chapter 2). Preferred stock that is mandatorily redeemable or that is convertible into a variable number of shares may be subject to ASC 480. An entity must also evaluate the conversion feature for potential bifurcation in accordance with ASC 815-15.

To evaluate an embedded feature for potential bifurcation, an entity must first determine whether the preferred stock is more akin to equity or debt (see Section 3.4.1.1). A conversion feature is equity-like and is therefore clearly and closely related to an equity host instrument. If the preferred stock is more akin to equity, the conversion feature is not bifurcated from the preferred stock (see Section 3.5.1).

On the other hand, because a conversion feature is equity-like, it is not clearly and closely related to a debt host instrument. Therefore, the analysis focuses on whether the conversion feature would be a derivative instrument if it were freestanding (including whether it meets the derivative scope exception in ASC 815-10-15-74(a) (see Section 3.6.1)). If the conversion feature does not meet the definition of a derivative instrument or qualifies for a derivative scope exception, it is not bifurcated from the preferred stock. If the conversion feature meets the definition of a derivative and does not qualify for a derivative scope exception, it must be bifurcated from the preferred stock. The bifurcated conversion feature is recognized initially and subsequently at fair value.

The entity accounts for the preferred stock in ASC 505-10 (if classified as permanent equity), ASC 480-10-S99-3A (if classified as temporary equity), ASC 480 (if classified as a liability), or ASC 470-20 (if classified as a liability with a substantial premium).

The table summarizes common conversion features in preferred stock.

CONVERSION FEATURE	DESCRIPTION
Traditional convertible preferred stock	Convertible into another equity security at a fixed conversion rate. For example, each share of preferred stock is convertible into two shares of common stock.
Combined fixed and variable conversion rate	Convertible into common stock at the lower of: ▶ A fixed conversion rate ▶ A discount to the common stock price (for example, convertible at 80% of the common stock price at the date of conversion). The feature is evaluated as a redemption feature (see Section 3.6.3).
Contingent conversion feature	The conversion feature is exercisable based on either: ▶ A market price trigger (a market condition based at least in part on the entity's own stock price) ▶ Multiple contingencies if one of the contingencies is a market price trigger and the instrument can be converted or share settled upon meeting the specified market condition.

CONVERSION FEATURE	DESCRIPTION
Contingently adjustable conversion ratio	The conversion feature adjusts based on a future event such as: ▶ A liquidation event or change in control ▶ A future financing at a price lower than the preferred stock's original conversion price ▶ An IPO at a price lower than a specified price.
Contingently exercisable conversion feature	The conversion feature is exercisable only upon a future event outside the holder's control.

RECLASSIFICATION OF CONVERTIBLE PREFERRED STOCK TO LIABILITY

Preferred stock that an entity must redeem (at a stated date or upon occurrence of an event that is certain to occur) and that has a substantive conversion option exercisable by the holder before redemption does not meet the definition of a mandatorily redeemable share in ASC 480. That is because the holder may choose to convert the preferred stock, so there is a possibility the stock will not be redeemed. However, if the conversion option expires, the conditionally redeemable share becomes mandatorily redeemable, and the entity reclassifies the share from equity to liability at its then-fair value. The entity recognizes no gain or loss on reclassification.

Reclassifications of preferred stock affect the computation of EPS in accordance with ASC 260-10-S99-2. The difference between the share's carrying amount and its fair value on the date of reclassification is treated like dividends on preferred stock and is recorded as a charge to retained earnings (or APIC in the absence of retained earnings) and an adjustment to net income available to common shareholders in computing EPS (see Section 2.4.6).

RECOGNIZING THE EFFECT OF A DOWN ROUND FEATURE IN A NONBIFURCATED CONVERSION OPTION

Many convertible preferred stock instruments include terms that adjust the conversion price if an entity sells shares at a price below the current conversion price or issues an equity-linked financial instrument with an exercise price lower than the preferred stock's current conversion price. In accordance with ASC 815-40-15-5D, such down round feature does not preclude a conversion feature from being indexed to the entity's own stock (see Section 4.5.2.3). If the conversion feature does not meet all the criteria for bifurcation, it is not bifurcated from the preferred stock.

An entity that presents EPS in accordance with ASC 260 must recognize the value of the effect of the down round feature (when that feature is triggered) as a deemed dividend (see Section 6.3.5.1), which reduces income available to common stockholders in computing basic EPS. The deemed dividend is measured as the difference between the following amounts (determined immediately after the down round feature is triggered):

- The fair value of the preferred stock (without the down round feature) with the conversion price immediately before the down round adjustment
- The fair value of the preferred stock (without the down round feature) with the conversion price immediately after the down round adjustment.

An entity recognizes the effect of a down round feature each time it is triggered but does not subsequently remeasure the effect of a down round feature previously recognized. Further, the entity does not subsequently amortize the APIC that resulted from recognizing the effect of the down round feature.

6.3.3.5 Modification of Terms or Exchange of Preferred Stock

An entity may exchange or modify the terms of its outstanding preferred stock for various reasons (for example, as part of an overall equity restructuring or in connection with issuing new series of preferred stock). An entity accounts for the modification or exchange of liability-classified preferred stock in accordance with ASC 470-50. See BDO's publication, **Troubled Debt Restructuring, Debt Modification, and Extinguishment** for more guidance on modifications (or exchanges) under ASC 470-50. However, U.S. GAAP does not specify how an entity must recognize an amendment to equity-classified preferred stock. Therefore, entities generally refer to the following SEC staff guidance, which indicates that an amendment to the preferred stock is accounted for as either an extinguishment or modification based on the significance of the amendment.

SEC STAFF GUIDANCE

Remarks before the 2014 AICPA Conference on Current SEC and PCAOB Developments

T. Kirk Crews, Professional Accounting Fellow, Office of the Chief Accountant

December 8, 2014

Accounting for amendments to or exchanges of preferred stock

> *The staff believes that an amendment to preferred stock can be of such significance that it represents an extinguishment of the existing preferred stock and the issuance of new preferred stock. On the other hand, the staff also believes that an amendment to preferred stock, while important to the parties, can lack the same level of significance and is more appropriately characterized as a modification. We believe current accounting literature supports this view. First, debt literature acknowledges that certain changes are merely modifications while other changes should be captured by extinguishment accounting. The staff believes it is appropriate to apply similar analysis to preferred stock. Second, in September 2009 when technical corrections were made to the scoping guidance to ASC 260-10-S99, the staff believed exchanges of preferred stock could be either extinguishments or modifications.* [Footnotes omitted]

That SEC staff guidance also discusses potential approaches to determine how to account for an amendment of preferred stock, indicating that the below approaches are acceptable in evaluating whether an amendment of preferred stock is accounted for as an extinguishment (see Section 6.3.3.5.1) or modification (see Section 6.3.3.5.2):

APPROACH	DESCRIPTION	EXTINGUISHMENT OR MODIFICATION	WHEN TO USE
Qualitative Approach	Consider the significance of any substantive contractual terms added, removed, or changed. Substantive contractual terms are those that are at least reasonably possible of being exercised. Factors to consider include: ▶ the business purpose for the changes ▶ how the changes may influence the economic decisions of the holder	▶ Qualitatively significant changes are an extinguishment. ▶ Qualitatively insignificant changes are a modification.	Generally, when the changes to the preferred stock instrument are either clearly insignificant or clearly substantial

APPROACH	DESCRIPTION	EXTINGUISHMENT OR MODIFICATION	WHEN TO USE
Cash Flow Approach	Compare the contractual cash flows immediately before and after the amendment, consistent with the 10% cash flow test in ASC 470-50.	▶ Changes in the present value of the cash flows of at least 10% are significant and accounted for as an extinguishment. ▶ Changes in the present value of the cash flows less than 10% are insignificant and are accounted for as a modification.	The preferred stock has well-defined periodic cash flows.
Fair Value Approach	Compare the preferred stock's fair values immediately before and after the amendment.	▶ Changes in fair value of at least 10% are significant and accounted for as an extinguishment. ▶ Changes in fair value less than 10% are insignificant and accounted for as a modification.	The preferred stock does not have well-defined cash flows and the qualitative approach is not conclusive.

In practice, the qualitative approach is most common. While there might be other options, an approach that considers only a legal exchange that results in the issuance of new preferred stock as an extinguishment (legal form approach) would likely not be appropriate. An entity may view the legal form of the transaction as one data point, but that factor is not determinative on its own when analyzing whether to recognize an amendment or exchange of preferred stock as a modification or extinguishment.

6.3.3.5.1 Accounting for an Amendment or Exchange as an Extinguishment of Preferred Stock

FASB REFERENCES

ASC 260-10-S99-2

An amendment of terms or exchange of preferred stock accounted for as an extinguishment results in a new basis of accounting for the amended or exchanged instrument. The entity recognizes the amended or exchanged shares at their fair value and derecognizes the carrying amount of the original shares.

The graphic shows the effect of an amendment accounted for as an extinguishment.

The fair value of the amended or exchanged preferred stock − The carrying amount of the preferred stock (net of issuance costs) on the extinguishment date = Effect of Extinguishment

The entity recognizes the effect of the extinguishment like a redemption as follows:

- If the fair value of the amended or exchanged preferred stock is more than the carrying amount of the original preferred stock, recognize the excess as a deemed dividend (as a charge to retained earnings or, in the absence of retained earnings, as APIC (see Section 6.3.5.1)). For entities presenting EPS, recognize the deemed dividend as a reduction to income available to common stockholders in computing EPS.
- If the carrying amount of the original preferred stock is more than the fair value of the amended or exchanged preferred stock, recognize the difference as either a credit to retained earnings or to APIC, and for entities presenting EPS, as an addition to income available to common stockholders in computing EPS.

6.3.3.5.2 Accounting for an Amendment or Exchange as a Modification of Preferred Stock

FASB REFERENCES

ASC 718-20-35-3

In the absence of guidance in U.S. GAAP, entities may analogize to the modification model for share-based compensation in ASC 718-20 when accounting for modifications to equity-classified preferred stock instruments. Under that model, an entity recognizes any increase in fair value that results from the modification by comparing the fair values of the preferred stock immediately before and after modification. The entity recognizes any increase in value, typically as a deemed dividend (see Section 6.3.5.1), and does not recognize a decrease in fair value.

SEC STAFF GUIDANCE

Remarks before the 2014 AICPA Conference on Current SEC and PCAOB Developments

T. Kirk Crews, Professional Accounting Fellow, Office of the Chief Accountant

December 8, 2014

Accounting for Preferred Stock Modifications

> *Assuming a registrant concludes an amendment to or exchange of preferred stock does not represent an extinguishment, the next question is how to account for the modification.*
>
> *The staff often observes and believes it is appropriate to analogize to the modification guidance contained in Subtopic 718-20, which addresses modifications to equity-classified share-based payment awards. With respect to measurement, one compares the fair value of the preferred stock after the modification to the fair value of the preferred stock immediately before the modification. If the modified instrument's fair value exceeds the fair value of the original instrument, then the entity recognizes the additional fair value to reflect the modification. With respect to recognition, the staff has not objected to recording the additional fair value to retained earnings as a deemed dividend from the entity to the preferred stockholders. In certain unique circumstances, it may be appropriate to reflect the debit as a charge to earnings as a form of compensation for agreeing to restructure. While the staff has accepted both views, our conclusion is highly dependent on the underlying purpose for and circumstances surrounding the modification.* [Footnotes omitted]

RECOGNIZING THE EFFECT OF MODIFICATION

Generally, an entity must recognize as a deemed dividend any incremental fair value resulting from the modification (see Section 6.3.5.1). In some unique circumstances, including when alignment with a particular investor is viewed as beneficial to the reporting entity, it may be appropriate for an entity to expense the incremental fair value as a form of compensation for agreeing to restructure.

Determining the appropriate recognition for a modification of preferred stock requires the use of professional judgment based on the facts and circumstances.

6.3.3.6 Derecognition of Preferred Stock

FASB REFERENCES

ASC 260-10-S99-2

The derecognition via conversion or redemption of an equity-classified preferred stock does not affect an entity's earnings. However, if the entity presents EPS, the derecognition could have an effect on the income available to common stockholders in computing EPS.

The table includes transactions that result in derecognition of preferred stock.

DERECOGNITION EVENT	DESCRIPTION	GUIDANCE
Conversion	Preferred stock converts to another class of stock pursuant to the stated conversion privileges in the agreement.	Section 6.3.3.6.1
Induced conversion	Preferred stock converts to another class of stock based on a limited-time offer that changes conversion privileges (including payment of additional consideration) to induce prompt conversion.	Section 6.3.3.6.2
Redemption	Preferred stock is redeemed in exchange for shares, cash, or other assets.	Section 6.3.3.6.3
Amendment or exchange accounted for as an extinguishment	An amendment or exchange of preferred stock instruments that results in extinguishment accounting is in substance a redemption of the preferred stock for new preferred stock.	Section 6.3.3.5.1
Reclassification from equity to liability	If an entity must reclassify preferred stock from equity to a liability, that reclassification is in substance a redemption of the preferred stock for debt.	Section 6.3.3.4

6.3.3.6.1 Preferred Stock Conversion

FASB REFERENCES

ASC 260-10-S99-2

Whether preferred stock is equity or liability classified, a conversion pursuant to its stated conversion privileges has no effect on retained earnings or EPS. Upon conversion, the entity debits the preferred stock and credits the capital account for the shares issued upon conversion.

In contrast, if the preferred stock is converted into a different number of common shares or a different class of shares than provided by the instrument's stated conversion privileges, and the conversion does not meet the conditions for an induced conversion (see Section 6.3.3.6.2), the entity recognizes the issuance of shares in settlement of the preferred stock as an extinguishment (see Section 6.3.3.6.3).

6.3.3.6.2 Preferred Stock Induced Conversion

FASB REFERENCES

ASC 260-10-S99-2

An entity must consider the guidance in ASC 470-20 to determine whether the conversion of a preferred stock is pursuant to an inducement offer (see Section 6.2.4.4). If the preferred stock converts into shares of another class of the entity's stock (for example, common stock) pursuant to an inducement offer, the SEC staff has said the entity must reduce the income available to common stockholders in computing EPS for the excess of:

- The fair value of all securities and other consideration transferred by the entity to the holders of the convertible preferred stock over
- The fair value of securities issuable pursuant to the original conversion terms

The entity recognizes the effect of the induced conversion as a deemed dividend (a charge to retained earnings or, in the absence of retained earnings, to APIC (see Section 6.3.5.1)).

6.3.3.6.3 Preferred Stock Extinguishment or Redemption

FASB REFERENCES

ASC 260-10-S99-2

An entity recognizes the settlement of an equity-classified preferred stock (for example, through an exercise of a redemption feature) as an extinguishment if the settlement is other than a conversion (either pursuant to stated conversion privileges or an induced conversion).

The graphic below shows the effect of a preferred stock extinguishment.

The fair value of the consideration an entity transfers to the holder − The carrying amount of the preferred stock (net of issuance costs) on the extinguishment date = Effect of Extinguishment

The entity recognizes the effect of a preferred stock extinguishment as follows:

- If the fair value of the consideration transferred to the holder is more than the carrying amount of the preferred stock, recognize the excess as a deemed dividend (a charge to retained earnings or, in the absence of retained earnings, as APIC (see Section 6.3.5.1)); for entities presenting EPS, recognize the excess as a deduction to income available to common stockholders in computing EPS.
- If the carrying amount of the preferred stock is more than the fair value of the consideration transferred, recognize the difference as either a credit to retained earnings or APIC; for entities presenting EPS, recognize the difference as an addition to income available to common stockholders in computing EPS.

The accounting for a preferred stock's extinguishment is the same whether an embedded conversion option is in- or out-of-the-money at the time of redemption.

6.3.4 Changes in Capital Structure

FASB REFERENCES

ASC 260-10-55-12, ASC 505-10-S99-4, ASC 505-20-15-1 through 15-3A, ASC 505-20-20: Stock Dividend and Stock Split, ASC 505-20-25-1, and ASC 505-20-25-4

ASC 505-20, *Stock Dividends and Stock Splits*, includes guidance on determining whether a stock dividend or split must be accounted for according to its form or based on its substance. The guidance applies to corporations and all stock dividends and splits. It does not apply to a distribution or issuance to shareholders of any of the following:

- Shares of another corporation held as an investment
- Subscription rights for additional shares
- Shares of a different class
- Shares of the same class if each shareholder can choose to receive cash or shares, including a distribution having both of the following characteristics:
  - The shareholder can choose to receive the entire distribution in cash or shares of equivalent value
  - There is a potential limitation on the total cash that all shareholders can elect to receive in the aggregate (an entity must analyze a commitment to make the distribution in accordance with ASC 480 (see Chapter 2)).

A stock split occurs when an entity issues its own common shares to its common shareholders for no consideration under conditions that indicate the split is mainly to increase the number of outstanding shares to effect a reduction in their per share price and obtain a wider distribution and improved marketability of the shares (see Section 6.3.4.1).

A stock dividend occurs when an entity issues its own common shares to its common shareholders for no consideration and under conditions that indicate the dividend is mainly to give the shareholders some ostensibly separate evidence of a part of their respective interests in the entity's accumulated earnings without distributing the entity's cash or other property. Therefore, it does not reduce the entity's assets, but it also does not add to the shareholders' interests; the proportional interest of each shareholder remains the same (see Section 6.3.4.2).

Depending on its size and other factors, a stock distribution is accounted for as either a stock split or stock dividend (see Section 6.3.4.3).

An entity must retroactively reflect in the balance sheet the stock dividends or splits that occur after the balance sheet date but before the financial statements are issued. It also must disclose the retroactive treatment in a footnote to the financial statements (that must be cross-referenced on the balance sheet) and state when the stock dividend or split became effective.

The SEC staff has provided the following guidance.

SEC STAFF GUIDANCE

SAB Topic 4.C, Changes in Capital Structure

Facts: A capital structure change to a stock dividend, stock split or reverse split occurs after the date of the latest reported balance sheet but before the release of the financial statements or the effective date of the registration statement, whichever is later.

Question: What effect must be given to such a change?

Interpretive Response: Such changes in the capital structure must be given retroactive effect in the balance sheet.

An appropriately cross-referenced note should disclose the retroactive treatment, explain the change made and state the date the change became effective.

If an entity presents EPS, it must retroactively adjust basic and diluted EPS for all periods presented for the effect of the stock dividend or split. Further, if the stock dividend or split occurred after the balance sheet date but before the issuance of the financial statements, the EPS computations include the number of shares adjusted for the effects of the stock dividend or split.

6.3.4.1 Accounting for Stock Splits

FASB REFERENCES

ASC 505-20-30-6

When an entity executes a stock split, it does not adjust retained earnings unless there is a legal requirement to do so. In a typical stock split, the number of shares and total par value are adjusted to reflect the new number of outstanding shares and new total par value. The entity adjusts the capital stock (reflecting par value) and APIC, if presented separately. If the total par value did not change because the par value per share is proportionally adjusted for the split, the entity does not make any adjustment to the capital accounts.

6.3.4.2 Accounting for Stock Dividends

FASB REFERENCES

ASC 505-20-05-2, ASC 505-20-25-2 through 25-3, and ASC 505-20-30-3 through 30-5

Shareholders may view stock dividends as distributions of corporate earnings equivalent to the fair value of the underlying stock. Stock dividends generally do not affect the stock price when they are proportionally small in comparison with the shares outstanding before the stock dividend (commonly referred to as "small" or "ordinary" stock dividends). In those cases, the fair value of the shares previously held does not substantially change because of the stock dividend.

An entity recognizes ordinary stock dividends by debiting retained earnings for the fair value of the new shares issued and crediting the corresponding capital stock and APIC accounts. The adjustment is done to reflect the transfer of value the shareholder may believe to have been distributed from retained earnings, thereby excluding those amounts from possible future distributions.

For a closely held entity, shareholders are presumed to have intimate knowledge of the entity's affairs, so they are not presumed to view stock dividends as distributions of corporate earnings. Therefore, the entity does not need to capitalize retained earnings in those cases unless the law requires it.

Some state laws require capitalizing only the par value of the shares issued (or, for shares with no par value, an amount within the board of directors' discretion). Those legal requirements are minimum requirements and do not prevent an entity from capitalizing a larger amount per share.

In other cases, stock dividends may reasonably be expected to reduce the stock price, in which case, it may in substance be a stock split. The point at which the relative size of the stock issuance is considered large enough to materially influence the stock price depends on the entity's facts and circumstances and the underlying market conditions of the entity's stock. However, a stock issuance of less than 20% to 25% of the number of previously outstanding shares is generally accounted for as a stock dividend rather than a stock split (see Sections 6.3.4.1 and 6.3.4.3).

BDO INSIGHTS — ACCOUNTING FOR A STOCK DIVIDEND WHEN AN ENTITY HAS AN ACCUMULATED DEFICIT

When an entity has an accumulated deficit, it must consider the governing state laws (for instance, whether the laws of the state where the entity is incorporated allow payment of dividends despite the accumulated deficit). Based on the facts and circumstances, when there is an accumulated deficit, we believe that when stock dividends:

- Are paid to common shareholders, it may be appropriate to reclassify only the stock's par value from APIC to common stock
- Are paid to preferred shareholders, it may be appropriate to charge the stock dividends to APIC by analogy to ASC 480-10-S99-2 (see Section 5.8.1) until it is exhausted.

Determining the proper recognition of stock dividends when in an accumulated deficit position requires the application of professional judgment based on the facts and circumstances.

6.3.4.3 Distinguishing Stock Dividends From Stock Splits

FASB REFERENCES

ASC 505-20-25-3 and ASC 505-20-25-6

The size of a stock distribution compared to the outstanding stock before the dividend affects the accounting for that distribution. Small or ordinary stock dividends are accounted for as stock dividends (see Section 6.3.4.2), while large stock dividends are accounted for as stock splits (see Section 6.3.4.1).

Although an entity must consider how it represents the nature of the stock issuance to its shareholders, under U.S. GAAP, the issuance of new shares of less than 20% or 25% of the previously outstanding shares or the frequent recurrence of stock distributions is generally accounted for as a stock dividend (even if the entity may have represented it to be a stock split). The SEC staff also has said it generally views stock distributions of less than 25% as stock dividends.

6.3.5 Other Equity Transactions

FASB REFERENCES

ASC 505-10-25-1 through 25-2

In practice, numerous transactions may be deemed capital transactions (such as transactions that are in essence distributions or capital contributions). An entity must apply professional judgment in evaluating transactions with stockholders based on the facts and circumstances.

Also, ASC 505-10 states that equity transactions must not be included in the determination of income. For instance:

- An entity cannot use APIC to relieve income of charges that would otherwise be made to the income statement in the current or future years, except as it relates to reorganizations in ASC 852-20-25-2.
- All of the following must be excluded from the determination of net income or the results of operations:
  - Adjustments or charges or credits resulting from transactions in the entity's own stock, except when other elements of the transaction require separate recognition (see Section 6.3.2.1)
  - Transfers to and from accounts properly designated as appropriated retained earnings
  - Adjustments made pursuant to a quasi-reorganization.

6.3.5.1 Transfers of Value to Stockholders (Deemed Dividends)

Dividends generally refer to distributions of value to stockholders (paid or payable in cash, other assets, common stock, or another class of stock) for no consideration. Similarly, deemed dividends result from transactions that involve a transfer of value to equity instrument holders. An entity recognizes deemed dividends similar to regular dividends, which is as an adjustment to:

- Retained earnings (or APIC in the absence of retained earnings)
- Income available to common stockholders in computing EPS (if the entity presents EPS).

The table includes examples of equity transactions that typically result in recognition of deemed dividends.

TRANSACTION	DESCRIPTION	GUIDANCE
Modification of terms or exchange of preferred stock	When preferred stock is modified or exchanged for another preferred stock instrument, that may result in recognizing a deemed dividend.	Section 6.3.3.5
Induced conversion of preferred stock	When preferred stock converts based on a limited-time offer that changes conversion privileges (including payment of additional consideration) to induce prompt conversion, the effect is recognized as a deemed dividend.	Section 6.3.3.6.2
Redemption of preferred stock	When preferred stock is redeemed for cash, other assets, or shares, it is extinguished, and the effect is recognized as a deemed dividend.	Section 6.3.3.6.3
Reclassification of preferred stock to liability	If preferred stock is reclassified from equity to liability, the reclassification is in substance a redemption of the preferred stock for debt. The redemption or extinguishment of preferred stock is recognized as a deemed dividend.	Section 6.3.3.4

TRANSACTION	DESCRIPTION	GUIDANCE
Subsequent measurement of preferred stock classified as temporary equity	The subsequent measurement of preferred stock that is classified as temporary equity and is currently redeemable or probable of becoming redeemable is recognized as a deemed dividend.	Section 5.8.1
Down round adjustment	An entity that presents EPS recognizes the value of the effect of the down round feature as a deemed dividend when the feature is triggered.	Sections 4.5.2.3 and 6.3.3.4
Modification of equity-classified equity-linked instrument	An entity recognizes the effect of the modification or exchange of an equity-linked instrument in the same manner as if cash had been paid. If the modification or exchange is not related to equity or debt financings or in the scope of other U.S. GAAP, the entity recognizes an increase in fair value as a deemed dividend.	Section 4.9

BDO INSIGHTS — RECOGNIZING DEEMED DIVIDENDS WHEN AN ENTITY HAS AN ACCUMULATED DEFICIT

When an entity has an accumulated deficit, we believe it is appropriate to recognize deemed dividends in APIC until it is exhausted (zero). Then the entity would recognize any additional deemed dividends as an adjustment to accumulated deficit.

Determining the appropriate treatment for deemed dividends requires the application of professional judgment based on the facts and circumstances, including considering applicable state laws and the entity's corporate charter, bylaws, and other governing documents.

6.3.5.2 Transfers of Value by Stockholders on Behalf of the Entity (Deemed Capital Contribution)

FASB REFERENCES

ASC 220-10-S99-4

An entity does not typically account for transactions between stockholders and other parties (for example, a stockholder's transfer of its shares to another stockholder). However, when a transaction by a stockholder is made for the entity's benefit, the entity must evaluate if the transaction is in essence a capital contribution, as noted in the following SEC staff guidance.

SEC STAFF GUIDANCE

SAB Topic 5.T, Accounting for Expenses or Liabilities Paid by Principal Stockholder(s)

> *Facts: Company X was a defendant in litigation for which the company had not recorded a liability in accordance with FASB ASC Topic 450, Contingencies. A principal stockholder* [FN34] *of the company transfers a portion of his shares to the plaintiff to settle such litigation. If the company had settled the litigation directly, the company would have recorded the settlement as an expense.*

SEC STAFF GUIDANCE

> *[FN34] The FASB ASC Master Glossary defines principal owners as "owners of record or known beneficial owners of more than 10 percent of the voting interests of the enterprise."*

Question: Must the settlement be reflected as an expense in the company's financial statements, and if so, how?

Interpretive Response: Yes. The value of the shares transferred should be reflected as an expense in the company's financial statements with a corresponding credit to contributed (paid-in) capital.

The staff believes that such a transaction is similar to those described in FASB ASC paragraph 718-10-15-4 (Compensation—Stock Compensation Topic), which states that "share-based payments awarded to a grantee by a related party or other holder of an economic interest in the entity as compensation for goods or services provided to the reporting entity are share-based payment transactions to be accounted for under this Topic unless the transfer is clearly for a purpose other than compensation for goods or services to the reporting entity." As explained in this paragraph, the substance of such a transaction is that the economic interest holder makes a capital contribution to the reporting entity, and the reporting entity makes a share-based payment to its grantee in exchange for goods or services provided to the reporting entity.

The staff believes that the problem of separating the benefit to the principal stockholder from the benefit to the company cited in FASB ASC Topic 718 is not limited to transactions involving stock compensation. Therefore, similar accounting is required in this and other[FN36] transactions where a principal stockholder pays an expense for the company, unless the stockholder's action is caused by a relationship or obligation completely unrelated to his position as a stockholder or such action clearly does not benefit the company. ...

> *[FN36] For example, SAB Topic 1.B indicates that the separate financial statements of a subsidiary should reflect any costs of its operations which are incurred by the parent on its behalf. Additionally, the staff notes that AICPA Technical Practice Aids §4160 also indicates that the payment by principal stockholders of a company's debt should be accounted for as a capital contribution.*

Transactions of the type discussed in the facts given . . . appear to be transacted to provide a benefit to the stockholder through the enhancement or maintenance of the value of the stockholder's investment. The staff believes that the substance of such transactions is the payment of an expense of the company through contributions by the stockholder. Therefore, the staff believes it would be inappropriate to account for such transactions according to the form of the transaction. [Some footnotes omitted]

BDO INSIGHTS — APPLICATION OF SAB TOPIC 5.T TO PRIVATE ENTITIES

Although SEC staff accounting bulletins (SABs) provide guidance for public entities, we believe the concepts in SAB Topic 5.T should be applied by all entities, including private entities, by analogy to ASC 718-10-15-4.

6.4 OTHER TOPICS

6.4.1 Registration Payment Arrangements

FASB REFERENCES

ASC 825-20-15-4, ASC 825-20-20: Registration Payment Arrangement, ASC 825-20-30-1 through 30-5, ASC 815-20-35-1, and ASC 815-20-55-2 through 55-14

Convertible debt, convertible preferred stock, and freestanding warrants are often accompanied by a registration payment arrangement that entitles the holder of that instrument to require the entity to either or both:

- File a registration statement for the resale of a specified financial instrument or that instrument's underlying shares and to endeavor to have the registration statement declared effective by the SEC (or other regulator) within a specified grace period
- Keep the registration statement effective for a specified period (or in perpetuity).

A registration payment arrangement often requires an entity to pay consideration to the holder if the entity fails to have the registration statement declared effective or maintain its effectiveness. The consideration may be a lump sum or periodic payments, and the form may vary (for example, cash; equity instruments; or adjustments to the instrument's terms, such as an increased interest rate on a debt instrument). For example, a typical registration rights agreement in a private placement requires an entity to use its best efforts to register the shares underlying the conversion option or warrant by a specified date or else pay a penalty (sometimes referred to as "liquidated damages"). The agreement may state, "The company will use its best efforts to cause the shares to be included in an effective registration statement, but in no event later than 180 days from the closing."

An entity accounts for any financial instruments subject to the registration payment arrangement in accordance with other U.S. GAAP exclusive of the contingent obligation to transfer consideration under the registration payment arrangement.

The entity accounts for the registration payment arrangement (in scope of ASC 825-20) as a separate unit of account from any financial instruments subject to that arrangement and measures it in accordance with ASC 450 as follows:

- If a liability for registration payments is probable and can be reasonably estimated at inception, the contingent liability must be measured in accordance with ASC 450 and included in the allocation of proceeds from the related financing transaction. The remaining proceeds are then allocated to any other financial instruments issued with the registration payment arrangement (see Section 2.8.2). Further, if the registration payment arrangement requires the entity to deliver shares as consideration and the liability is probable, the entity's share price at the reporting date is used to measure the contingent liability if the number of shares to be delivered can be reasonably estimated.
- If the registration payment becomes probable and can be reasonably estimated after the arrangement's inception, or if the measurement of the contingent liability subsequently increases or decreases, those changes are recognized in earnings.

ASC 825-20 does **not** apply to any of the following:

- Liquidated damages that are defined as a change in a conversion ratio.
- Liquidated damages that are determined by reference to either of:
  - An observable market other than the market for the issuer's stock (for example, the price of a commodity)
  - An observable index
- Arrangements in which the subject financial instruments are settled when the consideration is transferred (for example, a warrant that is contingently puttable if an effective registration statement for the resale of the underlying shares is not declared effective by the SEC within a specified grace period).

Accordingly, those provisions are considered in an entity's evaluation of the contract under other U.S. GAAP, such as ASC 480, ASC 815-15, and ASC 815-40 (see Chapters 2 through 4, respectively).

EXAMPLE 6-7 (ADAPTED FROM ASC 825-20-55-6 THROUGH 55-8): TRANSFER OF CONSIDERATION IS PROBABLE AT INCEPTION

FACTS

Entity A issues 10 million shares of common stock and 2 million freestanding warrants to purchase shares of common stock in a private placement for $100 million. It enters a registration payment arrangement in connection with the offering requiring it to use best efforts to:

- File a registration statement with the SEC (which must be declared effective within 180 days of the offering's closing date — that is, the grace period) for the resale of 12 million shares of common stock.
- Maintain the registration statement's effectiveness for three years.

Entity A must pay the investors liquidated damages in monthly cash payments of 1.5% per month of the $100 million total offering proceeds if either:

- The registration statement is not declared effective within 180 days of the offering's closing date.
- The registration statement ceases to be effective during the three years in which Entity A must maintain its effectiveness.

At closing, Entity A concludes it is probable that it will be required to pay liquidated damages to the investors for failing to obtain an effective registration statement within 180 days of the offering's closing date. Based on the facts and circumstances, Entity A can reasonably estimate both:

- The registration statement will become effective six months after the grace period expires.
- It can maintain the registration statement's effectiveness for the required three-year period.

CONCLUSION AND ANALYSIS

At inception, it is probable that Entity A will be required to pay liquidated damages to the investors for failing to obtain an effective registration statement within the grace period, and a range of payments can be reasonably estimated. Entity A must therefore recognize a contingent liability of $9 million ($100 million x 1.5% x 6 months). The remaining proceeds of $91 million are allocated between the common stock and warrants (see Section 2.8.2).

Entity A recognizes the instruments subject to the registration payment arrangement (the common stock and warrants) in accordance with other U.S. GAAP without regard to the contingent obligation to make payments under the registration payment arrangement.

EXAMPLE 6-8 (ADAPTED FROM ASC 825-20-55-2 THROUGH 55-5): TRANSFER OF CONSIDERATION IS NOT PROBABLE AT INCEPTION

FACTS

Assume the same facts as in Example 6-7, except that:

- At closing, Entity A concludes it is not probable that it will be required to pay liquidated damages to the investors. Entity A files a registration statement for the resale of the shares that is declared effective within 180 days of the offering's closing date.
- Because of changes in circumstances one year after the registration statement's effective date, Entity A concludes it is probable that the registration statement will cease to be effective for some portion of the remaining two-year period.
- At the reporting date, Entity A cannot reasonably estimate the exact amount of time the registration statement will cease to be effective, but it estimates a period ranging between nine and 18 months. Accordingly, it estimates a range of loss between $13.5 million ($100 million x 1.5% x 9 months) and $27 million ($100 million x 1.5% x 18 months), with no amount within that range appearing to be a better estimate than any other amount.

CONCLUSION AND ANALYSIS

At inception, there is no accounting required for the registration payment arrangement because it is not probable that Entity A will be required to pay liquidated damages. When it becomes probable that Entity A will be required to pay liquidated damages to the investors and a range of payments can be reasonably estimated, Entity A accrues a contingent liability by a charge to earnings. The minimum amount in the range of $13.5 million is accrued because no amount within the range of payments is a better estimate than any other amount.

Entity A recognizes the instruments subject to the registration payment arrangement (the common stock and warrants) in accordance with other U.S. GAAP without regard to the contingent obligation to make payments under the registration payment arrangement.

EXAMPLE 6-9 (ADAPTED FROM ASC 825-20-55-9 THROUGH 55-14): DEBT SUBJECT TO REGISTRATION PAYMENT ARRANGEMENT

FACTS

Entity A issues nonconvertible notes with a principal amount of $100 million and stated interest of 8% in a private placement. The notes are issued at par. Entity A enters a registration payment arrangement in connection with the offering, requiring it to use best efforts to:

- File a registration statement with the SEC (which must be declared effective within 180 days of the offering's closing date) for the resale of the notes.
- Maintain the registration statement's effectiveness for two years.

Entity A must pay the investors liquidated damages in the form of an interest rate increase of 50 basis points per month if either:

- The registration statement is not declared effective within 180 days of the offering's closing date.
- The registration statement ceases to be effective during the two years in which Entity A must maintain its effectiveness.

At closing, Entity A concludes it is not probable that it will be required to pay liquidated damages. Entity A files a registration statement for the resale of the notes, and the registration statement is declared effective within 180 days of the offering's closing date.

Because of changes in circumstances one year after the registration statement's effective date, Entity A concludes it is probable that the registration statement will cease to be effective for some portion of the remaining one-year period.

At the reporting date, Entity A cannot reasonably estimate the exact amount of time the registration statement will cease to be effective, but it estimates a period ranging between three and six months. Accordingly, it estimates a range of loss between $1.5 million ($100 million x 0.5% x 3 months) and $3 million ($100 million x 0.5% x 6 months), with no amount within that range appearing to be a better estimate than any other amount.

CONCLUSION AND ANALYSIS

At inception, there is no accounting required for the registration payment arrangement because it is not probable that Entity A will be required to pay liquidated damages. When it becomes probable that Entity A will be required to pay liquidated damages to the investors and a range of payments can be reasonably estimated, Entity A accrues a contingent liability by a charge to earnings. The minimum range amount of $1.5 million is accrued because no amount within the range of payments is a better estimate than any other amount.

Entity A recognizes the notes subject to the registration payment arrangement in accordance with other U.S. GAAP without regard to the contingent obligation to make payments under the registration payment arrangement.

Chapter 7 — Debt Restructurings, Modifications, and Exchanges

7.1 OVERVIEW

An entity may renegotiate and amend its debt arrangements with lenders for various reasons, such as to increase borrowings to finance an expansion of its operations, refinance debt that is nearing maturity, or manage cash flow difficulties. The debtor and creditor may agree to modify an existing loan agreement or exchange one debt instrument for another. For accounting purposes, the legal form of the transaction does not matter. Anytime a debtor and creditor change the terms of their relationship by amending a loan agreement, exchanging one instrument for another, or entering an incremental debt instrument, the debtor must determine the appropriate accounting model to apply to the restructured debt arrangement.

If the debtor pays off the original loan's creditor with proceeds from a new lender, it accounts for the original loan as an extinguishment (see Section 6.2.3) and the new loan as a separate borrowing. However, if the debtor restructures a loan arrangement with the same creditor, it must first consider the TDR guidance in ASC 470-60. If the debt restructuring is not a TDR, the debtor applies the guidance in ASC 470-50 to determine the appropriate accounting to apply.

See BDO's publication, Troubled Debt Restructuring, Debt Modification, and Extinguishment for more guidance.

Chapter 8 — Presentation and Disclosure

8.1 OVERVIEW

As discussed in previous chapters, financial instruments can be in the scope of various accounting topics within U.S. GAAP. The table lists the different types of instruments, the applicable accounting guidance, and respective chapters and sections that discuss their recognition, measurement, and presentation and disclosure requirements.

FINANCIAL INSTRUMENT TYPE	APPLICABLE ACCOUNTING GUIDANCE*	INITIAL RECOGNITION AND SUBSEQUENT MEASUREMENT GUIDANCE	PRESENTATION AND DISCLOSURE GUIDANCE
Debt instruments	ASC 470	Chapter 6	Section 8.3
Equity instruments	ASC 505	Chapter 6	Section 8.4
Redeemable instruments classified as temporary equity	ASC 480-10-S99-3A	Chapter 5	Section 8.4
Assets and liabilities within the scope of ASC 480	ASC 480	Chapter 2	Section 8.5
Hybrid instruments and embedded derivatives	ASC 815-10, ASC 815-15, and ASC 825-10	Chapter 3	Section 8.6
Freestanding equity-linked instruments not in the scope of ASC 480	ASC 815-40	Chapter 4	Section 8.7

*A financial instrument may be in the scope of more than one ASC topic, in which case an entity must follow the presentation and disclosure requirements of all applicable U.S. GAAP. For example, embedded derivatives in hybrid instruments are assessed for bifurcation under ASC 815-15, while the host contract is accounted for under other U.S. GAAP, such as ASC 470; ASC 505; or, if applicable, ASC 480-10-S99-3A.

If applicable, entities should also refer to ASC 260-10-45 and ASC 260-10-50 for presentation and disclosure requirements regarding EPS.

8.2 SCOPE

FASB REFERENCES

ASC Master Glossary: Public Business Entity and SEC Registrant

The guidance in this chapter applies to all entities unless otherwise noted.

Some disclosures are required only for SEC registrants or public business entities (PBEs). Private entities (entities that are neither SEC registrants nor PBEs) can elect to comply with the presentation and disclosure requirements for SEC registrants or PBEs. The table defines PBEs and SEC registrants.

PBE	SEC REGISTRANT
A business entity that meets **any** of the following: ▶ It is required to file or furnish financial statements (or choose to file or furnish financial statements, such as voluntary filers) with the SEC. ▶ Its financial statements or financial information must be (or are) included in an SEC filing. In that case, the entity is a PBE only for purposes of the financial statements filed or furnished with the SEC. ▶ It is required to file or furnish financial statements with a regulatory agency other than the SEC under the Securities Exchange Act of 1934 or rules or regulations under that act. ▶ It is required to file or furnish financial statements with a foreign or domestic regulatory agency for the sale of or for purposes of issuing securities without contractual transfer restrictions. ▶ It has issued, or is a conduit bond obligor for, securities traded, listed, or quoted on an exchange or over-the-counter market. ▶ It has one or more securities that are not subject to contractual transfer restrictions **and** it is required to prepare and make publicly available U.S. GAAP financial statements (including notes) on a periodic (for example, interim or annual) basis. An NFP entity or employee benefit plan is not a business entity.	An entity (or an entity controlled by another entity) that meets **any** of the following: ▶ It has issued or will issue debt or equity securities traded in a public market (a domestic or foreign stock exchange or over-the-counter market, including local or regional markets). ▶ It provides financial statements for the purpose of issuing any class of securities in a public market. ▶ It is required to file financial statements with the SEC.

8.3 DEBT INSTRUMENTS

FASB REFERENCES

ASC 210-10-15-3, ASC 210-10-20: Current Liabilities and Short-Term Obligations, ASC 210-10-45-5, ASC 210-10-45-9, ASC 470-10-20: Long-Term Obligations, and ASC 470-10-45-12A

Entities that present classified balance sheets must present a total of current liabilities, so they must determine whether debt obligations represent current or noncurrent liabilities. Current liabilities are obligations whose liquidation is reasonably expected to require the use of current assets or the creation of other current liabilities. Throughout this chapter, we refer to noncurrent liabilities as obligations excluded from current liabilities.

ASC 210-10-45-9 states that obligations expected to be liquidated within a relatively short period of time, usually 12 months, are included in current liabilities. Accordingly, entities generally classify a debt obligation based on whether it is due or will be due within one year (or within an entity's operating cycle if it is longer than one year) of the balance sheet date. Said differently, entities consider the term of the debt (whether short- or long-term) in determining its classification, subject to exceptions. Throughout this chapter, we use one year from the balance sheet date to refer to the one-year period (or, if longer than one year, an entity's operating cycle) after the balance sheet date.

SHORT- AND LONG-TERM OBLIGATIONS

U.S. GAAP defines short-term obligations as those scheduled to mature within one year of the entity's balance sheet date and long-term obligations as those scheduled to mature more than one year from the entity's balance sheet date. Short- and long-term obligations are not necessarily synonymous with current and noncurrent liabilities, respectively.

Entities include short-term obligations (and serial maturities of long-term obligations) as current liabilities, subject to exceptions. For example, an entity generally classifies short-term debt as a current liability. However, if an entity has the intent and ability to refinance the short-term debt on a long-term basis, it classifies the debt as a noncurrent liability because it is not expected to require the use of working capital during the ensuing fiscal year (see Sections 8.3.2 and 8.3.8).

Similarly, entities classify long-term obligations as noncurrent liabilities, subject to exceptions (such as when debt has become callable). For example, unless specific conditions are met (see Section 8.3.1.1), an entity classifies long-term debt that has become callable because of covenant violations as a current liability. Further, the debt arrangement's relevant terms — for example, subjective acceleration clauses, demand provisions or put options, prepayment options, and cash-settled conversion features — could cause an otherwise long-term debt to be classified as a current liability (see Sections 8.3.1.2, 8.3.4, 8.3.5, and 8.3.6, respectively).

In some cases, the entity's anticipated repayment sources also affect how it classifies debt, which might not be in line with how it estimates the life of the debt to accrue interest (see Section 8.3.7).

For revolving credit agreements, entities classify borrowings under those arrangements as current or noncurrent liabilities depending on whether the arrangement includes a subjective acceleration clause and a lock-box requirement (see Section 8.3.3).

8.3.1 Classification of Long-Term Obligations

FASB REFERENCES

ASC 210-10-20: Current Liabilities, ASC 210-10-45-9, and ASC 470-10-20: Long-Term Obligations

In accordance with ASC 210, current liabilities include obligations whose liquidation is reasonably expected to require the use of current assets or the creation of other current liabilities. Therefore, long-term obligations (those that mature more than one year from the balance sheet date) are generally presented as noncurrent liabilities, subject to exceptions. For instance, in determining whether to classify long-term obligations as current liabilities, entities consider:

- Whether a debt covenant violation has occurred (see Section 8.3.1.1)
- Whether the debt instrument includes a subjective acceleration clause (see Section 8.3.1.2)
- Other relevant terms of the debt arrangement, such as demand provisions or put options (see Section 8.3.4), prepayment options (see Section 8.3.5), and cash-settled conversion features (see Section 8.3.6).

A long-term obligation's serial maturities (the portion of amortizing principal payable within one year), if any, are generally presented as current liabilities unless the entity has the intent and ability to refinance them on a long-term basis (see Section 8.3.2).

8.3.1.1 Debt With Covenant Violations

FASB REFERENCES

ASC 470-10-20: Callable Obligation, ASC 470-10-45-1, ASC 470-10-45-11 through 45-12, and ASC 470-10-55-6

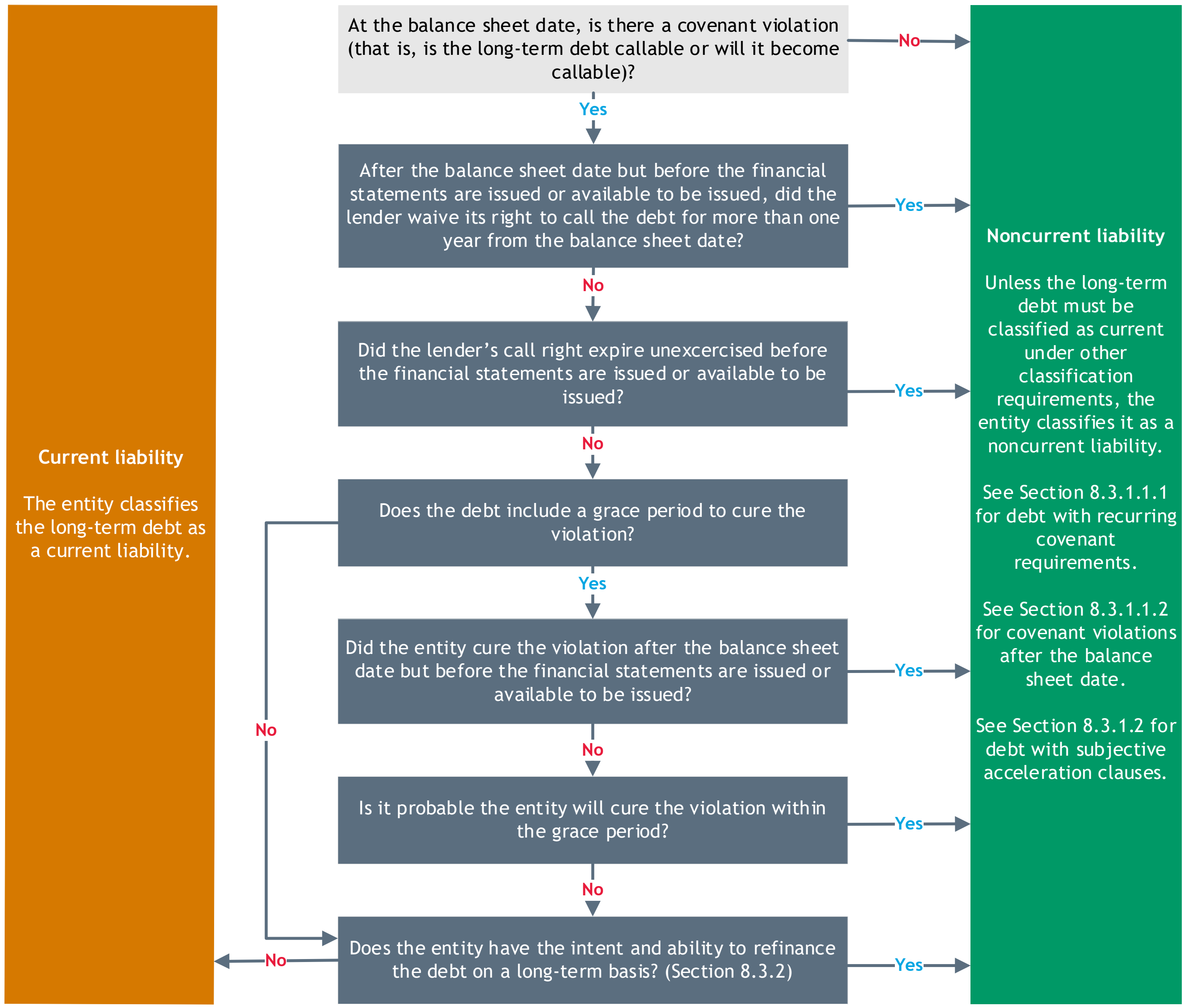
U.S. GAAP defines a callable obligation as an obligation that is callable at a given date because the lender has the right at that date to demand (or give notice of its intention to demand) the repayment of the obligation owed to it by the borrower. Debt agreements often require borrowers to comply with covenants that are objectively determinable (parties to the agreement can objectively determine when debt covenants have been violated). If the entity (borrower) violates a debt covenant, the debt may become callable by the lender. That is different from subjective acceleration clauses, which are discussed in Section 8.3.1.2.

Generally, a long-term obligation that is callable or will be callable because of an entity's covenant violation at the balance sheet date must be classified as a current liability unless **any** of the following exist:

- The lender has granted a waiver before the financial statements are issued or are available to be issued.
- The lender has subsequently lost the right to call the debt for more than one year from the balance sheet date. For example:
  - The agreement provides for a call period within which the lender can demand repayment, and that call right has expired unexercised before the financial statements are issued or are available to be issued.
  - The entity has cured the covenant violation and the debt is no longer callable before the financial statements are issued or are available to be issued.
- The debt has a grace period within which the entity may cure the violation, and it is probable that the entity will cure the violation within that period (therefore preventing the debt from becoming callable).
- The entity has the intent and ability to refinance the debt on a long-term basis (see Section 8.3.2).

ASC 470 does not distinguish between significant covenant violations and minor technical violations. A borrower might consider a violation technical, whereas the lender might consider the same violation critical. Further, a lender might use a technical violation to withdraw from its relationship with the borrower. If the violation is insignificant, the borrower should be able to obtain a waiver from the lender. Therefore, an entity must evaluate significant and minor technical covenant violations in the same manner.

The flowchart illustrates how an entity evaluates a long-term debt's classification.



EVALUATING DEBT COVENANT WAIVERS

An entity must evaluate waivers to verify the lender has waived its right to call the debt (for at least one year after the balance sheet date) in relation to any debt covenant violations. If the lender has simply stated that it does not **intend** to call the debt, that is **not** a satisfactory waiver. Further, the probability that the lender will subsequently waive its right is irrelevant.

If the long-term debt is callable because of violations of specific provisions in the debt agreement, the lender needs to waive its right for only those violations.

If the lender waives the covenant violation but retains the same or more restrictive covenant requirements, the entity must assess whether it is probable that it will fail to meet the covenants on any future compliance dates within the next 12 months (see Section 8.3.1.1.1).

ASSESSING GRACE PERIODS

Some debt agreements provide an explicit grace period to cure debt covenant violations. Debt with an existing covenant violation that is not callable at the balance sheet date but will become callable within one year if the violation is not cured within a specified grace period is presumably current. That is because the debt will become callable if the conditions existing at the balance sheet date do not change within the grace period.

However, the debt is classified as a noncurrent liability if the entity subsequently cures the covenant violation before the financial statements are issued or are available to be issued and, as a result, the lender loses the right to call the debt within one year from the balance sheet date. For example, assume a debt default exists at the balance sheet date, but the debt agreement allows the entity to cure the default within a 30-day grace period. If the entity cures the default within that grace period before the financial statements are issued or are available to be issued, the entity classifies the debt as a noncurrent liability.

When the lender has not waived the covenant violation and the entity has not cured it before the financial statements are issued or are available to be issued, but the grace period within which the entity may cure the violation extends beyond the issuance of the financial statements, the debt is classified as a noncurrent liability if it is probable that the entity will cure the violation within the grace period. Otherwise, the debt is classified as a current liability unless the entity has the intent and ability to refinance it on a long-term basis (see Section 8.3.2).

ASSESSING DEBT COVENANT CURES

Generally, curing a debt covenant violation means the lender has lost the right to demand repayment because the entity has complied with the terms of the debt agreement for curing an event of default.

An entity must not assume that future compliance with debt covenants cures a current covenant violation unless **expressly** stated in the debt agreement. Further, determining whether an entity has cured a covenant violation might not always be apparent from the provisions in the debt agreement. In the absence of confirmation from the lender, we believe the assistance of legal counsel may be necessary in that case. Reaching a conclusion requires the use of professional judgment based on the facts and circumstances.

Further, it is important that an entity consider the terms of the debt agreement, including the provisions related to covenant requirements, defaults, cures, and remedies.

8.3.1.1.1 Debt With Recurring Covenants

FASB REFERENCES

ASC 450-20-20: Probable and Reasonably Possible, ASC 470-10-45-1, ASC 470-10-45-11, and ASC 470-10-55-2 through 55-6

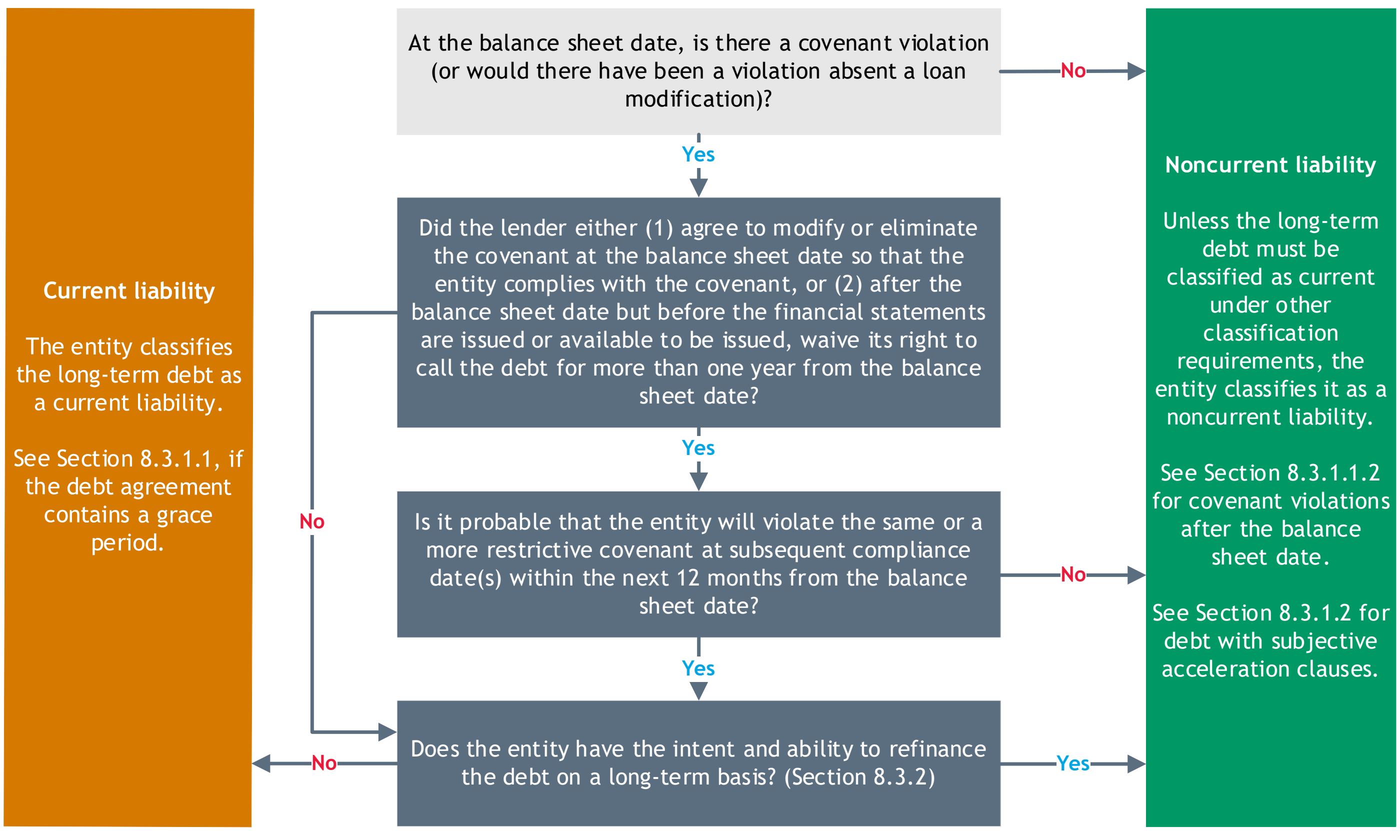
Debt agreements often include covenant requirements (for example, debt-to-equity ratios, fixed charge coverage ratios, or capital expenditure limits) an entity must meet on a periodic basis, such as quarterly or semiannually.

As discussed in Section 8.3.1.1, if an entity violates a covenant at the balance sheet date and, as a result, the long-term debt either has or will become callable, the debt may still be classified as a noncurrent liability if the lender waives its right to call the debt for more than one year from the balance sheet date.

If future covenant requirements are retained, the entity classifies the debt as a noncurrent liability unless it is probable that it will violate the future covenants within the next 12 months. Accordingly, if it is at least reasonably possible that the entity will meet the same or more restrictive covenant at subsequent measurement dates within the next 12 months from the balance sheet date, the entity classifies the debt as a noncurrent liability. That guidance also applies if (1) the debt agreement is modified to remove or change the debt covenants so that the entity will comply with the covenants at the balance sheet date, (2) absent the modification, the entity would have been in violation of the covenants at the balance sheet date, and (3) the entity must comply with the same or more restrictive covenants at future compliance date(s).

U.S. GAAP defines the term "probable" as *the future event or events are likely to occur* and "reasonably possible" as *the chance of the future event or events occurring is more than remote but less than likely*.

The flowchart illustrates how an entity classifies long-term debt with recurring covenants.



EXAMPLE 8-1 (ADAPTED FROM ASC 470-10-55-2 THROUGH 55-6): LONG-TERM DEBT OBLIGATION WITH COVENANT VIOLATIONS AND RECURRING COVENANTS

FACTS

Entity (borrower) has a long-term debt that requires quarterly compliance with specific financial ratios (such as a minimum current ratio, a minimum debt-to-equity ratio, or a minimum level of shareholders' equity). Noncompliance with any of the financial ratios gives the lender the right to call the debt. The table illustrates how the entity classifies that long-term debt under different scenarios.

SCENARIO	CONCLUSION AND ANALYSIS
▶ The covenants apply only after the balance sheet date. ▶ It is probable that the entity will fail to meet the covenant requirement at the next quarterly compliance date after the balance sheet date.	The debt is not callable at the balance sheet date because even though the entity must comply with future covenants, they apply only after the balance sheet date. Unless facts and circumstances indicate otherwise, the long-term debt must be classified as a **noncurrent** liability even though it is probable that the entity will fail to meet the covenant requirement at the next quarterly compliance date after the balance sheet date (see Section 8.3.1.1.3). The entity must disclose the adverse consequence of its probable violation of future covenants.
▶ The entity meets the current covenant at the balance sheet date. ▶ It is probable that the entity will fail to meet the same or a more restrictive covenant at the next quarterly compliance date after the balance sheet date.	The debt is not callable at the balance sheet date because the entity meets the current covenant. Unless facts and circumstances indicate otherwise, the long-term debt must be classified as a **noncurrent** liability even though it is probable that the entity will fail to meet the same or a more restrictive covenant at the next quarterly compliance date after the balance sheet date (see Section 8.3.1.1.3). The entity must disclose the adverse consequence of its probable violation of future covenants.
▶ The entity violates the current covenant at the balance sheet date. ▶ After the balance sheet date but before the financial statements are issued or are available to be issued, the lender waives its call right related to the current violation for a period of more than one year. ▶ The same or a more restrictive covenant must be met at the next quarterly compliance date, and it is probable that the entity will fail to meet that covenant at that subsequent date.	At the balance sheet date, the debt is callable because the entity is in violation of the covenant and the lender has the right to call the debt. While the lender waives its right to call the debt (for more than one year) after the balance sheet date but before the financial statements are issued or are available to be issued, the lender retains rights related to subsequent periodic covenant requirements, which must be analyzed further. Because it is probable that the entity will fail to meet the covenant at the next quarterly compliance date, the entity classifies the long-term debt as a **current** liability. However, if the entity has the intent and ability to refinance the debt on a long-term basis (as discussed in Section 8.3.2), it would classify the debt as a noncurrent liability.

SCENARIO	CONCLUSION AND ANALYSIS
▶ The entity meets the covenant in the last quarterly compliance date but before the balance sheet date, modifies the debt to eliminate the covenant at the balance sheet date, or modifies the covenant so that the entity will comply. ▶ Absent the modification, the entity would have been in violation of the covenant at the balance sheet date. ▶ The same or a more restrictive covenant must be met at the next quarterly compliance date, and it is probable that the entity will violate the covenant at that subsequent date.	In accordance with ASC 470-10-45-1, a covenant violation that would have occurred absent a loan modification is evaluated like a covenant violation at the balance sheet date. Because it is probable that the entity will fail to meet the covenant at the next quarterly compliance date, the entity classifies the long-term debt as a **current** liability. However, if the entity has the intent and ability to refinance the debt on a long-term basis (as discussed in Section 8.3.2), it would classify the debt as a noncurrent liability.

ASSESSING FEES PAID TO OBTAIN A WAIVER AND MODIFICATIONS TO REMOVE OR MODIFY COVENANTS UNDER OTHER U.S. GAAP

An entity might pay lender fees to obtain a waiver from the lender for a covenant violation or negotiate a modification of the loan to remove or modify the debt covenant requirement. While those are important considerations in applying the classification guidance, the entity must also assess those changes under ASC 470-50 and ASC 470-60. For example, while fees paid to a lender to obtain a waiver by themselves often do not result in accounting for the cash flow change as a debt extinguishment, an entity must not make that conclusion without a proper analysis.

8.3.1.1.2 Debt Covenant Violations After the Balance Sheet Date

FASB REFERENCES

ASC 470-10-45-1

ASC 470-10 includes guidance on classification of long-term debt with covenant violations at the balance sheet date. It does not include guidance for covenant violations that occur after the balance sheet date but before the financial statements are issued or are available to be issued. In those cases, an entity must classify the debt based on the facts and circumstances.

BDO INSIGHTS — DEBT COVENANT VIOLATIONS OCCURRING AFTER THE BALANCE SHEET DATE

ASC 470-10-45-1 notes that long-term debt with ongoing covenant compliance requirements is classified as a noncurrent liability unless two conditions are met:

- A covenant violation allowing the lender to call the debt has occurred **at the balance sheet date** (or would have occurred absent a modification)
- It is probable the borrower will not comply with the covenant at measurement dates within the next 12 months.

Accordingly, a debt's classification should generally be based on the facts and circumstances existing at the balance sheet date. However, ASC 470-10-45-1 also states that noncurrent classification is appropriate *unless facts and circumstances indicate otherwise*, suggesting there might be situations when it may be appropriate to classify long-term debt with ongoing covenants as a current liability even when both of the two conditions are not met.

Accordingly, we believe an entity must evaluate the facts and circumstances to determine if long-term debt should be classified as a current liability in situations such as the following:

- Debt was not callable at the balance sheet date but has then become callable because of a covenant violation **after the balance sheet date** and before the financial statements are issued or are available to be issued.
- Debt has an actual or known covenant violation **at the date the financial statements are issued or are available to be issued** (see Example 8-2).

Reaching a conclusion on how to classify debt with covenant violations after the balance sheet date requires the application of professional judgment based on the facts and circumstances.

EXAMPLE 8-2: DEBT THAT HAS BECOME CALLABLE BECAUSE OF A GOING CONCERN OPINION

FACTS

- Issuer A has a long-term debt that matures in five years.
- The debt agreement does not contain a subjective acceleration clause.
- The debt agreement includes some financial covenants and nonfinancial covenants, including if Issuer A's audit report contains a going concern emphasis, the lender can demand repayment immediately.
- Issuer A has a December 31 fiscal year end and is compliant with its financial covenants as of December 31, 20X4.
- Issuer A expects to issue its December 31, 20X4 financial statements on March 31, 20X5, and the audit report will express substantial doubt about the entity's ability to continue as a going concern. Issuer A has not obtained a waiver for that expected covenant violation.
- Issuer A does not intend to refinance the debt on a long-term basis.

CONCLUSION

In its December 31, 20X4 financial statements, Issuer A classifies the long-term debt as a current liability.

ANALYSIS

When Issuer A issues its financial statements, its going concern covenant violation is known. That covenant violation results in the debt becoming callable immediately upon issuing the financial statements. Before the financial statements are issued, Issuer A has not cured the violation and the lender has not waived its right to demand repayment. Based on the facts and circumstances, Issuer A classifies the long-term debt as a current liability in its December 31, 20X4 financial statements.

8.3.1.1.3 Probable Debt Covenant Violations

FASB REFERENCES

ASC 470-10-55-4 through 55-5

When an entity is in compliance with its debt covenants at the balance sheet date and through the date the financial statements are issued or are available to be issued, unless facts and circumstances indicate otherwise, the entity presents the long-term debt as a noncurrent liability. That is the case even if it is probable that the entity will violate the same or more restrictive debt covenants within one year of the balance sheet date and the debtor will have a right to demand the debt's repayment at that future date. That presentation is consistent with the example in ASC 470-10-55-4 through 55-5. The entity must disclose the potential adverse effect of its probable covenant violations.

8.3.1.2 Debt With a Subjective Acceleration Clause

FASB REFERENCES

ASC 470-10-20: Subjective Acceleration Clause and ASC 470-10-45-2

Some debt agreements include a subjective acceleration clause (SAC) allowing the lender to accelerate the debt's repayment based on conditions that are not objectively determinable. For example, the SAC may provide that the lender can require repayment if the entity does not maintain satisfactory operations, or if a material adverse change occurs.

Some circumstances, such as recurring losses or liquidity problems, may indicate that an entity should classify long-term debt with a SAC as a current liability. Other situations may indicate that the entity should disclose only that the clause exists (see BDO Insights in this section and Section 8.3.9.1). If the debt's acceleration is remote — for instance, because the lender historically has not accelerated due dates of loans with similar clauses and the entity's financial condition is strong and its prospects are bright — the entity presents the long-term debt as a noncurrent liability. It may choose to disclose that a SAC exists but is not required to do so.

If the debt's acceleration is more than remote, the entity must consider the facts and circumstances in determining how to classify the debt and should disclose the SAC.

See Section 8.3.3.1 for guidance on how a SAC affects the classification of borrowings under a revolving credit agreement.

BDO INSIGHTS — EVALUATING CLASSIFICATION OF DEBT WITH A SUBJECTIVE ACCELERATION CLAUSE

U.S. GAAP does not specify how to classify debt with a SAC when the debt's acceleration is more than remote. We believe an entity should determine the classification of the debt as follows:

- Step 1: Determine if the debt's acceleration is more than remote. If remote, the entity presents the debt as noncurrent and no disclosure is required. If more than remote, the entity moves to Step 2.
- Step 2: Determine classification based on the facts and circumstances. For example, before the financial statements are issued or are available to be issued:
  - If the lender has formally noted that a triggering event has occurred and demanded acceleration, we believe the entity should classify the debt as a current liability unless it has the intent and ability to refinance the debt on a long-term basis (see Section 8.3.2), with full disclosure of the facts in the notes to the financial statements.
  - If the lender has formally waived accelerated payments beyond one year from the balance sheet date, we believe all waived payments are excluded from current liabilities. The entity should disclose the waiver and its terms in a note to the financial statements.
  - If the lender has not formally noted that a triggering event has occurred or has formally noted a triggering event has occurred but has neither demanded accelerated payment nor waived its rights to such payment, the entity should disclose the facts as they exist and classify the debt based on the facts and circumstances. If it is probable that the lender will demand repayment within one year of the balance sheet date, we believe the entity should present the debt as a current liability (unless the entity has the intent and ability to refinance it on a long-term basis (see Section 8.3.2)).

Reaching a conclusion on how to classify debt with a SAC requires the application of professional judgment based on the facts and circumstances.

8.3.2 Classification of Short-Term Obligations

FASB REFERENCES

ASC 210-10-20: Current Liabilities and Short-Term Obligations, and ASC 470-10-45-12A through 45-14

In accordance with ASC 210, current liabilities include obligations whose liquidation is reasonably expected to require the use of current assets or the creation of other current liabilities. Therefore, short-term obligations (those that mature within one year of the balance sheet date) are generally classified as current liabilities.

However, an entity might intend to refinance a short-term obligation on a long-term basis and therefore not expect to use working capital within one year of the balance sheet date to liquidate the obligation. Refinancing a short-term obligation on a long-term basis means **either**:

- Replacing the short-term obligation with a long-term obligation or with equity securities
- Renewing, extending, or replacing the short-term obligation with short-term obligations for an uninterrupted period extending beyond one year from the balance sheet date.

The entity classifies the short-term obligation as a noncurrent liability if it intends to refinance the debt on a long-term basis and its intent is appropriately supported by an ability to complete the refinancing before the financial statements are issued or are available to be issued.

INTENT TO REFINANCE AND ABILITY TO CONSUMMATE THE FINANCING

An entity's intent to refinance on a long-term basis is an essential condition for classifying a short-term obligation as a noncurrent liability. That is because without intent there is a presumption that an entity would liquidate the short-term obligation using current assets or by creating other current liabilities. For instance, the existence of a financing agreement an entity can use to fund the short-term obligation's liquidation is irrelevant if the entity does not intend to exercise its right under that agreement.

However, intent alone is insufficient to overcome the presumption that a short-term obligation requires an entity to use current assets. The intent must be supported by the entity's demonstrated ability to act on that intent. An entity can demonstrate its ability to consummate the long-term financing by:

- Issuing long-term obligations or equity securities after the balance sheet date but before the financial statements are issued or are available to be issued (that is, replacing the short-term obligation with a long-term obligation or equity securities (see Section 8.3.2.1))
- Entering a financing agreement before the financial statements are issued or are available to be issued (see Section 8.3.2.2).

Generally, an entity demonstrates its intent to refinance a short-term obligation with funds from a financing agreement, new long-term obligations, or equity securities by holding those funds in reserve rather than using them in current operations. Repaying the short-term obligation after the balance sheet date (before the long-term financing is completed) using working capital invalidates the assertion that the entity intends to use proceeds from long-term financing to liquidate the short-term obligation (see Section 8.3.2.1).

On the other hand, an entity's intent to refinance is not negated simply because the entity is looking for a more advantageous source of financing than that provided by an existing financing agreement. However, to meet the "intent to refinance" condition, the entity must intend to exercise its rights under the financing agreement if the other source of financing does not become available. Also, the financing agreement cannot include conditions or allow the prospective lender to establish conditions, such as interest rates or collateral requirements, that are unreasonable to the entity (see Section 8.3.2.2).

The guidance on refinancing short-term obligations in ASC 470 does not apply to operating liabilities arising from transactions in the normal course of business that are payable on customary terms (such as accounts payable and payroll accruals). Those obligations are classified as current liabilities.

8.3.2.1 Refinancing by Issuing Long-term Obligations or Equity Securities

FASB REFERENCES

ASC 210-10-45-4, ASC 210-10-50-12, ASC 470-10-45-13 through 45-16, ASC 470-10-55-21 through 55-22, ASC 470-10-55-2, and ASC 470-10-55-33 through 55-36

As discussed in Section 8.3.2, an entity classifies a short-term obligation as a noncurrent liability if it has both the intent and ability to refinance that obligation on a long-term basis. To demonstrate its ability to complete its intended refinancing through post-balance-sheet issuance of a long-term obligation or equity securities, the entity must issue the instruments that replace the short-term obligation **before** the financial statements are issued or are available to be issued.

If the short-term obligation being refinanced exceeds the proceeds from issuing the long-term obligation or equity securities, the entity classifies the excess short-term obligation as a current liability.

If the entity issues equity securities, it classifies the short-term obligation as a noncurrent liability but cannot present that obligation as equity.

Any funds obtained on a long-term basis before the balance sheet date are excluded from current assets if the short-term obligation being liquidated is classified as a noncurrent liability.

BDO INSIGHTS — CLASSIFICATION OF FUNDS OBTAINED ON A LONG-TERM BASIS INTENDED FOR LIQUIDATING MATURING DEBT

ASC 470-10-45-13 requires that funds obtained on a long-term basis before the balance sheet date be excluded from current assets if the obligation to be liquidated using those funds is excluded from current liabilities (see ASC 470-10-55-21 through 55-23).

Further, ASC 210-10-45-4 states that funds that are clearly to be used in the near future for the liquidation of long-term debts (even if not actually set aside in special accounts) must be excluded from current assets. However, an entity may include those funds in current assets if they will be used to liquidate maturing debt classified as a current liability. Further, ASC 210-10-50-12 states that current liabilities exclude debts to be liquidated by funds that are not classified as current assets.

For instance, if an entity issues a long-term obligation or equity securities before the balance sheet date and intends to use the proceeds from that issuance to liquidate debt maturing within one year of the balance sheet date, it classifies the funds and maturing debt as follows:

- If the entity classifies the debt as a current liability (because the debt is maturing within one year of the balance sheet date), it classifies the funds intended for the debt's liquidation as current assets.
- If the entity classifies the debt as a noncurrent liability (because it has the intent and ability to refinance the maturing debt on a long-term basis by using the proceeds from the issuance of a long-term obligation or equity securities), it classifies the funds intended for the debt's liquidation as noncurrent assets.

Reaching a conclusion on the classification of maturing debt and the funds intended for its liquidation requires the application of professional judgment based on the facts and circumstances.

REPAYMENT OF A SHORT-TERM OBLIGATION AFTER THE BALANCE SHEET DATE

As discussed in Section 8.3.2, to meet the conditions in ASC 470-10-45-14(a), an entity must intend to use the proceeds from long-term financing (issuance of long-term obligations or equity securities) to liquidate the short-term obligation. Therefore, an entity classifies a short-term obligation as a current liability if it repays the obligation (or a portion of the obligation) after the balance sheet date and before the long-term financing is completed using current assets. It is irrelevant that the proceeds from the subsequent issuance of a long-term obligation or equity securities replenish the current assets used to repay the short-term obligation (see Example 8-5).

EXAMPLE 8-3 (ADAPTED FROM ASC 470-10-55-21 THROUGH 55-22): CLASSIFICATION OF SHORT-TERM OBLIGATIONS REFINANCED BY ISSUING A LONG-TERM OBLIGATION AFTER THE BALANCE SHEET DATE

FACTS

- As of December 31, 20X1, Entity A has the following short-term obligations, which it intends to refinance on a long-term basis:
  - $5 million of 6% long-term debt maturing in February 20X2
  - $3 million of 9% notes payable issued in November 20X1 and maturing in July 20X2.
- In January 20X2, Entity A issues $8 million of publicly traded debt with a 10-year maturity, which it expressly intends to use to liquidate the above obligations.
- Entity A uses the proceeds as follows:
  - In February 20X2, Entity A repays the $5 million debt maturing in February 20X2.
  - Entity A invests the remaining $3 million in U.S. treasuries that mature on the same date as the 9% notes payable. It intends to use the $3 million to repay its 9% notes payable maturing in July 20X2.
- Entity A's fiscal year end is December 31, and it issues its December 31, 20X1 financial statements on March 31, 20X2.

CONCLUSION

In its December 31, 20X1 financial statements, Entity A classifies as noncurrent liabilities the 6% long-term debt maturing in February 20X2 and 9% notes payable maturing in July 20X2.

ANALYSIS

Entity A has the intent and ability to refinance its short-term obligations, which it demonstrated by issuing a long-term obligation after the balance sheet date but before the financial statements are issued or are available to be issued, therefore meeting the conditions in ASC 470-10-45-14(a).

- Entity A repaid the 6% long-term debt maturing in February 20X2 using the proceeds from the long-term financing.
- Entity A obtained funds from the long-term financing expressly intended to liquidate the 9% notes payable maturing in July 20X2. It invested the funds in U.S. treasuries, so the funds are not intended for current operations.

Accordingly, Entity A classifies the 6% long-term debt and 9% notes payable as noncurrent liabilities.

EXAMPLE 8-4 (ADAPTED FROM ASC 470-10-55-21 THROUGH 55-22 and ASC 470-10-55-24): CLASSIFICATION OF SHORT-TERM OBLIGATIONS REFINANCED BY ISSUING EQUITY SECURITIES AFTER THE BALANCE SHEET DATE

FACTS

- Assume the same facts as in Example 8-3, except that:
  - Entity A issues $8 million of equity securities in January 20X2.

CONCLUSION

In its December 31, 20X1 financial statements, Entity A classifies as noncurrent liabilities the 6% long-term debt maturing in February 20X2 and 9% notes payable maturing in July 20X2.

ANALYSIS

Entity A has the intent and ability to refinance its short-term obligations, which it demonstrated by issuing equity securities after the balance sheet date but before the financial statements are issued or are available to be issued, therefore meeting the conditions in ASC 470-10-45-14(a). Accordingly, Entity A classifies the 6% long-term debt and 9% notes payable as noncurrent liabilities.

EXAMPLE 8-5 (ADAPTED FROM ASC 470-10-55-33 THROUGH 55-36): CLASSIFICATION OF A SHORT-TERM OBLIGATION REPAID BEFORE BEING REPLACED BY A LONG-TERM OBLIGATION

FACTS

- In 20X1, Entity A issues $3 million short-term commercial paper to finance its plant construction, which matures as follows: $1 million in July 20X1 and $2 million in September 20X1.
- Entity A's fiscal year end is June 30.
- At June 30, 20X1, Entity A intends to refinance the commercial paper by issuing long-term debt.
- In July 20X1, Entity A uses excess cash to liquidate $1 million of the commercial paper as it matures.
- In August 20X1, Entity A issues long-term debt for proceeds of $6 million, which it intends to use as follows:
  - Replenish $1 million of working capital used to liquidate $1 million of the commercial paper
  - Pay $2 million of commercial paper as it matures in September 20X1
  - Pay $3 million of plant construction costs expected to be incurred later in 20X1.
- Later in August 20X1, Entity A issues its June 30, 20X1 financial statements.

CONCLUSION

In its June 30, 20X1 financial statements, Entity A classifies $1 million of commercial paper as a current liability and $2 million of commercial paper as a noncurrent liability.*

ANALYSIS

- Entity A classifies $1 million of the commercial paper as a current liability at June 30, 20X1, because the short-term obligation was repaid **before** funds from the long-term debt were obtained. That Entity A later replenished the $1 million with proceeds from issuing long-term debt is irrelevant.
- As of June 30, 20X1, Entity A classifies the remaining $2 million of commercial paper as a noncurrent liability. Entity A demonstrated its ability to complete its intended refinancing of the $2 million of commercial paper on a long-term basis by issuing a long-term obligation after the balance sheet date but before the financial statements are issued.

*The conclusion would be the same if Entity A had entered a financing agreement (that meets the conditions discussed in Section 8.3.2.2) before the financial statements are issued or are available to be issued instead of issuing the long-term debt as described in this example.

8.3.2.2 Refinancing by Entering a Financing Agreement

FASB REFERENCES

ASC 470-10-45-14, ASC 470-10-45-17 through 45-21, ASC 470-10-55-16 through 55-17, ASC 470-10-55-19 through 55-20, and ASC 470-10-55-25 through 55-31

To demonstrate its ability to complete its intended refinancing by entering a financing agreement, an entity must enter that financing agreement **before** the financial statements are issued or are available to be issued. The financing agreement must clearly allow the entity to refinance the short-term obligation on a long-term basis on terms that are readily determinable.

The financing agreement also must meet **all** the following conditions:

- The financing agreement does not expire within one year from the balance sheet date. During that period, the lender (or prospective lender) or investor cannot cancel the agreement (or call on obligations incurred under the agreement), except for violations of any objectively determinable and measurable provisions.
  - Violation of a provision means failure to meet a condition included in the financing agreement, or a breach or violation of a provision such as a restrictive covenant, representation, or warranty, regardless of whether a grace period exists, or whether the lender is required to give notice.
  - A financing agreement that includes cancellation terms based on subjective conditions that can be evaluated differently by the parties to the agreement (such as a material adverse change clause or a requirement to maintain satisfactory operations) does not meet this condition. In other words, a financing agreement with a SAC (that is, the prospective lender can cancel the financing agreement if it determines that a material adverse change exists) does not meet this condition.
- There are no violations under the financing agreement (and no available information indicates a violation has occurred) as of the balance sheet date or before the financial statements are issued.
  - If violations exist, the entity must have obtained a waiver.
- The lender (or prospective lender) or investor must be financially capable of honoring the financing agreement.

REPLACING A SHORT-TERM OBLIGATION WITH ANOTHER SHORT-TERM OBLIGATION

An entity may refinance a short-term obligation by replacing it with another short-term obligation after the balance sheet date. That refinancing must meet the conditions discussed above to demonstrate the entity's ability to complete its intended refinancing of the short-term obligation on a long-term basis. For example, an entity may:

- Replace a short-term obligation with another short-term obligation under a revolving credit agreement that provides for the obligation's renewal or extension for an uninterrupted period extending beyond one year from the balance sheet date (see Example 8-8).
- Replace a short-term obligation originally made under a revolving credit agreement that includes a SAC. To demonstrate an entity's intent and ability to refinance short-term borrowings under a revolving credit agreement on a long-term basis, the refinancing must be based on another financing agreement (that is, other than the revolving credit agreement that includes a SAC) because a financing agreement with a SAC would not meet the conditions discussed above.
- Replace a short-term obligation through a rollover of commercial paper accompanied by a standby credit agreement (see Example 8-10).

The portion of a short-term obligation the entity classifies as a noncurrent liability is limited to the available funds under the financing agreement. The available funds exclude proceeds the entity cannot use to liquidate the short-term obligation — for instance, because of transfer restrictions or other restrictions in the agreement (see Example 8-7). The entity must classify the excess of the short-term obligation over the available funds as a current liability.

If the available funds fluctuate (for instance, in relation to the entity's needs or in proportion to the collateral value), the entity must classify as a current liability the excess of the short-term obligation over the estimated minimum available amount at any date from the debt's scheduled maturity to the end of the fiscal year (see Example 8-9). If the borrower cannot reasonably estimate the available funds, the entire short-term obligation must be presented as a current liability.

ALTERNATIVE SOURCES OF REFINANCING

Sometimes an entity seeks an alternative source of financing, even if it has already secured a financing agreement that meets the conditions for refinancing a short-term obligation on a long-term basis. As discussed in Section 8.3.2, that does not invalidate the entity's assertion that it has the intent to refinance the short-term obligation on a long-term basis using the existing financing agreement as long as it intends to exercise the financing agreement if the alternative source of financing does not become available. However, if the terms of the financing agreement are unreasonable (for example, the interest rate is unreasonable relative to the market rate or the entity's creditworthiness), the intent to refinance the short-term obligation on a long-term basis might not exist.

EXAMPLE 8-6 (ADAPTED FROM ASC 470-10-55-16 THROUGH 55-17): CLASSIFICATION OF SHORT-TERM OBLIGATIONS REFINANCED ON A LONG-TERM BASIS

FACTS

- As of December 31, 20X1, Entity A has the following short-term obligations, which it intends to refinance on a long-term basis:
  - $5 million of 6% long-term debt maturing in February 20X2
  - $3 million of 9% notes payable issued in November 20X1 and maturing in July 20X2.
- In December 20X1, Entity A negotiates a financing agreement with a commercial bank for a maximum borrowing of $8 million at any time through 20X3 with the following terms:
  - Borrowings are available at Entity A's request as it deems appropriate and will mature three years from the borrowing date.
  - Amounts borrowed will bear interest at the bank's prime rate. An annual commitment fee of 0.5% is payable on the difference between the amount borrowed and $8 million.
  - The agreement is cancelable by the prospective lender only if any of the following compliance provisions occur:
    - Entity A's working capital, excluding borrowings under the financing agreement, falls below $10 million.
    - Entity A becomes obligated under lease agreements to pay annual rent in excess of $1 million.
    - Entity A acquires treasury stock without the prospective lender's prior approval.
    - Entity A guarantees indebtedness of unaffiliated parties in excess of $0.5 million.
- The lender is expected to be financially capable of honoring the agreement, there is no evidence of a violation of any provision, and the terms of the borrowings are readily determinable.
- Entity A's fiscal year end is December 31. It issues its December 31, 20X1 financial statements on March 31, 20X2.

CONCLUSION

In its December 31, 20X1 financial statements, Entity A classifies as noncurrent liabilities the 6% long-term debt maturing in February 20X2 and the 9% notes payable maturing in July 20X2.

ANALYSIS

Entity A's intent to refinance its short-term obligations on a long-term basis is demonstrated by its ability to complete its intended refinancing by entering a financing agreement **before** the financial statements are issued or are available to be issued. The financing agreement clearly allows Entity A to refinance the short-term obligation on a long-term basis on terms that are readily determinable. Therefore, the conditions in ASC 470-10-45-14(b) are met because:

- The financing agreement does not expire within one year from the balance sheet date. During that period, the prospective lender cannot cancel the agreement (or call on obligations incurred under the agreement) except for a violation of objectively determinable and measurable provisions.
- There are no violations under the financing agreement as of the balance sheet date and before the financial statements are issued.
- The prospective lender is financially capable of honoring the financing agreement.

See ASC 470-10-55-18 for an illustration of how Entity A may present and disclose its liabilities on its balance sheet.

EXAMPLE 8-7 (ADAPTED FROM ASC 470-10-55-19 THROUGH 55-20): CLASSIFICATION OF SHORT-TERM OBLIGATIONS REFINANCED ON A LONG-TERM BASIS — LAWS PROHIBIT THE TRANSFER OF FUNDS

FACTS

Assume the same facts as in Example 8-6, except that:

- Instead of Entity A entering a financing agreement with a commercial bank, Entity A's foreign subsidiary negotiates a financing agreement with its local bank in December 20X1.
- Funds are available to the subsidiary for its unrestricted use, including loans to affiliated entities.
- Local laws prohibit the transfer of funds outside the country.

CONCLUSION

In its December 31, 20X1 financial statements, Entity A classifies as current liabilities the 6% long-term debt maturing in February 20X2 and the 9% notes payable maturing in July 20X2.

ANALYSIS

As discussed in Example 8-6, Entity A's intent and ability to refinance meet the conditions in ASC 470-10-45-14(b) because compliance with the financing agreement's provisions is objectively determinable and measurable. However, in accordance with ASC 470-10-45-18, the amount excluded from current liabilities is limited to the amount available to liquidate the short-term obligation being refinanced. Because the proceeds from borrowings under the foreign subsidiary agreement are not available for liquidation of Entity A's own liabilities (that is, the foreign subsidiary cannot transfer proceeds from borrowings to its parent because of local law restrictions), Entity A classifies as current liabilities the long-term debt maturing in February 20X2 and notes payable maturing in July 20X2.

EXAMPLE 8-8 (ADAPTED FROM ASC 470-10-55-25 THROUGH 55-26): CLASSIFICATION OF SHORT-TERM OBLIGATIONS REFINANCED ON A LONG-TERM BASIS WITH A REVOLVING CREDIT AGREEMENT

FACTS

Assume the same facts as in Example 8-6, except that:

- In December 20X1, instead of entering the financing agreement described in Example 8-6, Entity A negotiates with a commercial bank a revolving credit agreement that provides for unrestricted borrowings up to $10 million.
- Borrowings under the revolving credit agreement bear interest at 1% over the prevailing bank prime rate, with an 8% floor.
- Borrowings under the revolving credit agreement have stated maturities of 90 days. They are continuously renewable for 90-day periods at Entity A's option for three years if Entity A is compliant with the agreement's terms (same compliance provisions as those in Example 8-6).
- Entity A intends to renew obligations incurred under the revolving agreement for a period extending beyond one year from the balance sheet date.
- At December 31, 20X1, there are no outstanding borrowings under the revolving credit agreement.

CONCLUSION

In its December 31, 20X1 financial statements, Entity A classifies as noncurrent liabilities the 6% long-term debt maturing in February 20X2 and the 9% notes payable maturing in July 20X2.

ANALYSIS

In accordance with ASC 470-10-45-21, if an entity is replacing a short-term obligation with another short-term obligation under a revolving agreement, the agreement must meet the conditions in ASC 470-10-45-14(b) to demonstrate the entity's ability to refinance a short-term obligation on a long-term basis.

- The revolving credit agreement does not expire within one year from the balance sheet date. During that period, the lender cannot cancel the agreement (or call on obligations incurred under the agreement), except for a violation of objectively determinable and measurable provisions. The agreement also does not include a subjective acceleration clause.
- Entity A is compliant with the revolving credit agreement's provisions as of the balance sheet date and before the financial statements are issued.
- The lender is financially capable of honoring the revolving credit agreement.

Therefore, Entity A's intent and ability to refinance the short-term obligations meet the conditions in ASC 470-10-45-14(b). Entity A classifies as noncurrent liabilities the 6% long-term debt maturing in February 20X2 and 9% notes payable maturing in July 20X2.

EXAMPLE 8-9 (ADAPTED FROM ASC 470-10-55-27 THROUGH 55-29): CLASSIFICATION OF SHORT-TERM OBLIGATIONS REFINANCED ON A LONG-TERM BASIS WITH A REVOLVING CREDIT AGREEMENT WITH BORROWING LIMITS

FACTS

Assume the same facts as in Example 8-8, except that:

- The revolving credit agreement limits borrowings to the amount of Entity A's inventory, which is pledged as collateral.
- Inventory is expected to range between a high of $8 million during the second quarter of 20X2 and a low of $4 million during the fourth quarter of 20X2.

CONCLUSION

In its December 31, 20X1 financial statements, Entity A classifies only $4 million of its short-term obligations as noncurrent liabilities.

ANALYSIS

As discussed in Example 8-8, Entity A's intent and ability to refinance meet the conditions in ASC 470-10-45-14(b). However, because the minimum available funds are expected to be only $4 million (the expected low inventory balance in 20X2), Entity A classifies only $4 million of its short-term obligations as noncurrent liabilities.

Whether the obligation to be excluded from current liabilities is the 6% long-term debt or some portions of both it and the 9% notes payable depends on the intended timing of the borrowing. For example, if Entity A intends to refinance only the 9% notes payable due July 20X2, and the amount of its inventory is expected to reach a low of approximately $2 million during the second quarter of 20X2 but be at least $3 million in July 20X2 and thereafter during 20X2, Entity A would classify the $3 million in 9% notes payable as a noncurrent liability at December 31, 20X1.

EXAMPLE 8-10 (ADAPTED FROM ASC 470-10-55-30 THROUGH 55-31): CLASSIFICATION OF SHORT-TERM OBLIGATIONS REFINANCED ON A LONG-TERM BASIS WITH COMMERCIAL PAPER

FACTS

During 20X1, Entity A enters a warehouse construction contract, which it finances by issuing commercial paper. Also, Entity A enters a standby agreement with a commercial bank with the following terms:

- The standby agreement allows for maximum borrowings up to the expected warehouse construction costs and expires more than one year from the balance sheet date.
- The standby agreement requires that Entity A use the proceeds from the sale of commercial paper for construction costs.
- Entity A can borrow under the standby agreement only if it is unable to issue new commercial paper. Entity A also must use proceeds from borrowings to retire outstanding commercial paper and liquidate additional liabilities incurred during construction.
- The warehouse is pledged as collateral for the standby agreement.

The commercial bank can honor the standby agreement, and the terms of borrowings available under the agreement are readily determinable. Entity A is compliant with all terms of the standby agreement as of the balance sheet date and before the financial statements are issued.

Entity A's fiscal year end is December 31. It issues its December 31, 20X1 financial statements on March 31, 20X2. At December 31, 20X1, Entity A has $7 million of commercial paper outstanding, as well as $1 million of unpaid construction costs resulting from a progress billing through December 31.

CONCLUSION

In its December 31, 20X1 financial statements, Entity A classifies as noncurrent liabilities its $7 million of commercial paper and $1 million of unpaid construction costs.

ANALYSIS

In accordance with ASC 470-10-45-21, the standby agreement must meet the conditions in ASC 470-10-45-14(b) to demonstrate Entity A's ability to refinance its short-term obligations on a long-term basis.

- The standby agreement does not expire within one year from the balance sheet date. During that period, the lender cannot cancel the agreement (or call on obligations incurred under the agreement) other than for a violation of objectively determinable and measurable provisions.
- Entity A is compliant with the standby agreement's provisions as of the balance sheet date and before the financial statements are issued.
- The commercial bank is financially capable of honoring the standby agreement.

Because Entity A has the intent and ability to refinance the commercial paper on a long-term basis, either by uninterrupted renewal of the commercial paper or by borrowing under the standby agreement that meets the conditions in ASC 470-10-45-14(b), it classifies the $7 million of commercial paper as a noncurrent liability. The $1 million of unpaid progress billing refinanced on the same basis as the commercial paper is also classified as a noncurrent liability.

8.3.3 Classification of Debt Under Revolving Credit Agreements

FASB REFERENCES

ASC 470-10-45-3 through ASC 470-10-45-5, ASC 470-10-45-14, and ASC Master Glossary: Line of Credit Arrangement

A line of credit or revolving-debt arrangement typically allows a borrower to make multiple borrowings up to a specified maximum amount, repay all or portions of previous borrowings, and reborrow under the same arrangement.

If the borrowings are due at the end of a specified period beyond one year, the borrowings are long-term obligations (see Section 8.3.1). If the borrowings are subject to a subjective acceleration clause or SAC (a clause allowing the lender to accelerate the debt's repayment based on conditions that are not objectively determinable), the entity classifies them based on the guidance in Section 8.3.1.2. Further, revolving credit arrangements often include debt covenants, in which case, an entity must also consider the guidance in Section 8.3.1.1 to determine the borrowings' classification.

However, if the revolving credit agreement requires an entity to maintain a lock-box arrangement under which receipts from the entity's customers are remitted directly to the lender and reduce the debt's outstanding balance, the borrowings are considered short-term obligations (even if they are contractually due beyond one year). Similarly, if the borrowings roll over on a short-term basis (such as every 90 days), they are short-term obligations.

Short-term obligations may be classified as noncurrent only if the entity has the intent and ability to refinance them on a long-term basis and the conditions discussed in Section 8.3.2 are met. If the revolver also includes a SAC, the entity's intent and ability to refinance on a long-term basis must be demonstrated through another financing arrangement (see Section 8.3.3.1). Lock-box arrangements an entity maintains at its own discretion (not required by the arrangement) do not affect the classification of the borrowings under the revolver.

8.3.3.1 Revolving Credit Agreements Subject to Lock-Box Arrangements and Subjective Acceleration Clauses

FASB REFERENCES

ASC 470-10-20: Lock-Box Arrangement and Springing Lock-Box Arrangement and ASC 470-10-45-4 through 45-6

Some debt agreements contractually require borrowers to maintain a lock-box arrangement. A lock-box arrangement refers to any situation in which the borrower cannot avoid using working capital to repay the outstanding debt. An entity must consider borrowings under those arrangements as short-term obligations. Therefore, it must classify the borrowings as current liabilities unless it has an intent and ability to refinance them on a long-term basis (see Section 8.3.2).

BDO INSIGHTS — SAC AND LOCK-BOX ARRANGEMENTS

As discussed in Section 8.3.2.2, an entity may refinance a short-term obligation on a long-term basis via replacement by another short-term obligation on a continuous basis for more than one year from the balance sheet date. Therefore, borrowings under a revolving credit facility that has an expiration date of more than one year and does not have a SAC often can be classified as noncurrent liabilities (provided the entity intends to refinance them on a long-term basis (as discussed in Section 8.3.2) and the revolving credit facility meets the conditions discussed in Section 8.3.2.2).

However, if the revolving credit agreement includes both a SAC and a requirement to maintain a lock-box arrangement, the borrowings do not qualify for noncurrent classification unless the entity can demonstrate its ability to refinance on a long-term basis through means **other than** the revolving credit agreement that has a SAC (for example, through another financing agreement that meets the conditions discussed in Section 8.3.2.2).

The table summarizes how lock-box arrangements and SACs affect classification under a revolving credit agreement.

DESCRIPTION	SAC AND LOCK-BOX REQUIREMENTS	CLASSIFICATION
Short-term notes that are due as they roll over (for example, every 90 days)	No SAC (with or without a lock-box arrangement)	Current unless the entity has the intent and ability to refinance on a long-term basis (see Section 8.3.2). That intent and ability may be demonstrated by replacement with another short-term obligation on a continuous basis (for example, under the terms of a revolving credit agreement that allows renewal or extension of the short-term obligation for an uninterrupted period of more than one year from the balance sheet date) that meets the conditions in ASC 470-10-45-14(b) (see Section 8.3.2.2).
	With SAC (with or without a lock-box arrangement)	Current unless the entity has the intent and ability to refinance on a long-term basis (see Section 8.3.2). That intent and ability must be demonstrated by refinancing under an agreement (**other than** the revolving credit agreement that has a SAC) that meets the conditions in ASC 470-10-45-14(b) (see Section 8.3.2.2).
Long-term notes due at a specified date beyond one year from the balance sheet date (for example, three years)	No SAC and without a lock-box arrangement	Noncurrent however, the entity must assess whether debt covenant violations exist that cause the debt to be callable, in which case, it must assess those violations based on the guidance discussed in Section 8.3.1.1.
	With SAC but without a lock-box arrangement	Noncurrent if acceleration under the SAC is remote. If acceleration is more than remote, classification is based on the facts and circumstances (see Section 8.3.1.2). The entity must also assess whether there are debt covenant violations that cause the debt to be callable, in which case, it must assess those violations based on the guidance discussed in Section 8.3.1.1.
	No SAC but with a lock-box arrangement	Current unless the entity has the intent and ability to refinance on a long-term basis (see Section 8.3.2). That is because long-term notes issued under a revolving credit agreement are considered short-term obligations if the agreement includes a lock-box arrangement (even if they are contractually due beyond one year from the balance sheet date). The intent and ability to refinance on a long-term basis may be demonstrated by replacement with another short-term obligation on a continuous basis (for instance, under the terms of a revolving credit agreement that allows renewal or extension of the short-term obligation for an uninterrupted period of more than one year from the balance sheet date) that meets the conditions in ASC 470-10-45-14(b) (see Section 8.3.2.2).
	With SAC and with a lock-box arrangement	Current unless the entity has the intent and ability to refinance on a long-term basis (see Section 8.3.2). That is because long-term notes issued under a revolving credit agreement are considered short-term obligations if the agreement includes a lock-box arrangement (even if they are contractually due beyond one year from the balance sheet date). The intent and ability to refinance on a long-term basis must be demonstrated by refinancing under an agreement (**other than** the revolving credit agreement that has a SAC) that meets the conditions in ASC 470-10-45-14(b) (see Section 8.3.2.2).

Further, ASC 470 distinguishes between traditional and springing lock-box arrangements. Unlike traditional lock-box arrangements, springing arrangements do not automatically reduce the outstanding debt balance without another event occurring. However, once the event occurs, customer remittances must be used to reduce the debt balance, and the springing lock-box must be analyzed as a traditional lock-box.

The table summarizes the difference in how an entity classifies borrowings under a revolving credit agreement **with a SAC** based on the type of lock-box arrangement.

	TRADITIONAL LOCK-BOX ARRANGEMENT	SPRINGING LOCK-BOX ARRANGEMENT
Description	Payments from the entity's customers are remitted directly to the lender and reduce the debt outstanding. Said differently, remittances are used to repay the debt in the ordinary course of business and without another event occurring.	Remittances from the entity's customers are forwarded to the entity's general bank account and do not reduce the debt outstanding until and unless the lender exercises the subjective acceleration clause. In other words, remittances do not automatically reduce the debt outstanding without another event occurring.
Classification	As discussed in the preceding table, the entity classifies the (short- and long-term) borrowings with a SAC and traditional lock-box arrangement as current unless it has the intent and ability to refinance on a long-term basis (see Section 8.3.2). That intent and ability must be demonstrated by refinancing under an agreement (other than the revolving credit agreement that has a SAC) that meets the conditions in ASC 470-10-45-14(b) (see Section 8.3.2.2).	▶ The entity classifies short-term borrowings (such as notes rolling over every 90 days) as current liabilities unless it has the intent and ability to refinance on a long-term basis. That intent and ability must be demonstrated by refinancing under an agreement (other than the revolving credit agreement that has a SAC) that meets the conditions in ASC 470-10-45-14(b) (see Section 8.3.2.2). ▶ The entity classifies long-term borrowings (such as notes maturing in three years) as noncurrent liabilities if acceleration under the SAC is remote. If acceleration is more than remote, classification is based on the facts and circumstances (see Section 8.3.1.2). The entity must also assess whether there are debt covenant violations that cause the borrowings to be callable, in which case, it must assess those violations based on the guidance discussed in Section 8.3.1.1.

8.3.4 Classification of Due on Demand and Puttable Debt

FASB REFERENCES

ASC 470-10-45-9 through 45-10

Debt agreements may include repayment terms (for example, scheduled repayment dates or maturity dates) beyond one year but also allow the lender to demand the debt's repayment at any time. An entity classifies debt that is due on demand or will be due on demand within one year of the balance sheet date as a current liability (unless the entity has the intent and ability to refinance the debt on a long-term basis, as discussed in Section 8.3.2) regardless of whether the debt's liquidation is expected during that period. ASC 470 provides the following examples of language in loan agreements that indicates debt is due on demand:

- The term note shall mature in monthly installments as set forth therein or on demand, whichever is earlier.
- Principal and interest shall be due on demand, or if no demand is made, in quarterly installments beginning on…

A demand provision is not a subjective acceleration clause (see Section 8.3.1.2).

Similarly, debt that matures beyond one year from the balance sheet date but contains a put option the lender can exercise at any time within one year of the balance sheet date is classified as a current liability unless the entity has the intent and ability to refinance the debt on a long-term basis, as discussed in Section 8.3.2.

BDO INSIGHTS — DEBT WITH CONTINGENT PUT OPTIONS

Some debt instruments include terms that accelerate repayment (either automatically or at the lender's option) when specified contingent events occur (such as a change in control). If the event has occurred at the balance sheet date and the outstanding debt is due on demand or will be due on demand within one year of the balance sheet date, the entity classifies the debt as a current liability unless the entity has the intent and ability to refinance the debt on a long-term basis (see Section 8.3.2). The entity must consider the facts and circumstances when determining the debt's classification if the event occurs after the balance sheet date and before the financial statements are issued or are available to be issued.

Debt that becomes puttable by the lender because of covenant violations is not evaluated as debt with a contingent put option. Rather, it must be assessed under the guidance discussed in Section 8.3.1.1.

8.3.5 Classification of Prepayable Debt

FASB REFERENCES

ASC 210-10-45-4 and ASC 210-10-45-9

A debt agreement may provide a borrower with a right to prepay the debt. An entity's prepayment option (for example, at any time or upon the occurrence or nonoccurrence of a specified event) generally does not affect debt classification because the entity is not contractually required to prepay the debt. However, if the entity irrevocably exercises its prepayment option **before the balance sheet date** and the debt must be paid within one year of the balance sheet date, the entity must classify the debt as a current liability.

BDO INSIGHTS — EFFECT OF AN ENTITY'S PREPAYMENT OPTION ON DEBT CLASSIFICATION

ASC 210-10-45-9 states that current liabilities include liabilities "*whose regular and ordinary liquidation is expected to occur within a relatively short period of time, usually 12 months.*" Therefore, debt that matures more than one year from the balance sheet date is classified as a noncurrent liability if that obligation meets the conditions to be excluded from current liabilities, as discussed in Section 8.3.1. An entity's prepayment option generally does not affect the debt's classification. However, we believe it is acceptable to classify long-term debt as current if all the following conditions are met:

- The entity has a prepayment option that is exercisable at the balance sheet date (or will become exercisable within one year of the balance sheet date).
- The entity has the intent and ability to prepay the debt within one year of the balance sheet date (or prepays the debt after the balance sheet date and before the financial statements are issued or are available to be issued).
- The entity reasonably expects to prepay the debt using current assets existing at the balance sheet date or by incurring other current liabilities (that is, the debt's settlement will not use funds obtained from a long-term refinancing).

Determining the classification of a prepayable long-term debt requires the application of professional judgment based on the facts and circumstances.

8.3.6 Classification of Convertible Debt

FASB REFERENCES

ASC 470-20-45-1B and ASC 855-10-50-2 through 50-3

Generally, an entity classifies convertible debt as current or noncurrent liability based on the instrument's terms (before consideration of the conversion terms) as follows:

- As a current liability — If the entity does not have the intent and ability to refinance on a long-term basis (see Section 8.3.2), and **any** of the following exist at the balance sheet date:
  - The debt matures within one year of the balance sheet date
  - The debt is payable on demand or puttable by the lender at any time (see Section 8.3.4)
  - The debt includes a SAC and the debt's acceleration is probable (see Section 8.3.1.2)
  - The debt is callable or will become callable because of covenant violations (see Section 8.3.1.1).
- As a noncurrent liability — If the debt does not meet any of the conditions above, or if it meets any of the conditions, but the entity has the intent and ability to refinance the debt on a long-term basis (see Section 8.3.2).

The entity classifies the convertible debt based on its cash payment terms if the debt's conversion can be settled only by issuing shares (the conversion terms do not affect classification). If the debt's conversion must be settled in cash, shares, or a combination of cash and shares, the entity considers the debt's conversion terms to determine classification (in addition to the considerations discussed above). For instance, if the debt would otherwise be classified as a noncurrent liability (for example, because the debt matures more than one year from the balance sheet date) but is currently convertible (or will become convertible with the passage of time within one year of the balance sheet date) and the entity must settle the holder's conversion option in cash (or the holder can elect to convert in cash or shares at its option), the entity classifies the debt as a current liability.

CLASSIFICATION OF CONTINGENTLY CONVERTIBLE DEBT

As discussed above, when an entity must satisfy all or a portion of the convertible debt in cash, the debt's conversion terms affect classification when, at the balance sheet date, the debt is currently convertible or will become convertible within one year based solely on passage of time.

If the debt's conversion is contingent, it is currently convertible only if any contingencies are met at the balance sheet date. Meeting the contingencies after the balance sheet date but before the financial statements are issued or are available to be issued does not affect the debt's classification at the balance sheet date. Rather, the contingencies are treated as nonrecognized subsequent events in accordance with ASC 855, and the following must be disclosed:

- The nature of the event
- An estimate of the event's financial effect or a statement that such an estimate cannot be made
- Pro forma financial data if the nonrecognized subsequent event is so significant that disclosure can best be made by means of pro forma financial data.

BDO INSIGHTS — CLASSIFICATION OF CONVERTIBLE DEBT WITH CASH CONVERSION FEATURES

The table summarizes different types of cash convertible instruments and how an entity considers the conversion terms in determining the debt's classification (assuming that at the balance sheet date, the debt is currently convertible or will become convertible within one year based solely on passage of time and the entity does not have the intent and ability to refinance the debt on a long-term basis).

SCENARIO	DESCRIPTION	CONVERSION OPTION'S EFFECT ON CLASSIFICATION
The entity must settle all or part of the conversion value in cash.	▶ The entity must satisfy the debt's conversion value (fixed number of shares multiplied by the stock price on conversion date) entirely in cash (Instrument A). ▶ The entity must satisfy the principal in cash and may satisfy the conversion premium in either cash or shares (Instrument C).	Because the entity must settle the principal (accreted value) in cash, the debt is included in current liabilities (regardless of whether the conversion option is out-of-the-money). The debt is in substance demand debt (see Section 8.3.4) because the lender has a contractual right to convert and require the entity to settle the debt wholly or partly in cash. It is irrelevant whether the lender would exercise the conversion option.
The entity may settle the conversion value in cash or shares.	▶ The entity may satisfy the debt's conversion value either entirely in cash or shares (Instrument B). ▶ The entity may satisfy the debt's conversion value in any combination of cash and shares (Instrument X).	We believe it is acceptable to classify the debt based on the entity's intended settlement method. The approach is based on the definition of current liabilities, which includes obligations reasonably expected to require the use of current assets. Generally, the entity's classification should be consistent with assumptions used for other purposes, such as its cash flow forecasts.

Determining the classification of cash convertible instruments requires the application of professional judgment based on the facts and circumstances.

8.3.7 Classification of Increasing-Rate Debt

FASB REFERENCES

ASC 470-10-45-7 through 45-8

For some debt instruments, an entity may have an option to extend the maturity date (until a final maturity date is reached) in which the interest rate increases each time the maturity date is extended. The entity recognizes interest based on the debt's estimated life determined based on the entity's plans, ability, and intent to service the debt.

While the entity accrues interest on increasing-rate debt based on the debt's estimated life (see Section 6.2.7.3), its classification does not need to be consistent with the timeframe used to accrue interest. Rather, the entity determines whether to exclude the instrument from current liabilities based on the anticipated repayment sources (for example, current assets, short-term obligations, or a long-term refinancing agreement). In other words, if the entity plans to repay the debt with current assets or intends to finance repayment with short-term obligations, it classifies the debt as a current liability. If the entity has the intent and ability to refinance the debt on a long-term basis, it classifies the debt as a noncurrent liability (see Section 8.3.2).

If the entity repays the obligation at par before the estimated maturity date, it recognizes any excess accrued interest as an adjustment to interest expense.

8.3.8 Classification of Restructured Debt

FASB REFERENCES

ASC 470-60-45-1 through 45-2

An entity must consider changes in debt terms when determining the classification of restructured debt. For example, changes in the amount or timing (or both) of future cash payments affect the amounts presented as current and noncurrent liabilities at the balance sheet date.

Further, a TDR of a short-term obligation after the balance sheet date but before the financial statements are issued or are available to be issued may affect the classification of that obligation.

8.3.9 Debt — Other Presentation and Disclosure Requirements

Entities that issue debt instruments must disclose specific information about those instruments. This section discusses the general disclosure requirements for all debt instruments. It also covers:

- Presentation and disclosure requirements for debt premiums, discounts, and issuance costs
- Disclosure requirements for convertible debt instruments
- Disclosure requirements for TDRs and debt extinguishments.

8.3.9.1 Debt — General Information

FASB REFERENCES

ASC 470-10-50-1 through 50-5 and ASC 470-10-55-10 through 55-12

ASC 470-10 requires the following disclosures for debt instruments:

- The combined aggregate maturities and sinking fund requirements for all long-term borrowings for each of the five years following the date of the latest balance sheet (See Example 8-11)
- For an obligation classified as a noncurrent liability because it is probable the entity will cure a covenant violation within a grace period (see Section 8.3.1.1), the circumstances that allowed the entity to classify the debt as noncurrent
- For short-term obligations expected to be refinanced on a long-term basis and classified as noncurrent liabilities, the general description of the financing agreement and the terms of any new obligation incurred or expected to be incurred or equity securities issued or expected to be issued (see Section 8.3.2)
- The existence and terms of subjective acceleration clauses in some circumstances (see Section 8.3.1.2)
- The outstanding securities' rights and privileges (for example, participation rights, call prices and dates, and sinking fund requirements) in summary form.

EXAMPLE 8-11 (ADAPTED FROM ASC 470-10-55-10 THROUGH 55-12): DISCLOSURE OF LONG-TERM OBLIGATIONS' ANNUAL MATURITIES AND SINKING FUND REQUIREMENTS

FACTS

Entity D has the following instruments outstanding:

- A long-term loan for $100 million with annual sinking fund payments of $10 million in 20X2, 20X3, and 20X4; $15 million in 20X5 and 20X6; and $20 million in 20X7 and 20X8.
- A long-term loan for $50 million due in 20X5.
- A convertible debt with principal of $70 million that is convertible only at or after maturity in 20X9. The convertible debt requires a 2% annual cumulative sinking fund payment of $1.4 million until settled.
- A $30 million preferred stock that requires a 5% annual cumulative sinking fund payment of $1.5 million until retired.

DISCLOSURE

In accordance with ASC 470-10-50-1, Entity D's disclosure may be presented as illustrated below.

The maturities and sinking fund requirements on long-term loans and convertible debt and sinking fund requirements on preferred stock subject to mandatory redemption are as follows (in thousands):

	Long-term loans	Convertible debt	Preferred stock
20X2	$ 10,000	$ 1,400	$ 1,500
20X3	10,000	1,400	1,500
20X4	10,000	1,400	1,500
20X5	65,000	1,400	1,500
20X6	15,000	1,400	1,500

8.3.9.2 Debt Discount, Premium, and Issuance Costs

FASB REFERENCES

ASC 835-30-45-1A through 45-4, ASC 835-30-50-1, and ASC 835-30-55-8

A debt instrument's face amount may differ from its carrying amount because of debt issuance costs (see Section 6.2.5) and debt discount or premium (see Section 6.2.1.5). For debt instruments not reported at fair value, an entity must present debt issuance costs and debt discount (or premium) as a direct deduction from (or addition to) the debt balance presented on the face of the balance sheet. In other words, an entity must not present debt issuance costs, discount, or premium as an asset (as a deferred charge) or separate liability (as a deferred credit). Further, for each debt instrument, entities must disclose — either on the face of the balance sheet or in the notes to the financial statements — the following:

- The debt instrument's face amount (that is, the debt's principal balance)
- The effective interest rate.

ASC 835-30 also requires an entity to present amortization of debt issuance costs and discount or premium as interest expense (see Sections 6.2.2.1 and 6.2.5).

EXAMPLE 8-12 (ADAPTED FROM ASC 835-30-55-8): BALANCE SHEET PRESENTATION OF DISCOUNTED NOTES

The disclosures required by ASC 835-30-45-1 through 45-3 related to the balance sheet presentation of discounted notes may be presented as illustrated below.

	DECEMBER 31	
	20X2	**20X1**
LONG-TERM DEBT (see Note 1)		
Principal amount	$ 24,200,000	$ 24,200,000
Less unamortized discount and debt issuance costs	2,680,000	2,792,000
Long-term debt less unamortized discount and debt issuance costs	$ 21,520,000	$ 21,408,000

NOTE 1 — LONG-TERM DEBT

Long-term debt at December 31, 20X2, consisted of:	**Principal**	**Unamortized discount and debt issuance costs**
6% subordinated debentures due 20X9 (discount is based on imputed interest rate of 7%)	$ 20,000,000	$ 2,150,000
6.5% bank loan due 20X7	3,000,000	120,000
Noninterest bearing note issued in connection with acquisition of property due 20X9 (discount based on an imputed interest rate of 8%)	1,200,000	410,000
Total	$ 24,200,000	$ 2,680,000

8.3.9.2.1 Debt Issuance Costs, Lender Fees, and Commitment Fees Related to Revolving Credit Agreements

FASB REFERENCES

ASC 835-30-S45-1

An entity may incur costs to enter a revolving credit agreement (or a line-of-credit arrangement) regardless of whether it has borrowed funds under the agreement. That could result in the entity paying fees but not having a debt balance recognized in the financial statements.

ASC 835-30 includes presentation guidance for debt issuance costs, discounts, or premiums on debt instruments. However, it does not provide guidance for debt issuance costs and other fees related to revolving credit agreements.

BDO INSIGHTS — PRESENTATION OF FEES RELATED TO REVOLVING CREDIT AGREEMENTS

The table summarizes the common fees related to revolving credit agreements and their presentation.

TYPE	ANALYSIS
Debt issuance costs and lender fees	The SEC staff has said it would not object to an entity presenting debt issuance costs related to line-of-credit arrangements as a deferred asset and amortizing them ratably over the term of the arrangement, regardless of whether there are any outstanding amounts under the agreement. We believe private entities also can apply that SEC staff guidance. While the SEC staff guidance addresses presentation of debt issuance costs related to line-of-credit arrangements, regardless of whether there are any outstanding amounts, we believe an entity may apply a different (and consistent and rational) presentation approach when amounts are outstanding under a line of credit, such as by reclassifying a portion of debt issuance costs as a direct deduction of the debt balance. However, the SEC staff guidance provides a simpler approach. While discussed in the context of debt issuance costs, we believe the SEC staff guidance also applies to upfront lender fees paid on revolving credit agreements, regardless of whether the entity has borrowings outstanding under the revolving agreement.
Commitment fees	Lenders often charge upfront commitment fees under a revolving credit facility. Those fees represent an entity's cost to access capital. Therefore, we believe an entity should recognize those fees as a deferred asset and amortize them in the same manner as other lender fees and debt issuance costs.

Determining the appropriate presentation of debt issuance costs, lender fees, and commitment fees related to revolving credit agreements requires the application of professional judgment based on the facts and circumstances.

8.3.9.3 Convertible Debt

FASB REFERENCES

ASC 470-20-50-1A through 50-1I, ASC 470-20-55-69A through 55-69F

The objective of an entity's disclosures about convertible debt is to give financial statement users:

- Information about the convertible debt's terms and features
- An understanding of how the entity reported those instruments on its balance sheet and income statement
- Information about events, conditions, and circumstances that can affect the instruments' cash flow amounts or timing.

The table summarizes the ASC 470-20 disclosure requirements.

	DISCLOSURE REQUIREMENT
Terms and features	An entity must explain each outstanding convertible debt's pertinent rights and privileges, including: ▶ Principal amount ▶ Coupon rate ▶ Conversion or exercise prices or rates and number of shares the instrument is potentially convertible into ▶ Pertinent dates, such as conversion date(s) and maturity date ▶ Parties that control the conversion rights ▶ Manner of settlement upon conversion and any alternative settlement methods, such as cash, shares, or a combination of cash and shares ▶ Terms that may adjust conversion or exercise prices (excluding standard antidilution provisions), number of shares to be issued, or other conversion rights and the timing of those rights ▶ Any applicable liquidation preference and unusual voting rights ▶ Instrument's other material terms and features not listed above.
Contingently convertible instruments	For contingently convertible instruments or instruments described in ASC 470-20-05-8 through 05-8A, an entity must disclose the following incremental information: ▶ Events or changes in circumstances that would adjust or change the contingency or result in meeting the contingency ▶ Information on whether the shares that would be issued if the contingently convertible securities were converted are included in the diluted EPS computation and the reasons why or why not ▶ Other information about the contingencies' nature and the conversion's potential impact.
Information about amounts reported on the balance sheet date	For each convertible debt as of each date for which a balance sheet is presented, an entity must disclose: ▶ Unamortized premium, discount, or issuance costs ▶ Substantial premium recorded as paid-in capital, if applicable ▶ Instrument's net carrying amount ▶ For PBEs, the instrument's fair value amount and fair value hierarchy level in accordance with ASC 825-10-50-10 through 50-15. (See Example 8-13.)
Events, conditions, and circumstances that can affect the instrument's cash flows	As of the date of the latest balance sheet presented, an entity must disclose: ▶ Conversion or exercise price changes during the reporting period except for changes caused by standard antidilution provisions ▶ Events or changes in circumstances during the reporting period that result in meeting the conversion contingencies or significantly changing the conversion terms ▶ Number of shares issued upon conversion, exercise, or satisfaction of required conditions during the reporting period ▶ Maturities and sinking fund requirements for convertible debt instruments for each of the following five years.

	DISCLOSURE REQUIREMENT
Interest recognized	For each period for which an income statement is presented, an entity must disclose the following information about interest recognized: ▶ Effective interest rate for the period ▶ Interest recognized for the period disaggregated by both of the following: • Contractual interest expense • Amortization of the premium, discount, or issuance costs (see Example 8-14).
Derivative transactions entered with convertible debt	An entity must disclose derivative transactions entered in connection with the issuance of convertible debt instruments, regardless of whether those derivative transactions are accounted for as assets, liabilities, or equity instruments (for example, a purchased call option that is expected to substantially offset the conversion option's changes in fair value or its potential dilutive effect): ▶ Terms of those derivative transactions (including settlement terms) ▶ How those derivative transactions relate to the convertible debt ▶ Number of shares underlying the derivative transactions ▶ Reasons for entering those derivative transactions.
Incremental disclosures required by other U.S. GAAP	In addition to the above disclosure requirements, an entity must provide disclosures required by other U.S. GAAP: ▶ For conversion options accounted for as derivatives, the applicable disclosures required by ASC 815-15 ▶ For instruments measured at fair value in accordance with ASC 825-10, the applicable disclosures required by ASC 820-10 and ASC 825-10.

EXAMPLE 8-13 (ADAPTED FROM ASC 470-20-55-69A THROUGH 55-69C): CONVERTIBLE DEBT DISCLOSURES

FACTS

Entity A is a PBE that has the following convertible debt instruments outstanding as of December 31, 20X7 and 20X6:

- 1.2% convertible debt due December 31, 20X8
- Zero-coupon convertible debt due December 31, 20X9.

DISCLOSURES

In accordance with ASC 470-20-50-1D, Entity A discloses specific information for each balance sheet date, which may be in the tabular formats as shown below.

The table summarizes the convertible debt instruments as of December 31, 20X7 (in thousands).

	Principal	Unamortized discount and issuance costs	Net carrying amount	Fair value	Fair value leveling
1.2% convertible debt due December 31, 20X8	$ 1,000	$ (18)	$ 982	$ 1,100	Level 2
Zero-coupon convertible debt due December 31, 20X9	500	(9)	491	462	Level 3

The table summarizes the convertible debt instruments as of December 31, 20X6 (in thousands).

	Principal	Unamortized discount and issuance costs	Net carrying amount	Fair value	Fair value leveling
1.2% convertible debt due December 31, 20X8	$ 1,000	$ (35)	$ 965	$ 1,015	Level 2
Zero-coupon convertible debt due December 31, 20X9	500	(14)	486	450	Level 3

Alternatively, Entity A may provide the disclosures in narrative descriptions, such as:

1.2% Convertible Debt Instrument Due December 31, 20X8

As of December 31, 20X7 and 20X6, the convertible debt instrument's net carrying amount was $982,000 and $965,000, respectively, with unamortized debt discount and issuance costs of $18,000 and $35,000. As of December 31, 20X7 and 20X6, the convertible debt instrument's estimated fair value (Level 2) was $1.1 million and $1.015 million, respectively.

Zero-Coupon Convertible Debt Instrument Due December 31, 20X9

As of December 31, 20X7 and 20X6, the convertible debt instrument's net carrying amount was $491,000 and $486,000, respectively, with unamortized debt discount and issuance costs of $9,000 and $14,000. As of December 31, 20X7 and 20X8, the convertible debt instrument's estimated fair value (Level 3) was $462,000 and $450,000, respectively.

EXAMPLE 8-14 (ADAPTED FROM ASC 470-20-55-69D THROUGH 55-69F): CONVERTIBLE DEBT — INTEREST EXPENSE DISCLOSURES

FACTS

Entity A has two outstanding convertible debt instruments as of December 31, 20X7. It issued the instruments before January 1, 20X5.

DISCLOSURES

In accordance with ASC 470-20-50-1F(b), Entity A discloses specific interest expense information for each income statement, which may be in the tabular format as shown below.

The table summarizes the interest expense related to convertible debt instruments.

	YEAR ENDED DECEMBER 31		
	20X7	**20X6**	**20X5**
Coupon interest	$ 12,000	$ 12,000	$ 12,000
Amortization of debt discount and issuance costs	22,000	22,000	21,000
Total	$ 34,000	$ 34,000	$ 33,000

Alternatively, Entity A may provide the disclosures in narrative descriptions, such as:

For the years ended December 31, 20X7, 20X6, and 20X5, the total interest expense was $34,000, $34,000, and $33,000 with coupon interest expense of $12,000 for each year and the amortization of debt discount and issuance costs of $22,000, $22,000, and $21,000, respectively.

8.3.9.4 Troubled Debt Restructurings and Debt Extinguishments

FASB REFERENCES

ASC 470-60-50-1 through 50-2

For TDRs that have occurred during a period for which financial statements are presented, ASC 470-60 requires debtors to disclose the following information, either on the face of the financial statements or in the related notes (entities must provide those disclosures even if the debt is no longer outstanding after a TDR):

- For each restructuring, a description of the principal changes in terms, the major settlement features, or both; (separate restructurings within a fiscal period for the same category of payables (for example, accounts payable or subordinated debt) may be grouped for disclosure purposes)
- Aggregate gain on debt restructuring
- Aggregate net gain or loss on transfers of assets recognized during the period
- Per-share amount of the aggregate gain on debt restructuring.

For periods after a TDR, an entity must disclose the extent to which contingent payables are included in the carrying amount of the restructured debt in accordance with ASC 470-60-35-7. An entity must also disclose the information required by ASC 450, if applicable, including the total amounts that are contingently payable on restructured payables and the conditions under which those amounts would become payable or would be forgiven.

BDO INSIGHTS — PRESENTATION OF TDR AND DEBT EXTINGUISHMENT GAINS AND LOSSES

A gain (or loss) from a TDR or debt extinguishment must be recognized currently in income in the period of the restructuring or extinguishment and identified as a separate item in the income statement. We believe an entity generally may present the gain or loss as either a separate line item on the income statement (as a nonoperating income or expense line item) or in interest expense with separate disclosure of the amount in the notes to the financial statements.

Further, when the creditor is a related party, the entity must apply professional judgment to determine how to recognize a restructuring or extinguishment gain. For example, if, based on the facts and circumstances, the restructuring represents a capital transaction, the gain is recognized in APIC (rather than in income).

8.3.10 Debt — Incremental Presentation and Disclosures for SEC Registrants

FASB REFERENCES

ASC 210-10-S45-1, ASC 210-10-S50-7, ASC 470-10-S15-1, ASC 470-10-S45-1 through S45-4, ASC 470-10-S50-1 through S50-8, and ASC 835-30-S45-1

Financial statements that are filed with the SEC (for example, financial statements of SEC registrants) or included in an SEC filing (for example, financial statements included under S-X Rules 3-05, 3-09, and 3-10) must comply with incremental presentation and disclosure requirements in Regulation S-X and other SEC disclosure and reporting guidance related to debt instruments, including those listed below. Smaller reporting companies may follow the scaled disclosure requirements under Article 8 of Regulation S-X.

PRESENTATION TOPIC	APPLICABLE GUIDANCE
Presentation and classification of various items within the balance sheet	ASC 210-10-S99-1 (S-X Rule 5-02)
Compensating balance arrangements	For SEC staff views on the applicability of the disclosure requirements to compensating balances and short-term borrowing arrangements, see ASC 210-10-S99-2 (SAB Topic 6.H.1)
Subsidiary's loan payable	For SEC staff views on the presentation of a subsidiary's loans when the parent's fiscal year differs from the subsidiary's, see ASC 470-10-S99-4 and SEC Observer Comment: *Classification of Subsidiary's Loan Payable in Consolidated Balance Sheet When Subsidiary's and Parent's Fiscal Years Differ*
Long-term debt	For presentation of: ▶ Bonds, mortgages, and other long-term debt, see ASC 210-10-S99-1 (S-X Rule 5-02.22) ▶ Long-term indebtedness to related parties, see ASC 210-10-S99-1 (S-X Rule 5-02.23) and 235-10-S99-1 (S-X Rule 4-08(k))

PRESENTATION TOPIC	APPLICABLE GUIDANCE
Construction loans	For SEC staff views on the classification of revolving loans pertaining to construction of long-term projects, see ASC 470-10-S99-3 (SAB Topic 6.H.2)
Subordinated debt	For SEC staff views on the presentation of subordinated debt, see ASC 470-10-S99-2 (SAB Topic 4.A)
Debt issuance costs associated with line-of-credit arrangements	For SEC staff views on the presentation and subsequent measurement of debt issuance costs related to line-of-credit arrangements, see ASC 835-30-S45-1 (see Section 8.3.9.2.1)

DISCLOSURE TOPIC	APPLICABLE GUIDANCE
Long-term obligations	For disclosure requirements for: ▶ Bonds, mortgages, and other long-term debt, see ASC 210-10-S99-1 (S-X Rule 5-02.22) ▶ Changes in bonds, mortgages, and other long-term debt, see ASC 235-10-S99-1 (S-X Rule 4.08(f))
Short-term obligations	For disclosure requirements, see ASC 210-10-S99-1 (S-X Rule 5-02.19(b))
Defaults	For disclosure requirements, see ASC 235-10-S99-1 (S-X Rule 4.08(c))
Repurchase and reverse repurchase agreements	For disclosure requirements, see ASC 235-10-S99-1 (S-X Rule 4.08(m))
Guarantors and issuers of guaranteed securities registered or being registered	For disclosure requirements: ▶ Applicable to financial statements of guarantors and issuers of guaranteed securities registered or being registered, see ASC 470-10-S99-1 (S-X Rule 3-10) ▶ About guarantors and issuers of guaranteed securities registered or being registered, see ASC 470-10-S99-1A (S-X Rule 13-01)
Affiliates whose securities collateralize securities registered or being registered	For disclosure requirements about a registrant's affiliates whose securities collateralize any class of securities registered or being registered, see ASC 470-10-S99-1B (S-X Rule 13-02)
Other assets, including deferred costs	ASC 210-10-S99-1 (S-X Rule 5.02.17)

8.4 EQUITY INSTRUMENTS

FASB REFERENCES

ASC 505-10-50-2

An entity that presents a balance sheet and income statement must disclose for at least the most recent annual period presented and any subsequent interim period presented any changes in:

- Retained earnings
- Separate accounts comprising stockholders' equity
- The number of shares of equity securities.

The entity may provide those disclosures by either presenting a separate statement of changes in stockholders' equity or including the information in the notes to the financial statements.

The remainder of this section discusses additional presentation and disclosure requirements by equity instrument type.

8.4.1 All Outstanding Equity Securities

FASB REFERENCES

ASC 505-10-50-3

For all outstanding equity securities, entities must disclose the following in summary form:

- Rights and privileges, such as:
  - Dividend and liquidation preferences
  - Participation rights
  - Call prices and dates
  - Conversion or exercise prices or rates and pertinent dates
  - Sinking-fund requirements
  - Unusual voting rights
  - Significant terms of contracts to issue additional shares or terms that may adjust the conversion or exercise prices (excluding standard anti-dilution provisions)
- Number of shares issued upon conversion, exercise, or satisfaction of required conditions during at least the most recent annual reporting period and any subsequent interim period presented
- Actual changes to conversion or exercise prices that occur during the reporting period (excluding changes resulting from standard antidilution provisions).

8.4.1.1 Receivables for Equity Issuance

FASB REFERENCES

ASC 310-10-S99-2 and ASC 505-10-45-2

When an entity receives a note (rather than cash) in exchange for issuing shares or as contribution to paid-in-capital, the note is generally presented as a reduction to equity (and not an asset), except under two limited circumstances:

- The note is collected before the financial statements are issued or are available to be issued.
- There is substantial evidence of ability and intent to pay within a reasonably short time.

Further, SEC registrants must present receivables for equity issuance as a reduction of shareholders' equity on the face of the balance sheet when the amounts are due from officers and directors (unless the receivables are collected before issuing the financial statements).

SEC STAFF GUIDANCE

SAB Topic 4.E: Receivables From Sale of Stock

> ***Facts:*** Capital stock is sometimes issued to officers or other employees before the cash payment is received.
>
> ***Question:*** How should the receivables from the officers or other employees be presented in the balance sheet?
>
> ***Interpretive response:*** The amount recorded as a receivable should be presented in the balance sheet as a deduction from stockholders' equity. This is generally consistent with Rule 5-02.30 of Regulation S-X which states that accounts or notes receivable arising from transactions involving the registrant's capital stock should be presented as deductions from stockholders' equity and not as assets.
>
> *It should be noted generally that all amounts receivable from officers and directors resulting from sales of stock or from other transactions (other than expense advances or sales on normal trade terms) should be separately stated in the balance sheet irrespective of whether such amounts may be shown as assets or are required to be reported as deductions from stockholders' equity.*
>
> *The staff will not suggest that a receivable from an officer or director be deducted from stockholders' equity if the receivable was paid in cash prior to the publication of the financial statements and the payment date is stated in a note to the financial statements. However, the staff would consider the subsequent return of such cash payment to the officer or director to be part of a scheme or plan to evade the registration or reporting requirements of the securities laws.*

8.4.1.2 Instruments With a Down Round Feature

FASB REFERENCES

ASC 505-10-50-3A

For a financial instrument with a down round feature that has been triggered during the reporting period and for which the entity has recognized the effect in accordance with ASC 260-10-25-1 (see Section 4.5.2.3), an entity must disclose:

- That the feature has been triggered
- The value of the effect of the down round feature that was triggered.

8.4.1.3 Redeemable Securities

FASB REFERENCES

ASC 505-10-50-11

An entity must disclose for all issues of capital stock that are redeemable at fixed or determinable prices on fixed or determinable dates, the annual redemption requirements (separately by issue or combined) in each of the five years following the date of the latest balance sheet presented.

8.4.2 Preferred Stock

FASB REFERENCES

ASC 505-10-50-4 through 50-5

Entities must disclose the following information about preferred stock in their financial statements:

- For preferred (or other senior) stock with preferences in involuntary liquidation considerably in excess of par or stated value, the stock's liquidation preference (the relationship between the preference in liquidation and the par or stated value of the shares). The disclosure must be made in the equity section on the face of the balance sheet and in the aggregate (rather than on a per-share basis or through disclosure in the notes), either parenthetically or in short.
- The aggregate or per-share amounts at which preferred stock may be called or is subject to redemption through sinking fund operations or otherwise. The disclosure may be made either on the face of the balance sheet or in the notes.
- The aggregate and per-share amounts of arrearages in cumulative preferred dividends. The disclosure may be made either on the face of the balance sheet or in the notes.

ASU 2023-06, *DISCLOSURE IMPROVEMENTS: CODIFICATION AMENDMENTS*

In October 2023, the FASB issued ASU 2023-06, *Disclosure Improvements: Codification Amendments in Response to the SEC's Disclosure Update and Simplification Initiative*, which amends the guidance in ASC 505-10-50-4 and requires entities to disclose the preferred (or other senior) stock's liquidation preference in involuntary liquidation if it is other than par or stated value (rather than being considerably in excess of par or stated value). That will align the guidance in ASC 505-10-50-4 with the requirement in S-X Rule 4-08(d) (see Sections 8.4.6.3 and 8.4.6.4.1).

For SEC registrants and entities required to file or furnish financial statements with or to the SEC in preparation for the sale of or for purposes of issuing securities that are not subject to contractual restrictions on transfer, ASU 2023-06 is effective on the date the SEC's removal of the related guidance from Regulation S-X or Regulation S-K becomes effective. Early adoption is prohibited for those entities. For all other entities, ASU 2023-06 is effective two years after it becomes effective for all entities other than noted in the preceding paragraph. This guidance is not effective as of the date this Blueprint was published.

8.4.2.1 Convertible Preferred Stock

FASB REFERENCES

ASC 505-10-50-12 through 50-18

The objective of an entity's disclosures about convertible preferred stock is to give financial statements users:

- Information about the convertible stock's terms and features
- An understanding of how the entity reported those instruments on the entity's balance sheet and income statement
- Information about events, conditions, and circumstances that can affect how to assess the amount or timing of an entity's future cash flows related to those instruments.

The table summarizes the ASC 505 disclosure requirements for convertible preferred stock.

	DISCLOSURE REQUIREMENT
Terms and features	An entity must explain the pertinent rights and privileges of each outstanding instrument, including: ▶ Number of shares issued and par value ▶ Dividends ▶ Conversion or exercise prices or rates and number of shares the instrument is potentially convertible into ▶ Pertinent dates, such as conversion date(s) ▶ Parties that control the conversion rights ▶ Manner of settlement upon conversion and any alternative settlement methods, such as cash, shares, or a combination of cash and shares ▶ Terms that may change conversion or exercise prices, number of shares to be issued, or other conversion rights and the timing thereof (excluding standard antidilution provisions) ▶ Liquidation preference required by ASC 505-10-50-4 (see Section 8.4.2) and unusual voting rights ▶ The instrument's other material terms and features not listed above.

	DISCLOSURE REQUIREMENT
Contingently convertible instruments	For contingently convertible instruments or convertible preferred stock instruments described in ASC 505-10-05-6 through 05-7 (convertible preferred stock with a contingently adjustable conversion ratio or convertible preferred stock that may become convertible only upon the occurrence of a future event outside the holder’s control), an entity must disclose the following incremental information: ▶ Events or changes in circumstances that would adjust or change the contingency or result in meeting the contingency ▶ Information on whether the shares that would be issued if the contingently convertible securities were converted are included in the diluted EPS computation and the reasons why or why not ▶ Other information about the contingencies' nature and the conversion's potential impact.
Dividends	For each period for which a balance sheet is presented, an entity must disclose: ▶ Dividends declared — the disclosure requirement is incremental to the dividends disclosure discussed in Section 8.4.2.
Events, conditions, and circumstances that can affect the instrument’s cash flows	As of the date of the latest balance sheet presented, an entity must disclose: ▶ Changes to conversion or exercise prices during the reporting period except for changes resulting from standard antidilution provisions ▶ Events or changes in circumstances during the reporting period that result in meeting the conversion contingencies or significantly changing the conversion terms ▶ Number of shares issued upon conversion, exercise, or satisfaction of required conditions during the reporting period.
Derivative transactions entered with convertible preferred stock	An entity must disclose the derivative transactions entered in connection with the issuance of convertible preferred stock, regardless of whether those derivative transactions are accounted for as assets, liabilities, or equity instruments: ▶ Terms of the derivative transactions (including settlement terms) ▶ The derivative transactions’ relationship to the convertible preferred stock ▶ Number of shares underlying the derivative transactions ▶ Reasons for entering the derivative transactions.
Incremental disclosures required by other U.S. GAAP	For conversion options accounted for as derivatives, an entity must include the applicable disclosures required by ASC 815-15.

8.4.3 Treasury Stock

FASB REFERENCES

ASC 505-30-45-1, ASC 505-30-50-2, and ASC 505-30-50-4

If an entity repurchases its outstanding common stock for reasons other than formal or constructive retirement (or if the entity has not yet determined the treasury stock's ultimate disposition), it may:

- Present the cost of acquired stock separately as a deduction from the total of capital stock, APIC, and retained earnings.
- Treat the cost of acquired stock similar to the accounting treatment for retired stock under ASC 505-30-30-7 through 30-10 (see Section 6.3.2.2).

Entities must also disclose:

- Restrictions on availability of retained earnings to pay dividends and other significant effects of state laws relating to treasury stock transactions
- Allocation of amounts paid and accounting treatment for stock repurchased at a price significantly in excess of its fair value (see Section 6.3.2.1).

8.4.4. Stock Splits

FASB REFERENCES

ASC 505-20-50-1

When a stock dividend is in substance a stock split (see Section 6.3.4.1), entities must avoid using the word "dividend" in related corporate resolutions, notices, and announcements. If, because of legal requirements, that cannot be done, entities must describe the transaction as a stock split effected in the form of a dividend.

8.4.5 Appropriations of Retained Earnings

FASB REFERENCES

ASC 505-10-45-3 through 45-4

Retained earnings is the accumulation of an entity's earnings net of losses since inception. Dividends distributed to shareholders reduce retained earnings. Entities that appropriate retained earnings for specific purposes (such as to reserve for specific contractual obligations or litigations) must present the appropriated retained earnings in stockholders' equity on the balance sheet and must clearly identify the appropriation. An entity cannot charge costs or losses to appropriated retained earnings nor recognize any appropriated retained earnings as income.

8.4.6 Equity — Incremental Presentation and Disclosures for SEC Registrants

FASB REFERENCES

ASC 210-10-S45-1, ASC 210-10-S50-11, ASC 505-20-S25-1 through S25-3, ASC 505-10-S45-1 through S45-9, ASC 505-10-S50-1 through S50-3, and ASC 505-10-S50-5 through S50-6

Regulation S-X includes incremental presentation and disclosure requirements for SEC registrants and other entities that prepare their financial statements in accordance with Regulation S-X.

Entities must provide information and separately present the following captions on the balance sheet:

- Redeemable stock (see Section 8.4.6.4)
- Nonredeemable stock (see Section 8.4.6.3)
- Common stock (see Section 8.4.6.2)
- APIC (may be combined with the stock caption to which it applies)
- Other additional capital (may be combined with the stock caption to which it applies)
- Appropriated and unappropriated retained earnings
- Accumulated other comprehensive income.

Further, the financial statements must comply with incremental presentation and disclosure requirements in Regulation S-X and other SEC disclosure and reporting guidance related to equity accounts, including those listed in the table below.

PRESENTATION TOPIC	APPLICABLE GUIDANCE
Presentation and classification of various items within the balance sheet	ASC 210-10-S99-1 (S-X Rule 5-02)
Discounts on and unamortized balances of shares	ASC 505-10-S99-2 (S-X Rule 4-07) (see Section 8.4.6.1)
Preferred stock that is not redeemable or is redeemable solely at the issuer's option	ASC 210-10-S99-1 (S-X Rule 5-02.28) (see Section 8.4.6.3)
Common stock	ASC 210-10-S99-1 (S-X Rule 5-02.29) (see Section 8.4.6.2)
Other stockholders' equity	ASC 210-10-S99-1 (S-X Rule 5-02.30)
Subordinated debt	For SEC staff views on prohibiting the presentation of subordinated debt within stockholders' equity, see ASC 470-10-S99-2 (SAB Topic 4.A)
Undistributed earnings upon termination of S election	For SEC staff views on presenting S corporation undistributed earnings on the date the S election is terminated, see ASC 505-10-S99-3 (SAB Topic 4.B)
Receivables from the issuance of capital stock to officers and other employees	ASC 310-10-S99-2 (SAB Topic 4.E) (see Section 8.4.1.1)

PRESENTATION TOPIC	APPLICABLE GUIDANCE
Equity section in limited partnership financial statements	ASC 505-10-S99-5 (SAB Topic 4.F)
Notes and other receivables in a general partner's balance sheet	ASC 310-10-S99-3 (SAB Topic 4.G)

DISCLOSURE TOPIC	APPLICABLE GUIDANCE
Changes in each caption of other stockholders' equity	ASC 505-10-S99-1 (S-X Rule 3-04) (see Section 8.4.6.1)
Redeemable preferred stock	ASC 210-10-S99-1 (S-X Rule 5.02.27) (see Section 8.4.6.4.1)
Preferred shares	ASC 235-10-S99-1 (S-X Rule 4-08(d)) (see Sections 8.4.6.3 and 8.4.6.4.1)
Restrictions that limit payment of dividends by the Registrant	ASC 235-10-S99-1 (S-X Rule 4-08(e)) (see Section 8.4.6.5)
Guarantors and issuers of guaranteed securities registered or being registered	For disclosure requirements: ▶ Applicable to financial statements of guarantors and issuers of guaranteed debt or debt-like securities registered or being registered, see ASC 470-10-S99-1 (S-X Rule 3-10) ▶ About guarantors and issuers of guaranteed debt or debt-like securities registered or being registered, see ASC 470-10-S99-1A (S-X Rule 13-01)
Dividends declared by a subsidiary after the balance sheet date	ASC 855-10-S99-1 (SAB Topic 1.B.3)
Capital structure change after the latest balance sheet but before the release of the financial statements	ASC 505-10-S99-4 (SAB Topic 4.C) (see Section 8.4.6.6)
Issuance of free distributions by Japanese companies	ASC 505-10-S99-1 (SAB Topic 1.D.2)

8.4.6.1 Changes in Stockholders' Equity and Noncontrolling Interests

FASB REFERENCES

ASC 505-10-S99-1 through S99-2

Entities must disclose the changes in each caption of stockholders' equity and noncontrolling interests in either a separate statement or a note to the financial statements in the form of a reconciliation of the beginning balance to the ending balance for each period for which an income statement is filed. The reconciliation must:

- Describe all significant reconciling items by appropriate captions
- Show contributions from and distributions to owners separately
- State any adjustments to the beginning balance of the earliest period presented for retroactively applied items
- State the amount of dividends per share and in the aggregate for each class of shares.

Further, entities must separately show discounts on shares or any unamortized balances thereof as deductions from the applicable accounts. They also must provide a separate schedule in the notes to the financial statements showing the effects of any changes in the registrant's ownership interest in a subsidiary on the equity attributable to the registrant.

RECONCILIATION OF CHANGES IN STOCKHOLDERS' EQUITY FOR QUARTER- AND YEAR-TO-DATE PERIODS

SEC registrants must present a reconciliation of changes in stockholders' equity for each period in which an income statement is presented, with subtotals for each interim period. [6] Accordingly, for quarterly reports on Form 10-Q, SEC registrants must present a reconciliation of changes in stockholder's equity for the current quarter- and year-to-date interim periods and comparative periods. They may disclose changes in stockholders' equity in one of two ways:

- Reconcile the changes in two separate schedules detailing the quarter- and year-to-date changes
- Reconcile the changes in one schedule, detailing the changes in each quarter in the fiscal year.

8.4.6.2 Common Stock

FASB REFERENCES

ASC 210-10-S99-1(29)

Entities must present the following information about common stock:

DISCLOSURE REQUIREMENT	DISCLOSURE LOCATION
▶ For each class of common shares: • Number of shares issued or outstanding and dollar amount thereof for each class of common shares • The fact that common stock is convertible, if applicable	On the face of the balance sheet

[6] Rules 3-04, 8-03(a)(5), and 10-07(a)(7)

DISCLOSURE REQUIREMENT	DISCLOSURE LOCATION
▶ For each class of common shares: • Title of the issue • Number of shares authorized and, if convertible, the basis of conversion • Dollar amount of any common shares subscribed but unissued and the deduction of subscriptions receivable therefrom	On the face of the balance sheet or in the notes to the financial statements
▶ Changes in each class of common shares for each period for which an income statement is presented	In the notes to the financial statements or a separate statement

8.4.6.3 Nonredeemable Preferred Stock

FASB REFERENCES

ASC 210-10-S99-1(28) and ASC 235-10-S99-1(d)

Entities must present additional information about nonredeemable preferred stock (that is, stock that is not redeemable or is redeemable solely at the entity's option) as follows:

DISCLOSURE REQUIREMENT	DISCLOSURE LOCATION
▶ Title of each issue and dollar amount thereof ▶ Dollar amount of any shares subscribed but unissued and the deduction of subscription receivable therefrom	On the face of the balance sheet. If more than one issue is outstanding, the disclosure can be made in the notes to the financial statements.
▶ Number of shares authorized ▶ Number of shares issued or outstanding	On the face of the balance sheet or in the notes to the financial statements for each issue
▶ Changes in each class of preferred shares for each period for which an income statement is presented	In the notes to the financial statements or a separate statement
▶ Aggregate preferences on involuntary liquidation if other than par or stated value	Parenthetically on the face of the balance sheet

8.4.6.4 Redeemable Stock

FASB REFERENCES

ASC 210-10-S99-1(27) and ASC 480-10-S99-3A(24)

Entities must present redeemable stock as a separate caption on the balance sheet. Redeemable stock includes any class of stock that has **any** of the following characteristics:

- Redeemable at a fixed or determinable price on a fixed or determinable date or dates, whether by operation of a sinking fund or otherwise
- Redeemable at the holder's option
- Redeemable based on conditions that are not solely within the entity's control.

See Chapter 5 for more guidance on redeemable stock.

ENTITIES MUST PRESENT TEMPORARY EQUITY SEPARATE FROM PERMANENT EQUITY

An entity cannot present redeemable stock under the general stockholders' equity balance sheet caption and must use a balance sheet caption that clearly depicts that the stock is redeemable. Also, if the entity includes the redeemable stock in the statement of changes in stockholders' equity, the redeemable preferred stock (temporary equity) must be delineated with a black line from permanent equity (nonredeemable equity, other stockholders' equity, or noncontrolling interests).

In the notes to the financial statements for redeemable stock (entities must also consider the disclosure requirements discussed in Section 8.4.6.4.1, if applicable), an entity must disclose:

- Description of the accounting method used to adjust the redemption amount
- Redemption amount as if currently redeemable (if the SEC registrant accretes changes in the redemption amount)
- Reasons it is not probable that the instrument will become redeemable (if the SEC registrant does not accrete changes in the redemption amount)
- When charges or credits to net income available to stockholders are material, a reconciliation between net income and income available to common stockholders used to compute EPS.

8.4.6.4.1 Redeemable Preferred Stock

FASB REFERENCES

ASC 210-10-S99-1(27) and ASC 235-10-S99-1(d)

In addition to the disclosure requirements discussed in Section 8.4.6.4, entities must include the below disclosures for preferred stock subject to mandatory redemption requirements or whose redemption is outside the issuer's control:

DISCLOSURE REQUIREMENT	DISCLOSURE LOCATION
▶ Title of each issue ▶ Carrying amount ▶ Redemption amount ▶ Dollar amount of any shares subscribed but unissued and the deduction of subscription receivable therefrom	On the face of the balance sheet. If more than one issue is outstanding, amounts may be aggregated on the face of the balance sheet and the details presented in a separate note to the financial statements that includes "Redeemable Preferred Stocks" in its caption.
▶ Accounting treatment for difference between carrying and redemption amount, if applicable	In a separate note to the financial statements that includes "Redeemable Preferred Stocks" in its caption
For each issue: ▶ Number of shares authorized ▶ Number of shares issued or outstanding	On the face of the balance sheet or in a separate note to the financial statements that includes "Redeemable Preferred Stocks" in its caption
▶ General description of each issue, including its redemption features (for example, sinking fund, at option of holders, out of future earnings) and any holders' rights in the event of default, including any effect on junior securities in the event a required dividend, sinking fund, or other redemption payment is not made ▶ Combined aggregate amount of annual redemption requirements for all issues for each of the five years following the date of the latest balance sheet ▶ Changes in each issue for each period for which an income statement is presented	In a separate note to the financial statements that includes "Redeemable Preferred Stocks" in its caption
▶ Aggregate preferences on involuntary liquidation, if other than par or stated value	Parenthetically on the face of the balance sheet

8.4.6.5 Dividend Restrictions

FASB REFERENCES

ASC 235-10-S99-1(e)

An entity must disclose information about dividend payment restrictions as follows:

- A description of the most significant restrictions on the payment of dividends, indicating their sources, pertinent provisions, and amount of retained earnings or net income restricted or free of restrictions
- Amount of consolidated retained earnings, which represents undistributed earnings of 50% or less owned persons accounted for by the equity method
- When material:
  - A description of the nature of any restrictions on the ability of consolidated and unconsolidated subsidiaries to transfer funds to the registrant in the form of cash dividends, loans, or advances (for example, borrowing arrangements, regulatory restraints, or foreign government)
  - Separate disclosure of the restricted net assets for unconsolidated and consolidated subsidiaries as of the end of the most recently completed fiscal year.

8.4.6.6 Changes in Capital Structure

FASB REFERENCES

ASC 505-10-S99-4

An entity must retroactively reflect in the balance sheet changes in capital structure (for example, stock dividends and stock splits) that occur after the balance sheet date but before the financial statements are issued. An entity also must disclose the retroactive treatment in a footnote to the financial statements (the note must be cross-referenced on the balance sheet) and state when the stock dividend or split became effective.

8.5 ASSETS AND LIABILITIES WITHIN ASC 480

As discussed in Section 2.1, ASC 480 requires entities to classify as liabilities (or assets in some cases) the following financial instruments: mandatorily redeemable shares, obligations to repurchase an entity's equity shares (or obligations indexed to such obligations), and obligations an entity must or may settle in a variable number of shares (that meet specific conditions). This section discusses the presentation and disclosure requirements for financial instruments that are in the scope of ASC 480.

8.5.1 ASC 480 Presentation Requirements

FASB REFERENCES

ASC 480-10-45-1 through 45-2A

An entity classifies instruments in the scope of ASC 480 as liabilities (or as assets in some cases). Those instruments cannot be presented in the balance sheet's temporary equity section.

BDO INSIGHTS — CLASSIFICATION OF ASC 480 INSTRUMENTS

ASC 480 does not specify the balance sheet classification (current versus noncurrent) for instruments in its scope. We believe entities must classify those instruments based on the guidance in ASC 210-10 and ASC 470-10. In other words, amounts due within 12 months or less are generally current liabilities. Conversely, amounts (or other assets or resources) an entity will receive within 12 months or less are current assets.

Entities that have issued mandatorily redeemable shares classified as liabilities **and** do not have other outstanding equity instruments must present:

- Mandatorily redeemable shares **separately** from other liabilities in the balance sheet
- Interest cost for mandatorily redeemable shares **separately** from interest due to other creditors in the income statement
- Payments to holders of mandatorily redeemable shares **separately** from payments due to other creditors in the statement of cash flows.

Entities that have outstanding shares, **all** of which are mandatorily redeemable on the occurrence of events that are certain to occur and are not subject to the scope exceptions in ASC 480-10-15-7A through 15-7F (see Sections 2.2.4 and 2.4.2), must present either a deficit or equity depending on the redeemable shares' redemption price and book value (see Section 2.4.7):

- Excess of liabilities over assets (deficit) — for the excess of the shares' redemption price over book value
- Excess of assets over liabilities (equity) — for the excess of the shares' book value over the shares' redemption price.

8.5.2 ASC 480 Disclosure Requirements

FASB REFERENCES

ASC 480-10-50-1 through 50-4

The table summarizes the disclosure requirements in ASC 480.

TYPE OF INSTRUMENT	DISCLOSURE REQUIREMENT
All financial instruments in the scope of ASC 480	An entity must disclose: ▶ Nature and terms of financial instruments ▶ Rights and obligations embodied in those instruments, including both: • Any settlement alternatives in the contract • The party that controls the settlement alternatives ▶ For all outstanding financial instruments and each settlement alternative: • Amount that would be paid or number of shares that would be issued and their fair value if the settlement were to occur at the reporting date (determined under the contract conditions) • How the changes in fair value of the entity's shares affect settlement amounts (for example, "the entity is obligated to issue an additional X shares or pay an additional Y dollars in cash for each $1 decrease in the fair value of one share") • Maximum amount the entity could be required to pay to redeem the instrument by physical settlement, if applicable

TYPE OF INSTRUMENT	DISCLOSURE REQUIREMENT
	• Maximum number of shares that could be required to be issued, if applicable • Lack of limits on the amount that the entity could be required to pay or the number of shares that the entity could be required to issue, if applicable ▶ For actual issuances and settlements of redeemable securities, the disclosures required by ASC 505 (see Section 8.4.1).
Forward contracts and options	For forward contracts and options indexed to the entity's equity shares, an entity must disclose: ▶ Forward price or option strike price ▶ Number of entity's shares to which the contract is indexed ▶ Settlement date(s) of the contract, as applicable.
Mandatorily redeemable shares	When an entity has mandatorily redeemable shares and no other outstanding equity instruments, the entity must disclose the liability components subject to the redemption feature that would otherwise be related to shareholders' interest and other comprehensive income (if any). For example, the entity should disclose the par value and other paid-in amounts of mandatorily redeemable instruments separately from retained earnings (or accumulated deficit).

8.6 HYBRID INSTRUMENTS AND EMBEDDED DERIVATIVES

A hybrid instrument consists of a host contract and an embedded derivative (see Section 3.2.2). ASC 815-15 requires entities to account for embedded derivatives separately from the host contract if they meet the criteria discussed in Section 3.4.

This section discusses presentation and disclosure requirements for hybrid instruments measured at fair value in their entirety. For hybrid instruments that are not measured at fair value in their entirety, with or without bifurcated embedded derivatives, entities must comply with the presentation and disclosure requirements in:

- Section 8.3 if the hybrid instrument is a debt instrument
- Section 8.4 if the hybrid instrument is an equity instrument.

The presentation and disclosure requirements for bifurcated embedded derivatives are the same as the presentation and disclosure requirements for freestanding derivative instruments in ASC 815-10.

8.6.1 ASC 815-15 Presentation Requirements

FASB REFERENCES

ASC 815-15-45-1 through 45-2, ASC 825-10-45-1B through 45-2, and ASC 825-10-45-5 and ASC 825-10-45-6

ASC 815-15 allows entities to measure hybrid instruments at fair value in their entirety if the entity cannot reliably identify and measure the embedded derivative (the practicability exception, which is uncommon). An entity can also elect to measure the hybrid financial instruments at fair value in their entirety if the entity elects (and the instrument is eligible for) the fair value option. The entity does not bifurcate embedded derivatives from the host contract if the entity measures the instrument at fair value in its entirety. For all other hybrid instruments, entities must bifurcate the embedded derivatives that meet the criteria for separation from the host contracts (see Chapter 3).

The table summarizes the presentation for hybrid financial instruments that are entirely measured at fair value under the practicability exception and fair value option.

FINANCIAL STATEMENT	PRESENTATION
Balance sheet	An entity must present the hybrid instrument's fair value separately from the carrying amounts of other instruments that are not remeasured at fair value using either of the following formats: ▶ Present the fair and non-fair value carrying amounts as separate line items ▶ Present the hybrid instruments in the aggregate and parenthetically disclose the fair value carrying amount included in the aggregated amount.
Statement of comprehensive income	For a financial liability an entity measures using the fair value option, the entity must: ▶ Present in earnings changes in fair value resulting from changes **other than** changes in the instrument's credit risk ▶ Present in other comprehensive income fair value changes resulting from changes in the instrument's credit risk ▶ Upon derecognition, present in earnings the cumulative gain or loss on the financial liability that resulted from changes in instrument-specific credit risk.

BDO INSIGHTS — HYBRID INSTRUMENTS WITH EMBEDDED DERIVATIVES THAT ARE SEPARATED

We believe entities should present the host contract and the bifurcated embedded derivative on the balance sheet as follows:

- If the host contract is classified as permanent or temporary equity, present the bifurcated embedded derivative separately from the host contract.
- If the host contract is classified as an asset or liability, present the bifurcated embedded derivative either separately from or together with the host contract. The entity must apply the elected policy consistently.

8.6.2 ASC 815-15 Disclosure Requirements: Hybrid Instruments That Are Not Separated

FASB REFERENCES

ASC 815-15-50-1 through 50-2, ASC 825-10-50-24, ASC 825-10-50-26 through 50-28(d), and ASC 825-10-50-30 through 50-32

When entities measure hybrid instruments at fair value under the fair value option or practicability exception, they must provide information to help financial statement users understand how measuring those instruments at fair value affects earnings.

Also, issuers of hybrid instruments measured at fair value under the fair value option or practicability exception must comply with the ASC 825 disclosure requirements. The ASC 825 disclosures are intended to facilitate the comparisons between entities that remeasure similar assets and liabilities at other than fair value and comparisons between similar assets and liabilities an entity remeasures using different measurement attributes.

The table summarizes the ASC 825 disclosures (for hybrid financial instruments issued by the entity) required for each annual and interim period for which the entity presents financial statements. The ASC 825 disclosure requirements do not replace the disclosure requirements in other U.S. GAAP, such as those required under ASC 820. Entities are encouraged but not required to present the ASC 825 disclosures in combination with related ASC 820 disclosures.

<table>
<tr><th></th><th>DISCLOSURE REQUIREMENT</th></tr>
<tr><td>Balance Sheet</td><td>As of each date for which an interim and annual balance sheet is presented, an entity must disclose:
Its reasons for electing the fair value option for each eligible item or group of similar eligible items
When the entity elected the fair value option for some but not all eligible instruments, both of the following:
Description of the similar instruments and the reasons for partial election
How the group of similar instruments relate to individual balance sheet line items
For each balance sheet line item that includes instruments for which the entity has elected the fair value option, both of the following:
How each balance sheet line item relates to major assets and liabilities classes presented in accordance with ASC 820 (including how the instruments' carrying amounts relate to what is reported in the balance sheet)
The aggregate carrying amount of any instruments ineligible for the fair value option that are included in each balance sheet line item
Difference between the aggregate fair value and the aggregate unpaid principal balance for long-term debt instruments that have contractual principal amounts and for which the fair value option has been elected.</td></tr>
<tr><td>Income Statement</td><td>For each interim and annual period an income statement is presented, an entity must disclose:
For each balance sheet line item that includes instruments for which the entity has elected the fair value option, the changes in fair value (gains and losses) included in earnings during the period and the income statement line item that includes those gains and losses. The entity may disclose changes in fair value of FVO instruments together with changes in fair value of other instruments (such as those items required to be remeasured at fair value by other U.S. GAAP).
How the entity measured interest and dividends and where the entity reported them in the income statement.
For financial liabilities, the effects of the instrument-specific credit risk and changes in it, including:
The change — during the period and cumulatively — in the liability's fair value that is attributable to changes in the instrument-specific credit risk
The entity's method for determining the gains or losses attributable to changes in instrument-specific credit risk
If the entity settles a liability during the period, any amount previously recorded in other comprehensive income that the entity recognized in net income at settlement.</td></tr>
<tr><td>Other required disclosures</td><td>In annual periods only, an entity must disclose:
Methods and significant assumptions used to estimate the instrument's fair value
Information required by ASC 820-10-50-2(bbb), except for the quantitative disclosures about significant unobservable inputs used in Level 3 fair value measurements
If an entity elects the fair value option at the time of a remeasurement event (see Section 3.4.2.1), it must disclose both of the following for the period of the election:
Qualitative information about the nature of the event
Quantitative information by balance sheet line item indicating which income statement line items include the effect on earnings of initially electing the fair value option for an item.</td></tr>
</table>

8.6.3 ASC 815-15 Disclosure Requirements: Embedded Conversion Option That Is No Longer Bifurcated

FASB REFERENCES

ASC 815-15-50-3

If an embedded conversion option previously accounted for as a derivative instrument no longer meets the separation criteria, an entity must disclose both of the following:

- The principal changes causing the embedded conversion option to no longer require bifurcation
- The conversion option liability reclassified to stockholders' equity.

8.7 FREESTANDING EQUITY-LINKED CONTRACTS

FASB REFERENCES

ASC 505-10-50-3, ASC 505-10-50-11, ASC 505-10-50-18, ASC 815-40-50-1A, ASC 815-40-50-2 through 50-6, and ASC 820-10-15-1

An entity must provide disclosures about contracts in its own equity to help financial statements users understand:

- The contracts' terms and features
- How the entity reflects the contracts in its balance sheet and income statement
- The events, conditions, and circumstances that can affect the amount or timing of the contracts' future cash flows but have not yet been reflected in the financial statements.

ASC 815-40 applies to contracts that are potentially indexed to, and potentially settled in, an entity's own equity (see Chapter 4). The ASC 815-40 disclosure requirements apply to in-scope freestanding contracts regardless of whether the contracts meet the criteria to be classified in equity. Entities are not required to provide ASC 505 disclosures for equity-classified contracts other than those listed in the table below. Entities must provide the additional disclosures required by ASC 815-10 for asset- or liability-classified contracts that meet the definition of a derivative instrument.

The table summarizes the disclosure requirements for contracts within the scope of ASC 815-40.

	DISCLOSURE REQUIREMENT
Options or forward contracts indexed to the entity's equity	An entity must disclose the following contract information: ▶ The forward rate ▶ The option strike price ▶ The number of entity's shares to which the contract is indexed ▶ The contract's settlement date(s) ▶ The entity's accounting for the contract (that is, as an asset, liability, or equity).
Contracts with settlement alternatives	For contracts with settlement alternatives, an entity must disclose: ▶ A description of those alternatives ▶ Who controls the settlement alternatives ▶ The maximum number of shares that could be required to be issued to net share settle a contract, if applicable

	DISCLOSURE REQUIREMENT
	▶ The contract’s current fair value for each settlement alternative (denominated in monetary amounts or number of shares) if the settlement were to occur at the reporting date ▶ How changes in the fair value of the entity's shares affect the settlement amounts (for example, “the issuer is obligated to issue an additional X shares or pay an additional Y dollars in cash for each $1 decrease in the fair value of one share”). The entity should consider whether a tabular format would provide the most concise and informative presentation.
Contracts with no limit on number of shares that may be issued	If the contract does not have a fixed or determinable maximum number of underlying shares, an entity must disclose that it could be required to issue a potentially infinite number of shares to settle the contract.
Actual issuances or settlements	For actual issuances or settlements, an entity must disclose: ▶ The number of shares issued upon conversion, exercise, or satisfaction of required conditions during at least the most recent annual reporting period and any subsequent interim period presented.
Redeemable securities	For redeemable equity instruments classified as temporary equity (or that would be classified as temporary equity if the entity were a public entity) in accordance with ASC 505, an entity must disclose: ▶ The annual redemption requirements, separately by issue or combined, in each of the five years following the date of the latest balance sheet presented.
Contracts entered in connection with issuing a convertible preferred stock	For equity-classified contracts within the scope of ASC 815-40 entered in connection with issuing a convertible preferred stock, in accordance with ASC 505, an entity must disclose: ▶ The transaction terms (including settlement terms) ▶ Relationship between the transactions and the convertible preferred stock ▶ The number of shares underlying the transactions ▶ Reasons for entering the transactions.
Reclassifications and related accounting policy	If an entity reclassifies contracts into (or out of) equity (see Section 4.8), it must disclose: ▶ The contract reclassifications, including partial reclassifications ▶ The reason for the reclassification and the effect on the entity's financial statements Further, determining how to partially reclassify contracts is an accounting policy decision that must be disclosed in accordance with ASC 235.
Modifications or exchanges of freestanding equity-classified written call options	For equity-classified written call options an entity modified or exchanged during any of the periods presented and for which the entity recognized the effect in accordance with ASC 815-40-35-17, the entity must disclose: ▶ The nature of the modification or exchange transaction ▶ The effect of the modification or exchange ▶ The manner in which the effect of the modification or exchange has been recognized.
Fair value	For contracts within the scope of ASC 815-40 that are classified as assets or liabilities (and as long as the contracts remain classified as assets or liabilities): ▶ Fair value information required by ASC 820-10-50 ▶ Changes in the contract’s fair value.

In addition to the above requirements, SEC registrants must disclose the price at which warrants are exercisable (on the face of or in the notes to the financial statements).

Appendix A — Instruments That Are Derivatives in Their Entirety

A.1 DEFINITION OF DERIVATIVE INSTRUMENT

FASB REFERENCES

ASC 815-10-15-3 and ASC 815-10-15-83

As discussed in Section 3.2.2, an entity does not bifurcate embedded derivatives in financial instruments that are accounted for at fair value. That includes instruments that are accounted for as derivatives in their entirety under ASC 815-10 (that is, freestanding financial instruments that meet the definition of a derivative and do not qualify for any scope exceptions).

A derivative instrument is a contract that has **all** the following characteristics:

Has one or more underlyings and one or more notional amounts or payment provisions or both (Section A.1.1)	+	Has little or no initial net investment (Section A.1.2)	+	Meets net settlement (Section A.1.3)	=	Derivative Instrument

If an entity determines that a financial instrument meets the definition of a derivative instrument, it next evaluates if any exceptions from derivative accounting apply (see Section 3.2.3). If a freestanding financial instrument is not accounted for as a derivative instrument in its entirety (because it does not meet the definition of a derivative instrument or an exception applies), an entity evaluates any embedded derivatives for bifurcation (see Section 3.4).

On the other hand, if an entity determines that a freestanding financial instrument meets the definition of a derivative instrument and no scope exception applies, the financial instrument is accounted for as a derivative instrument in its entirety — as a derivative asset or liability under ASC 815-10 — and initially and subsequently measured at fair value. Consequently, any embedded derivatives in that instrument are not bifurcated.

If a freestanding financial instrument does not meet the definition of a derivative instrument at inception, but changes in facts and circumstances cause the instrument to later meet the definition, that instrument is accounted for as a derivative instrument at that later date (unless a scope exception applies).

FASB PROJECT — DERIVATIVES SCOPE REFINEMENTS

On July 23, 2024, the FASB proposed refining the scope of ASC 815. The project includes incorporating an exception for contracts with underlyings based on the operations or activities that are specific to one of the parties to the contract, developing alternatives for refining the predominant characteristics test in ASC 815-10-15-60, and clarifying the interaction between ASC 815 and ASC 606, *Revenue from Contracts with Customers*, related to noncash consideration. Affected entities should continue to monitor the project for further developments.

A.1.1 First Characteristic of a Derivative: Underlying and Notional Amount or Payment Provision

FASB REFERENCES

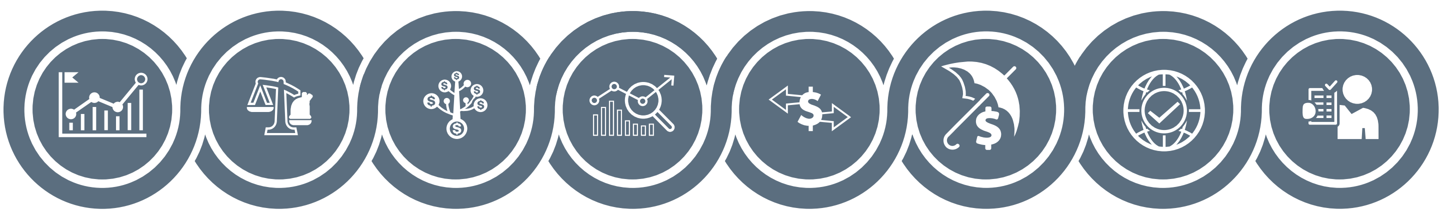
ASC 815-10-15-88 through 15-90 and ASC 815-10-15-92 through 15-93

The first characteristic of a derivative instrument is that the contract has **both**:

- One or more underlyings
- One or more notional amounts or payment provisions (or both).

An **underlying** is a variable that, with either a notional amount or a payment provision, determines the settlement of a derivative instrument. Any variable whose changes are observable or otherwise objectively verifiable can be an underlying. It can be a price or rate of an asset or liability, but it is not the asset or liability itself.

For example, an underlying generally is one or a combination of:



- A security price or security price index
- A commodity price or commodity price index
- An interest rate or interest rate index
- A credit rating or credit index
- An exchange rate or exchange rate index
- An insurance index or catastrophe loss index
- A climatic or geological condition, another physical variable, or a related index
- The occurrence or nonoccurrence of a specified event

A **notional amount** can be a number of currency units, shares, bushels, pounds, or other units specified in the contract. It can also be the face amount in a contract.

A **payment provision** specifies a fixed or determinable settlement a party will make if the underlying behaves in a specified manner.

A derivative instrument allows parties to participate in some or all of the effects of changes in the underlying. However, an underlying by itself cannot determine the derivative instrument's settlement or value. Therefore, derivative instruments must also have either a notional amount (the number of units specified in the contract) or a payment provision (or both).

Typically, a derivative instrument’s settlement is determined by multiplying the notional amount by the underlying, as shown below.

In some cases, determining the settlement amount involves using a formula with leverage factors, such as a multiplier (for example, times a stated number) or other constants. In other cases, a derivative instrument has payment provisions that require a fixed or determinable settlement if an underlying changes in a specified way (for example, a specified payment the party will make if a referenced interest rate increases by 300 basis points).

When a contract includes an underlying and either a notional amount or payment provision (or both), the parties can compute the contract’s periodic settlement and resulting changes in fair value. That contract therefore meets the first derivative characteristic.

For example, for a warrant to buy an entity’s stock, the number of shares issued upon exercise is the notional amount and the stock price is the underlying. The parties can compute the contract’s settlement amount using those two elements. Therefore, that contract has the first derivative characteristic. The warrant allows the holder to participate in changes in the entity’s stock price without actually owning (or before owning) the underlying shares.

A.1.2 Second Characteristic of a Derivative: Little or No Initial Net Investment

FASB REFERENCES

ASC 815-10-15-94 through 15-97

The second characteristic of a derivative instrument is that it requires zero initial net investment or an initial net investment that is smaller than what other types of contracts expected to respond similarly to changes in market factors would require. This characteristic allows parties to participate in price changes of an underlying without actually owning the asset or owing the liability associated with it.

While many derivative instruments require no initial net investment, some require an initial net investment to compensate for the following:

- Off-market conditions (for example, a premium on a forward purchase contract with a price less than the current forward price). To illustrate, a swap or forward contract generally does not require an initial net investment unless the terms favor one party over the other.
- Time value of money (for example, a premium on an option). For instance, an option generally requires that one party make an initial net investment (a premium) because that party has the rights under the contract and the other party has the obligations.

To meet the second derivative characteristic, the contract’s initial net investment (adjusted for the time value of money) must be zero or an amount that is less (by more than a nominal amount) than what would be exchanged either to acquire the asset or incur the obligation related to the underlying. The amount of that asset acquired or liability incurred should be comparable to the contract’s effective notional amount (that is, the stated notional amount adjusted for any leverage factor). However, a slightly off-market contract can still have the second derivative characteristic based on the facts and circumstances.

For example, a warrant to buy an entity’s shares generally requires the counterparty to pay a premium (the initial net investment) because that counterparty has the right, if elected, to receive the shares under the contract and the issuer has the obligation to issue the shares if elected by the counterparty. That initial net investment is typically less (by more than a nominal amount) than the initial net investment the counterparty would have paid to acquire the underlying shares. If so, that warrant meets the initial net investment characteristic.

In contrast, a contract that at inception requires a party to invest or receive an amount approximating the contract's notional amount (or that is equal to or more than the amount determined by applying the effective notional amount to the underlying) does not meet the second characteristic and therefore is not a derivative instrument.

The table illustrates how an entity evaluates the initial net investment characteristic.

STEP 1 Does the instrument require an initial net investment that is equal to (or greater than) the notional amount (or the notional amount plus a premium or minus a discount) or that is determined by applying the notional amount to the underlying?	**STEP 2** Is the initial net investment (as adjusted for time value) less (by more than a nominal amount) than the initial net investment that would be commensurate with the amount that would be exchanged either to acquire the asset or to incur the obligation related to the underlying?
If no, proceed to Step 2 ▶ For example, if an entity issues warrants in exchange for \$200 cash that gives the holder a right to buy 100 shares with a current price of \$10 per share, the answer to this question is no because the contract does not require the holder to pay an initial net investment equal to the contract's notional amount or by applying the notional amount to the underlying (100 shares x \$10). Rather, the holder pays a different amount (\$200). Therefore, the entity must further analyze the contract in Step 2.	If yes, the little or no initial net investment characteristic is met ▶ Continuing with the warrant example in Step 1, the initial net investment that would be required to acquire the asset related to the underlying (the 100 shares) is the notional amount applied to the underlying (100 shares x \$10 = \$1,000). The contract's initial net investment (\$200) is therefore smaller by more than a nominal amount (by 80%). The contract meets the initial net investment characteristic. It also meets the first derivative characteristic because it includes an underlying and notional amount (see Section A.1.1) and should therefore be assessed for the net settlement characteristic (see Section A.1.3) to determine whether the warrant meets the definition of a derivative instrument.
If yes, the little or no initial net investment characteristic is not met, and the contract is not a derivative. For example: ▶ If an entity issues debt in exchange for cash equal to the debt's face amount (the contract's notional amount), the debt has an initial net investment that is equal to the notional amount, so it does not meet the initial net investment test and is not a derivative instrument. ▶ If a counterparty prepays a forward sale contract by paying an amount equal to the number of underlying shares times the share's current share price (the notional amount applied to the underlying), the forward contract does not meet the initial net investment test and is therefore not a derivative instrument.	Not applicable. The instrument is not a derivative instrument in its entirety. However, it may be a hybrid instrument subject to the guidance in ASC 815-15 (see Section 3.2.2).

BDO INSIGHTS — MEANING OF NOMINAL AMOUNT

Because U.S. GAAP does not define the term "nominal amount,", determining whether the initial net investment in a contract is smaller by more than a nominal amount than the initial net investment required to acquire the asset (or incur the obligation) related to the underlying requires the application of professional judgment based on the facts and circumstances. However, when determining whether a contract has this characteristic of a derivative, we believe "by more than a nominal amount" means by at least 10%. Additional judgment may be needed if the difference is less than 10%.

A.1.3 Third Characteristic of a Derivative: Net Settlement

FASB REFERENCES

ASC 815-10-15-99

The third characteristic of a derivative instrument is that it allows contract settlement without either party accepting the risks and costs customarily associated with owning and delivering the asset associated with the underlying (often referred to as the "net settlement characteristic").

Net settlement generally involves a one-way transfer of an asset (for example, cash or shares) by the party in a loss position to the counterparty in a gain position. In contrast, gross or physical settlement involves a two-way transfer of an asset (for example, cash) by one party in exchange for the transfer of the asset associated with the underlying (for example, shares) from the other counterparty.

In the context of the third characteristic of a derivative instrument, net settlement applies when **neither** party to the contract must deliver an asset that **both**:

- Is associated with the underlying
- Has a principal amount, stated amount, face value, number of shares, or other denomination that equals the notional amount (or the notional amount plus a premium or minus a discount).

This Blueprint refers to that asset as an "**asset associated with the underlying**."

If one of the parties to the contract is required to deliver an asset associated with the underlying, the contract may still meet the net settlement characteristic if it can readily be net settled by a means outside the contract or provides for delivery of an asset that puts the recipient in a position not substantially different from net settlement.

Therefore, a contract meets the third characteristic of a derivative instrument if its settlement provisions meet **any** of the following forms of net settlement under ASC 815-10-15-99:

Under contract terms

Neither party is required to deliver an asset associated with the underlying (see Section A.1.3.1)

Through market mechanism

One party must deliver an asset associated with the underlying, but an established market mechanism facilitates net settlement outside the contract (see Section A.1.3.2)

By delivery of derivative instrument or asset readily convertible to cash

One party is required to deliver an asset associated with the underlying, but that asset is readily convertible to cash or is itself a derivative instrument (see Section A.1.3.3)

A.1.3.1 Net Settlement Under Contract Terms

FASB REFERENCES

ASC 815-10-15-83(c), ASC 815-10-15-100, ASC 815-10-15-102, ASC 815-10-15-104, ASC 815-10-15-107 through 15-109, and ASC 815-10-55-90

As discussed in Section A.1.3, a contract that can be net settled under contract terms meets the third derivative characteristic.

Net settlement under contract terms

The following generally describes that form of settlement:

- Neither party is required to deliver an asset associated with the underlying.
- The contract terms implicitly or explicitly require or allow net settlement.
  - Net settlement may be in a form of net share settlement
    - A contract meets the net settlement characteristic if either party can elect net share settlement (regardless of whether the net shares received are readily convertible to cash or are restricted for more than 31 days). If the entity (rather than the holder) can choose to net share settle the contract, it must consider whether the contract qualifies for the exception in ASC 815-10-15-74(a) (see Section 3.2.3.1).
  - Net settlement may be in a form of net cash settlement
    - Net settlement may be made in cash or by delivery of any other asset (whether or not that asset is readily convertible to cash), including the right to receive future payments (such as a structured payout of the gain or loss under the contract) instead of an immediate net cash settlement. That contract meets the net settlement characteristic if the fair value of the cash flows to be received (or paid) under the structured payout approximately equals the amount that would have been received (or paid) if the contract had been immediately net settled.

EXERCISE OF CALL OR PUT OPTIONS ON A DEBT INSTRUMENT MEETS NET SETTLEMENT

In accordance with ASC 815-10-15-107 through 15-109 the potential settlement of a debt instrument through the exercise of a call or put option meets the net settlement characteristic because it does not require either party to deliver an asset associated with the underlying. In settling a debt instrument through an exercise of a call or put option, the debtor does not receive an asset, even if the creditor concurrently returns the evidence of the debtor's indebtedness (for example, a note payable marked paid by the creditor). Further, the cash paid to the creditor at settlement is not an asset associated with the underlying. Therefore, the debt instrument meets the net settlement characteristic.

That guidance applies to freestanding purchased call and written put options on a debt instrument and to call and put options (such as a prepayment option) embedded in a hybrid instrument that contains a debt host contract; for example, legal form debt instruments and some preferred stock instruments (see Section 3.6.3.3). An entity cannot apply the guidance by analogy to embedded options in a hybrid instrument that does not contain a debt host contract.

The guidance also does not apply to call or put options added to a debt instrument by a third party (either contemporaneously or after the issuance of a debt instrument), which the investor accounts for as a freestanding derivative instrument.

EXAMPLE A-1 (ADAPTED FROM ASC 815-10-55-90): NET SHARE SETTLEMENT UNDER CONTRACT TERMS

FACTS

Entity X issues a warrant to buy 100 shares of its common stock at $10 a share to Entity A.

- Entity X is a privately held entity.
- Entity X can choose physical settlement or net share settlement (through a cashless exercise).

CONCLUSION

The warrant meets the net settlement characteristic.

ANALYSIS

A contract meets the net settlement characteristic if its terms implicitly or explicitly require or allow net settlement. Under the contract terms, Entity X can physically settle or net share settle the warrant. Therefore, the warrant meets the net settlement characteristic. The fact that the shares of Entity X are not readily convertible to cash is not relevant. The same conclusion would be reached if Entity A, rather than Entity X, had the right to net share settle the warrant. Said differently, if either party to the arrangement can net share settle the contract, the net settlement characteristic is met.

Entity X must evaluate whether the contract meets the other two characteristics of a derivative.

A.1.3.2 Net Settlement Through Market Mechanism

FASB REFERENCES

ASC 815-10-15-110 through 15-111, ASC 815-10-15-113 through 15-118

As discussed in Section A.1.3, a contract that can be net settled through a market mechanism meets the third derivative characteristic.

Net settlement through market mechanism

The following generally describes that form of settlement:

- One party must deliver an asset associated with the underlying (that is, through gross settlement), but an established market mechanism facilitates net settlement outside the contract (for example, exchange-traded derivatives that can be closed or net settled in active markets before their expiration or maturity).
  - An entity must evaluate whether a market mechanism exists at contract inception and throughout the life of a contract.
  - The term "market mechanism" is interpreted broadly and includes any institutional arrangement or other agreement having the required primary characteristics discussed in the table below.

A method of settling a contract qualifies as an established market mechanism if the institutional arrangement (or other arrangement) has **all** the primary characteristics shown in the table (an entity must also consider the indicators for each of the primary characteristics, but all indicators need not be present).

PRIMARY CHARACTERISTICS	CONSIDERATIONS	INDICATORS
▶ It allows one party to readily liquidate its net position in the contract (that is, to realize the **net** gain or loss under a contract through a net payment).	▶ Net settlement may occur in cash or other assets. ▶ A contract settlement that results only in a gross exchange or delivery of an asset for cash (or other payment in kind) does not meet this primary characteristic.	▶ There is available access to potential counterparties (regardless of the seller's size or market position). ▶ Risks assumed by a market-maker acquiring a contract can be transferred by means other than by repackaging the original contract into a different form.

PRIMARY CHARACTERISTICS	CONSIDERATIONS	INDICATORS
▶ It results in one party becoming fully relieved of its rights and obligations under the contract (that is, it allows one party to surrender all future rights or avoid all future performance obligations under the contract).	▶ Contracts that do not allow assignment from the original issuer to another party do not meet this primary characteristic. ▶ If the contract requires consent before assignment and it is at least **reasonably possible** that the counterparty will withhold permission to assign, the contract does not meet net settlement through market mechanism. If withholding permission to assign is **remote**, there is net settlement through market mechanism. In making that assessment, an entity considers factors, such as industry practices, past experiences with the counterparty, and whether sufficient potential assignees exist to relieve unacceptable credit risk or performance risk for the nonassigning party. ▶ An ability to enter an offsetting contract in and of itself is not a market mechanism (because the rights and obligations from the original contract survive).	▶ Multiple market participants are willing and able to enter a transaction at market prices to assume the seller’s rights and obligations. ▶ There is sufficient liquidity in the market for the contract (typically indicated by the transaction volume, as well as a relatively narrow observable bid-ask spread).
▶ It does not require significant transaction costs to liquidate the net position.	▶ Transaction costs are significant if they are at least 10% of the contract’s fair value.	▶ No indicators are provided for this primary characteristic.
▶ It liquidates the net position without significant negotiation and due diligence and within a time frame that is customary for the same type of contract.	▶ A market mechanism facilitates easy and expedient contract settlement (whether in cash or other assets).	▶ Binding prices can be readily obtained. ▶ Transfers involve standardized documentation and settlement procedures. ▶ Individual contract sales do not require negotiation and unique structuring. ▶ Closing period is not extensive (such as because of the need to allow legal consultation and document review).

A.1.3.3 Net Settlement by Delivery of Derivative Instrument or Asset Readily Convertible to Cash

FASB REFERENCES

ASC 815-10-15-119 through 15-123, ASC 815-10-15-125 through 15-127, ASC 815-10-15-129 through 15-137, ASC 815-10-15-139, ASC 815-10-20, ASC 815-10-55-84, and ASC 815-10-55-87 through 55-89

As discussed in Section A.1.3, a contract that can be settled by delivery of an asset associated with the underlying that is readily convertible to cash or is itself a derivative instrument meets the third derivative characteristic.

Net settlement by delivery of derivative instrument or asset readily convertible to cash

The following generally describes that form of settlement:

- One party is required to deliver an asset associated with the underlying (that is, through gross settlement) that is readily convertible to cash or is itself a derivative instrument; for example:
  - A forward contract that requires delivery of exchange-traded equity security (an asset readily convertible to cash)
  - An option to require delivery of a swap contract (a derivative instrument).
- That form of settlement meets the third derivative characteristic because it puts the recipient of the asset in a position that is not substantially different from net settlement.

MEANING OF READILY CONVERTIBLE TO CASH

The phrase "readily convertible to cash'" means assets have **both**:

- Interchangeable (fungible) units
- Quoted prices available in an active market that can rapidly absorb the quantity held by the entity without significantly affecting the price.

An asset is considered readily convertible to cash only if the net cash that would be received from selling it in an active market is either equal to or not significantly less than what the recipient would have received in net settlement. In other words, the parties generally should be indifferent as to whether to exchange cash or the asset associated with the underlying. However, that does not mean that the net proceeds that would be received from selling the asset in an active market need to be equal to (or would approximate) what the recipient would have received under a net settlement provision.

In determining whether an asset is readily convertible to cash, an entity must also consider the significance of the estimated costs to convert the asset to cash:

- If the conversion costs are insignificant, receiving the asset puts the recipient in a position that is not substantially different from net settlement. In that case, the conversion costs do not preclude the asset from being considered readily convertible to cash.
- If the conversion costs are significant, the contract does not meet the net settlement characteristic of a derivative instrument.

Estimated conversion costs are considered significant if they are at least 10% of the gross sales proceeds that would be received from selling the assets in the closest or most economical active market (based on the spot price at contract inception). An entity must assess the significance of the conversion costs only at contract inception.

An entity must evaluate whether items delivered under a contract are readily convertible to cash at inception and throughout the contract's life (except for the effect of the conversion costs discussed above).

For some financial instruments discussed in this Blueprint, whether an asset associated with the underlying is readily convertible to cash refers to whether an entity's shares of stock are readily convertible to cash.

A stock that is not publicly traded is not readily convertible to cash even if an entity can use it as collateral in a borrowing.

On the other hand, when evaluating whether shares of stock that publicly trade in an active market are readily convertible to cash, specific conditions must be met.

CONDITIONS	GENERALLY, THE STOCK IS READILY CONVERTIBLE TO CASH	GENERALLY, THE STOCK IS NOT READILY CONVERTIBLE TO CASH
Whether upon the instrument's exercise an active market can rapidly absorb the quantity of stock issued without significantly affecting the stock price The instrument's form is important. Individual instruments cannot be combined for evaluation purposes to circumvent this analysis (see Examples 3-3 and 3-4).	▶ If an entity's stock is publicly traded, but the market is not very active and the number of shares to be exchanged is small compared to the daily transaction volume	▶ If an entity's stock is publicly traded, but the market is not very active and the number of shares to be exchanged is large compared to the daily transaction volume
Whether the estimated costs to convert the stock to cash is expected to be significant (assessed only at inception of the contract)	▶ The estimated costs to convert the stock to cash are not significant	▶ The estimated costs to convert the stock to cash are significant
For a stock purchase warrant on shares in a publicly traded entity, whether the holder is restricted from transferring the stock issued upon exercise and how long the transfer restrictions are. That applies only to warrants issued by an entity for its own shares (or shares of consolidated subsidiary) for which the shares issued are newly outstanding (including issuance of treasury shares) and are subject to transfer or sale restrictions starting from exercise of the warrant. An entity cannot apply the guidance on restricted stock by analogy to other types of contracts (for example, a forward contract or warrants for shares of third-party stock).	▶ If either: • The sale or transfer of issued shares is not restricted or restricted only in connection with being pledged as collateral • The sale or transfer of issued shares is restricted other than in connection with being pledged as collateral only for 31 days or less from the date the warrant is exercised	▶ If the sale or transfer of issued shares is restricted other than in connection with being pledged as collateral for more than 31 days from the date the warrant is exercised unless the holder can by contract or otherwise cause the requirement to be met within 31 days of the warrant's exercise date. For example, if the shares can be reasonably expected to qualify for sale within 31 days of their receipt under SEC Rule 144, *Selling Restricted and Control Securities*, or other SEC rules, the shares are considered readily convertible to cash, assuming there is an active market that can rapidly absorb the quantity of stock upon exercise without significantly affecting the stock price and the conversion costs are expected to be not significant.

An entity must evaluate whether items delivered under a contract are readily convertible to cash at inception and throughout the contract's life (the significance of conversion costs is assessed only at inception). For instance, the following events are considered in an entity's reassessment:

- A market develops for the entity's shares
  - For example, a nontransferable forward contract on a nonpublic entity's stock that allows only for gross physical settlement does not meet the net settlement characteristic at contract inception. However, if the entity subsequently completes an IPO, the shares would be considered readily convertible to cash (assuming an active market can rapidly absorb the shares without significantly affecting the stock price). Accordingly, the contract meets the net settlement characteristic at that later date.
- Daily trading volume changes for a sustained period
  - For example, a nontransferable forward contract on a public entity's stock that requires delivery on a single date of a significant number of shares that at contract inception would significantly affect the stock price in the market if sold within a few days does not meet the net settlement characteristic at inception. But, if at some subsequent date, the trading activity increases significantly and the number of underlying shares would be minimal compared to the new average daily trading volume, the contract meets the net settlement characteristic at that later date.
- An entity is delisted
  - For example, a nontransferable forward contract on a public entity's stock meets the net settlement characteristic at contract inception (assuming there is an active market for the entity's stock that can rapidly absorb the underlying shares without significantly affecting the stock price and the conversion costs are expected to be insignificant). However, if the entity is subsequently delisted (and the contract does not otherwise meet the net settlement characteristic), the shares underlying the contract are no longer considered readily convertible to cash and the contract no longer meets the net settlement characteristic at that later date.

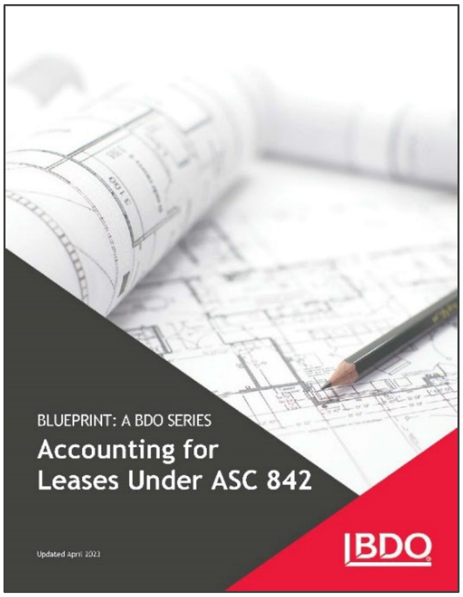
Appendix B — Flowcharts

The following flowcharts in this Blueprint may be useful in evaluating financial instruments.

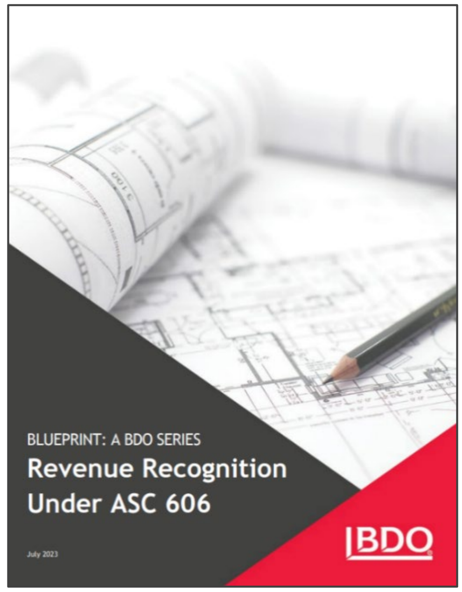
DESCRIPTION	SECTION
Distinguishing liabilities from equity overview	Section 2.1
Hybrid instruments and embedded derivatives overview	Section 3.1
Conversion features in a debt host contract	Section 3.6.1
Interest-rate-related features	Section 3.6.2
Call options and put options on debt instruments	Section 3.6.3
Analyzing contracts in an entity's own equity ▶ Application to freestanding financial instruments ▶ Application to embedded features	Section 4.4.1 Section 4.4.2
Temporary equity overview	Section 5.1
Classification of long-term obligations ▶ Debt with covenant violations ▶ Debt with recurring covenants	Section 8.3.1.1 Section 8.3.1.1.1

Appendix C — BDO Blueprints

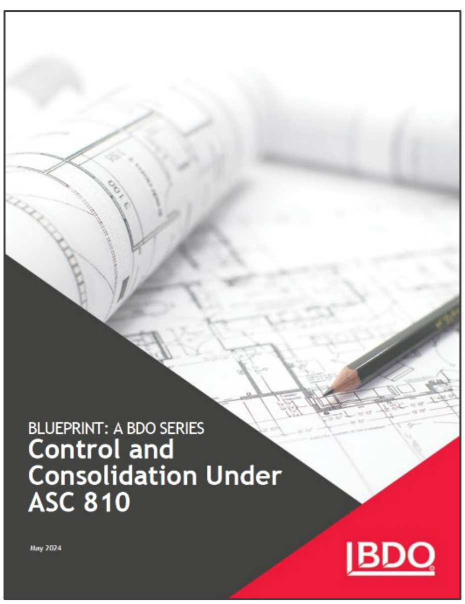
Other publications in BDO's Blueprint series are available on the BDO Center for Accounting Standards and Reporting Matters.



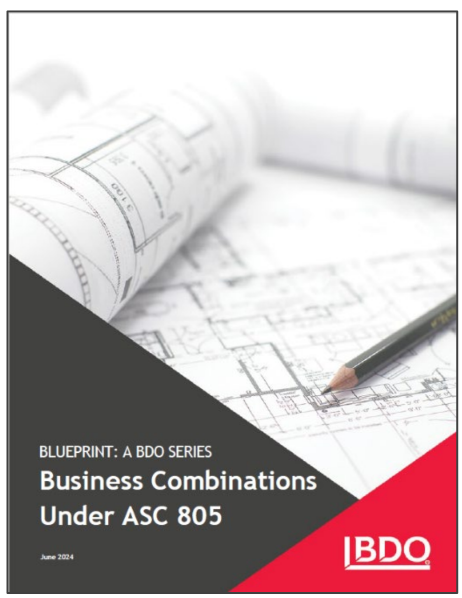
Accounting for Leases Under ASC 842



Revenue Recognition Under ASC 606



Control and Consolidation Under ASC 810



Business Combinations Under ASC 805

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