FIFTH EDITION / UPDATED MAY 2019

A PRACTICE AID FROM BDO'S NATIONAL ASSURANCE PRACTICE

COMPLEX FINANCIAL INSTRUMENTS

BDO

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This is the fifth edition of the Practice Aid which has been updated to May 2019.

HOW TO USE THE PRACTICE AID

The Practice Aid includes detailed flowcharts for analyzing embedded conversion options, freestanding warrants, and embedded puts and calls. Each step in the flowchart is explained in detail in the Practice Aid. As each step is explained, the flowcharts are repeated, and your location in the overall flowchart is identified. We recommend that you begin your analysis with the flowchart and then start your extended analysis in the appropriate sections of the Practice Aid. We encourage you to utilize the flowcharts flexibly – in some circumstances it might be more efficient to begin the analysis of embedded conversion options at Step C.

BACKGROUND AND PURPOSE

AS THE DESIGN OF FINANCIAL INSTRUMENTS CONTINUES TO EVOLVE, PUBLIC AND PRIVATE COMPANIES HAVE INCREASINGLY ENTERED INTO CREATIVE FINANCING TRANSACTIONS.

These transactions often involve the issuance of conversion options embedded in debt or preferred shares (such as convertible debt or convertible preferred shares) and freestanding warrants to purchase the issuer's shares. We have received many questions about accounting for these types of transactions. The SEC staff frequently questions whether the appropriate accounting analysis has been performed, and as a result of these questions a number of companies have restated prior financial statements. The purpose of this document is to summarize the GAAP that applies to issuers of convertible securities, freestanding warrants, and puts and calls, and to discuss other common issues that should be considered in debt and equity financings.

Companies should begin the analysis by identifying the financial instruments issued. For example, a company may have issued one instrument with embedded conversion options or two freestanding instruments (e.g., nonconvertible debt with detachable warrants). It is important that companies read the contracts thoroughly to identify all of the terms that may require recognition in the financial statements. Companies are faced with additional challenges if the terms of a financing are scattered in several different agreements. For example, a capital raising transaction frequently includes a securities purchase agreement, a warrant agreement, and a registration rights agreement.

Initially, companies should determine whether the instruments they issued are considered freestanding or embedded, i.e., combined with another contract. This determination is a matter of judgment. Accordingly, the following questions should be considered:

- Was one contract issued in contemplation of and simultaneously with another contract? For example, were nondetachable warrants issued in conjunction with debt?
- Can the holder of the contracts sell, transfer and/or exercise each contract separately? For example, must the debt be tendered in order to exercise the warrants?
- Were the contracts executed with the same counterparty either directly or through an intermediary?
- Do the contracts or transactions relate to the same risk?
- Is there an apparent economic need or substantive business purpose for structuring the transactions separately that could not also have been accomplished in a single transaction?

Different accounting conclusions may be reached based on whether contracts are evaluated separately or as a single combined unit. As such, this decision must be made prior to identifying the appropriate literature to apply. In particular, ASC 480-10 applies only to freestanding instruments, whereas ASC 815 provides guidance for hybrid instruments, i.e., contracts comprised of a host such as a debt instrument and an embedded feature such as a conversion option.

After reading the contracts and identifying the financial instruments, companies should answer the following questions that are discussed in detail in this Practice Aid for each instrument:

1. Is the freestanding financial instrument a mandatorily redeemable preferred stock, a warrant for redeemable stock, or a puttable warrant, i.e., is it within the scope of ASC 480-10?

2. Does the financial instrument include embedded conversion options?
   If so, is the issuer required to bifurcate the conversion option from the host contract under ASC 815-15? That is,
   a. Are the economic risks and characteristics of the embedded conversion options clearly and closely related to the economic risks and characteristics of the host contract? If yes, bifurcation is not required.
   b. Is the hybrid instrument (i.e., the contract comprising the host and the embedded conversion options) remeasured to fair value at each balance sheet date with changes reported in earnings? If yes, bifurcation is not required.
   c. Would the embedded conversion option, if freestanding, qualify as a derivative under ASC 815-10? If no, bifurcation is not required.

   Does the embedded conversion option meet the ASC 815-10-15-74 scope exception? If the answer to each of the following questions is yes, derivative accounting is not required. That is,

   d. Is the embedded conversion option indexed to the company's own stock under ASC 815-40-15;
   e. Can the embedded conversion option be classified in shareholders' equity under ASC 815-40-25-1 through 6; and
   f. If the hybrid instrument is convertible, is it conventional convertible; or, if it is not conventional convertible, can the embedded conversion option be classified in stockholders' equity under ASC 815-40-25-7 through 25-35?

3. Is the financial instrument a freestanding warrant?
   If so, does the warrant meet the ASC 815-10-15-74 scope exception? If the answer to each of the following questions is yes, the warrant can be accounted for in equity. That is,
   a. Is the freestanding warrant indexed to the company's own stock under ASC 815-40-15;
   b. Can the freestanding warrant be classified in shareholders' equity under ASC 815-40-25-1 through 6; and
   c. Can the freestanding warrant be classified in stockholders' equity under ASC 815-40-25-7 through 35?

4. Does the financial instrument include embedded puts and/or calls or other features that require bifurcation from the host contract under ASC 815?

5. Has the fair value option been elected for a hybrid instrument?

6. What is the appropriate balance sheet classification of contingently redeemable shares?

7. How are the proceeds from the capital raising transaction allocated and what are the journal entries?

8. How do you calculate diluted earnings per share for issuers with potential common shares represented by conversion options and warrants?

9. Are deferred income taxes required?

10. How and over what period are debt issue costs and debt discounts or premiums amortized?

11. What is the appropriate accounting and journal entries for conversions of debt or preferred stock instruments into common stock and for accounting after original issuance?

12. What is the accounting for troubled debt restructurings, debt extinguishments and debt modifications?

These questions will be addressed in-depth and analyzed in the context of examples and case studies for R Company.

REDEEMABLE PREFERRED STOCK, WARRANTS FOR REDEEMABLE PREFERRED STOCK, AND PUTTABLE WARRANTS

STEP A: IS THE FINANCIAL INSTRUMENT WITHIN THE SCOPE OF ASC 480-10?

Freestanding Financial Instruments

Step A in analyzing a complex financial instrument is to determine whether it falls within the scope of ASC 480-10. The following three categories of freestanding financial instruments are required to be accounted for as liabilities under ASC 480-10:

- Mandatorily redeemable shares;
- Instruments (other than an outstanding share) that do or may obligate the issuer to buy back some of its shares (or are indexed to such an obligation) in exchange for cash or other assets — e.g., written puts (puts written by the issuer on its own shares and held by others); and
- Obligations that must or may be settled with a variable number of shares the monetary value of which is based solely or predominantly on —
    - A fixed monetary amount known at inception;
    - A variable other than the fair value of the issuer's shares such as a market index; or
    - A variable inversely related to the fair value of the issuer's shares.

The second category of instruments falls under ASC 480-10, but is not germane to the analysis of shares. If the shares do fall into categories one or three, they are measured initially at fair value. If the shares do not fall into categories one or three, the instruments must be analyzed under ASC 815.

Category One – Mandatorily Redeemable Shares

Mandatorily redeemable shares are shares that an entity is required to redeem for cash or other assets at a fixed or determinable date or upon an event that is certain to occur.[1] Mandatorily redeemable shares should be measured subsequently in one of two ways:

[1] For instruments issued by nonpublic companies that were mandatorily redeemable on fixed dates for fixed amounts or by reference to an interest rate index, currency index, or another external index, ASC 480-10 became effective for fiscal years beginning after December 15, 2004. For all of the other financial instruments of nonpublic companies that are mandatorily redeemable, the provisions of ASC 480 were deferred indefinitely. ASU 2017-11 recharacterized the indefinite deferral (presented as pending content in the Codification) as a scope exception. No change in practice is expected as a result of these amendments.

1. If both the amount to be paid and the settlement date are fixed, those instruments must be measured subsequently at the present value of the amount to be paid at settlement, accruing interest cost using the rate implicit at inception; or
2. If either the amount to be paid or the settlement date varies based on specified conditions, those instruments should be measured subsequently at the amount of cash that would be paid under the conditions specified in the contract if settlement occurred at the reporting date, recognizing the resulting change in that amount from the previous reporting date as interest cost.

Any amounts paid or to be paid to holders of such instruments in excess of the initial measurement amount should be reflected in interest cost.

Some preferred share instruments are required to be redeemed at a stated date and are within the scope of ASC 480-10. However, a convertible preferred share that is redeemable at a stated date would not meet the definition of a mandatorily redeemable share, because it would not be redeemed if the holder chose to convert to common shares (assuming that the conversion right is substantive). (These shares should be reported as temporary equity. See the Practice Aid section, Balance Sheet Classification of Shares.)

Category Three – Obligations that Must or May Be Settled with a Variable Number of Shares

The concept of predominance in this third category of obligations that must or may be settled with a variable number of shares is not defined in ASC 480-10 and is not straightforward. ASC 480-10-55 provides guidance and states that the issuer must analyze the instrument at inception and consider all of the possible outcomes to reach a conclusion as to which obligation is predominant. The issuer should consider all information that is on point including current stock price, stock volatility, strike price, and any other relevant factors. Some companies may interpret predominance as anything in excess of 50%, similar to the more-likely-than-not threshold in ASC 740 while others may attach a higher probability of 70%, 80% or 90%, etc.

We believe either approach is acceptable and must be documented and consistently applied as an accounting policy election.

Obligations to issue a variable number of shares should be measured subsequently at fair value with changes in fair value recognized in earnings, unless other GAAP specifies another measurement attribute. In practice, it may be acceptable for companies to consider certain obligations to settle in a variable number of shares with a value based solely or predominantly on a fixed monetary amount known at inception as, in substance, stock-settled debt. Further, the interest method (as defined in the ASC's Master Glossary) is typically used for the periodic amortization of discount or premium on debt instruments.

A common example of instruments in the third category is a $100 borrowing that requires the issuance, at the end of one year, of a variable number of shares with a then current value of $125. The instrument is accounted for as a liability at fair value as it is not equity to the issuer because the holder is indifferent to changes in the value of the shares.

Certain convertible preferred shares are liabilities under the third category of ASC 480-10. These instruments are issued in the form of preferred shares that are convertible into a variable number of common shares (i.e., the "conversion price" continuously resets), the monetary value of which is fixed, tied to a variable such as market index, or varies inversely with the value of the issuer's common shares.

Category Two – Freestanding Warrants

ASC 480-10-25 and ASC 480-10-55 explain that freestanding warrants are obligations for the company to repurchase its shares (or instrument indexed to its shares) and represent liabilities if:

- The warrants (or instruments indexed to the company's shares) are puttable, *OR*
- The warrants (or instruments indexed to the company's shares) are exercisable for shares that are puttable or mandatorily redeemable.

This guidance applies regardless of the timing of the put or the redemption price because the underlying instruments represent obligations to transfer assets.

Examples of warrants that would be classified as liabilities under ASC 480-10 include the following:

1. Warrants to purchase common shares at $10 per share. The warrants include a put feature that allows the holder to put the warrants back to the issuer for $2 rather than exercising the warrant.
2. Warrants to purchase preferred shares at $10 per share. The preferred shares are puttable at the option of the holder for $12 cash immediately after exercise of the warrant.
3. Warrants to purchase preferred shares at $10 per share. The preferred shares are mandatorily redeemable at $12/share after 5 years.
4. Warrants to purchase preferred shares at $10 per share. The preferred shares are puttable for $12/share upon a change in control.
5. Warrants to purchase preferred shares at $10 per share. In the event of an IPO, the preferred shares are puttable at 80% of the IPO price.

ANALYZE CONVERTIBLE PREFERRED STOCK

Facts

On May 14, 2017, R Company issued 3,000,000 shares of Series A Preferred Stock at $10 per share ($30,000,000).

CONVERSION OPTION – Shares of Series A Preferred Stock must be converted by the holder on May 14, 2020. The number of shares to be delivered must equal a value of $35,000,000 on the conversion date.

Analysis

Step A: Is the Series A Preferred Stock within the scope of ASC 480-10?

YES – The preferred stock represents an obligation to issue a variable number of common shares that equal a fixed monetary amount known at inception. The Series A Preferred Stock should be accounted for initially at fair value. Since the preferred stock represents in substance stock-settled debt, the company may determine it is appropriate to use the interest method for periodic amortization.

ANALYZE REDEEMABLE PREFERRED STOCK ISSUED WITH WARRANTS

Facts

Preferred Stock

On June 15, 2018, R Company issued 2,000,000 of Series B Preferred Stock at $10 per share.

DIVIDENDS – From and after the date of the issuance of any shares of R Company Series B Preferred Stock and for so long as any such shares remain outstanding, dividends shall accrue on such shares of Series B Preferred Stock on the first day of each calendar quarter at the rate of $.50 per share (subject to appropriate adjustment in the event of any stock dividend, stock split, combination or other recapitalization with respect to the Series B Preferred Stock). Accruing dividends shall accrue from calendar quarter to calendar quarter, whether or not declared, and shall be cumulative.

REDEMPTION – Shares of Series B Preferred Stock shall be redeemed by R Company on June 15, 2023 at a price equal to the Series B original issue price per share, plus any accruing dividends accrued but unpaid thereon, whether or not declared, together with any other dividends declared but unpaid thereon.

SURRENDER OF CERTIFICATES – On or before the applicable redemption date, each holder of shares of Series B Preferred Stock to be redeemed on such redemption date shall surrender the certificate or certificates representing such shares to R Company, in the manner and at the place designated in the redemption notice, and thereupon the redemption price for such shares shall be payable to the order of the person whose name appears on such certificate or certificates as the owner thereof.

Warrants

For each 10 shares of Series B Preferred Stock purchased, holder and his, her or its registered transferees, successor or assigns are entitled to subscribe for and purchase 10 shares of the fully paid and nonassessable Series B Preferred Stock of R Company at $10 per share, subject to appropriate adjustment in the event of any stock dividend, stock split, combination or other recapitalization with respect to the Series B Preferred Stock.

TERM – The purchase right represented by this warrant is exercisable at any time and from time to time from the purchase date through and including the close of business on the fifth anniversary of the purchase date.

Analysis of Step A

Is the Series B Preferred Stock within the scope of ASC 480-10?

YES – The preferred stock is mandatorily redeemable. It is required to be redeemed for cash equal to the original issue price plus accrued dividends at June 15, 2023, a fixed date.

If the Series B Preferred Stock were convertible into a fixed number of common shares, would it be within the scope of ASC 480-10?

NO – The Series B Preferred Stock would not be within the scope of ASC 480-10. This is because the redemption of the preferred stock is *conditional upon* the conversion option not being exercised, and therefore, the instrument does not meet the definition of a mandatorily redeemable financial instrument.

Is the warrant within the scope of ASC 480-10?

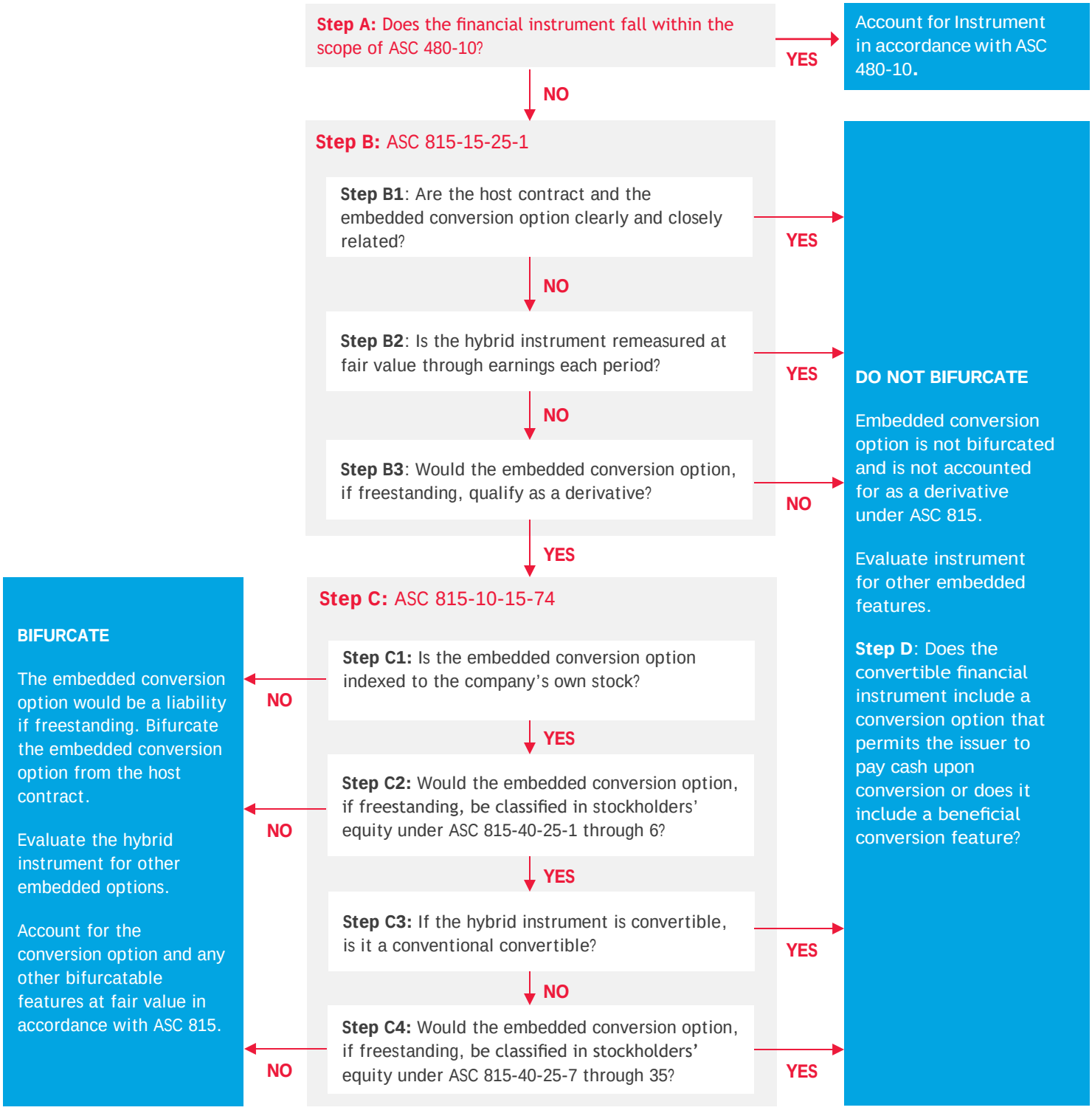
YES – Since the preferred stock is mandatorily redeemable, the warrant for the redeemable preferred stock is within the scope of ASC 480-10 and represents a liability that should be recorded at fair value initially, and reported at fair value each quarter with the changes reported in the statement of operations.

Would this answer change if the warrant was exercisable for common stock of the company?

IT DEPENDS ON THE TERMS OF THE WARRANTS AND COMMON STOCK – If the stock was not redeemable, and the warrants were indexed to the company's stock and classified in shareholders' equity, the warrants would be classified as equity rather than as a liability.

EMBEDDED CONVERSION OPTIONS FLOWCHART

Flowchart #1



EMBEDDED CONVERSION OPTIONS

FLOWCHART STEP B: DOES THE FINANCIAL INSTRUMENT INCLUDE AN EMBEDDED CONVERSION OPTION THAT REQUIRES BIFURCATION FROM THE HOST INSTRUMENT?

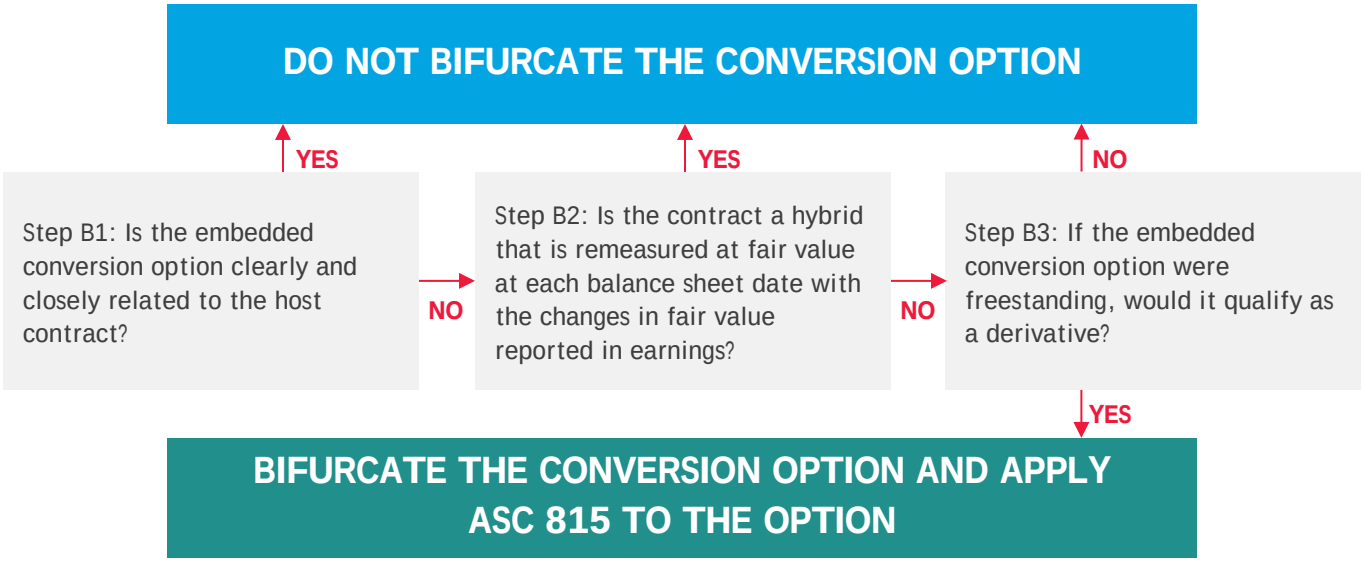
Introduction

Once we determine that the financial instrument is not within the scope of Flowchart Step A and ASC 480-10, we proceed to Step B to determine whether it has an **embedded conversion option** that requires bifurcation from the host contract under ASC 815-15-25-1.

For example, for a convertible debt instrument, the debt note represents the host contract and the option to convert into the issuer's shares is the embedded conversion option. The convertible debt instrument can also be referred to as a hybrid instrument, that is, a financial instrument that includes derivatives such as embedded conversion options *plus* a host contract. ASC 815-15-25-1 requires that embedded conversion options be bifurcated from the host contract and accounted for at fair value if all three of the following criteria are met:

1. The economic characteristics and risks of the embedded conversion option are not clearly and closely related to the economic characteristics and risks of the host contract.
2. The hybrid instrument that includes both the host and the embedded conversion option is not remeasured at fair value under applicable GAAP with changes reported in earnings each reporting period.
3. A separate instrument with the same terms as the embedded conversion option would be a derivative instrument.

The following chart illustrates this decision process. Note that for clarity we have worded all three criteria in the positive.



If any one of the three criteria of ASC 815-15-25-1 results in the arrows pointing up, then the embedded conversion feature is not bifurcated from the host contract. The instrument should then be evaluated under ASC 470-20 to determine whether it includes a conversion option that permits the issuer to pay cash upon conversion, and if not, whether a beneficial conversion feature[2] is present that should be accounted for.

Common Embedded Derivatives

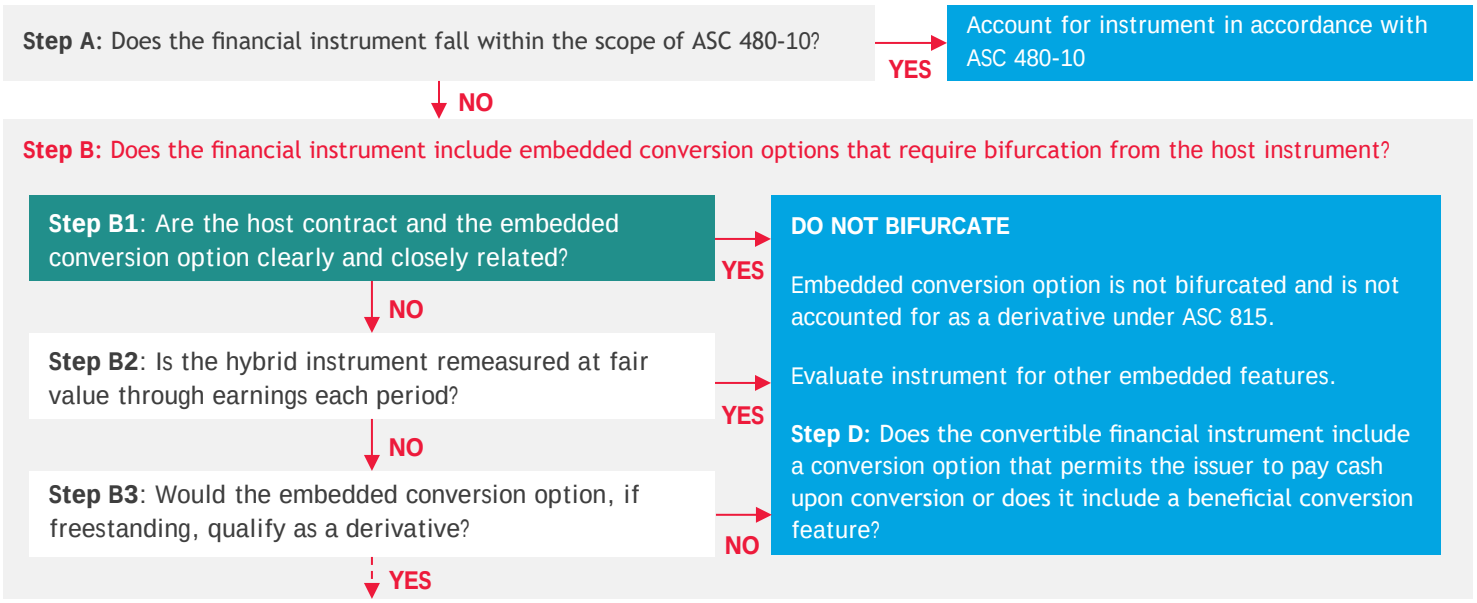
ASC 815 requires bifurcation of all embedded derivative features that meet its criteria, not just conversion options. In practice we have seen the following common embedded features that require further analysis:

- Contingent put – the holder of a convertible note has the right to require the issuer to prepay (pay off the remaining principal balance of) the note at a certain price upon the occurrence of defined events (see Flowchart #3).
- Contingent call – the issuer of a convertible note has the right to prepay (pay off the remaining balance of) the note at a certain price upon the occurrence of defined events (see Flowchart #3).
- Interest rate reset forward –
    - the interest rate on a convertible note adjusts based on bank prime; however, the rate cannot decline to less than X% unless certain market conditions are met.
    - the interest rate on a convertible note adjusts if the shares underlying the conversion feature are registered and the market price of the underlying stock exceeds the fixed conversion price by certain factors.

In practice, some instruments may contain several embedded features that must be bifurcated from the host. In such a case, all of the bifurcated embedded features are bundled together and accounted for as a single compound derivative.[3]

Step B Analysis

Next, we will examine each of the three considerations of Step B individually and in-depth.



[2] A conversion feature is beneficial if it is in-the-money at the commitment date. If the conversion price is $5 and the fair value of the underlying stock is more than $5 at the commitment date, the conversion feature is beneficial. Beneficial conversion features are discussed further at Step D.

[3] See ASC 815-15-25-7.

STEP B1: ARE THE HOST CONTRACT AND THE EMBEDDED CONVERSION OPTION CLEARLY AND CLOSELY RELATED?

Host Instrument

The host contract must be evaluated to determine whether it is more akin to debt or equity. Often, this exercise is straightforward (e.g., convertible debt instruments where the host contract is a debt instrument). In other exercises, the nature of the host contract is not as clear, including the analysis of certain preferred share host contracts. In these circumstances, determining the type of host contract can be complex and require judgment. All the features of the host contract must be considered and no one feature is determinative. This analysis is discussed in greater detail in the following sections.

Clearly and Closely Related

The concept of clearly and closely related refers to the relationship between the economic characteristics and risks of the embedded conversion option and the economic characteristics and risks of the host contract. The factors to consider include the type of host and the underlying.[4] For a debt host contract, clearly and closely related underlyings include interest rates, inflation, and creditworthiness. For an equity host contract, the clearly and closely related underlyings include the price of a share in the entity.

Debt Host with Embedded Conversion Option

In a typical convertible debt arrangement, the host contract is represented by a debt instrument that provides for certain interest payments and the repayment of principal. The embedded conversion option is generally represented by the option to purchase the common stock of the company at a fixed price (that is, a call option). In this situation, the conversion option has the economic characteristics and risks of an equity interest whereas the host contract is a debt instrument.

ASC 815-15-25-51 states "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 issuer'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.

[4] An underlying may be 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.

Preferred Stock Host with Embedded Conversion Option

In general, the analysis of preferred stock instruments is the same as the analysis of convertible debt instruments described above. However, preferred stock arrangements may include specific terms such as conversion rights, redemption rights, voting rights, and liquidation and dividend payment preferences, among other features that may result in the preferred stock instrument exhibiting characteristics of both debt and equity instruments. The determination of the nature of the preferred stock host in those situations (as debt-like or equity-like) requires judgment.

For hybrid financial instruments issued in the form of a share (such as preferred stock), the nature of the host contract should be determined by considering all stated and implied substantive terms and features of the hybrid financial instrument, weighing each term and feature based on the relevant facts and circumstances. That is, the entity should consider the economic characteristics and risks of the entire hybrid financial instrument, including the embedded derivative feature being evaluated. No single term or feature necessarily is determinative. Rather, the nature of the host contract depends on the economic characteristics and risks of the entire hybrid financial instrument. For example, the presence of a fixed-price, noncontingent redemption option held by the investor in a convertible preferred stock contract is not, in and of itself, determinative in assessing whether the nature of the host contract is more akin to a debt instrument or more akin to an equity instrument. Although an individual term or feature may weigh more heavily in the evaluation based on facts and circumstances, an entity should use judgment based on an evaluation of all the relevant terms and features.

In evaluating the nature of the host instrument, the entity is required to consider the substance of the terms and features within the hybrid instrument. In other words, an entity should assess the relative strength (the substance) of each term and feature (the debt-like or equity-like terms and features) based on the relevant facts and circumstances when assessing how to weigh those terms and features. In doing so, ASC 815-15-25-17C provides the following attributes that an entity may consider:

a. The characteristics of the terms and features themselves; for example, contingent versus non-contingent, in-the-money versus out–of-the money;

b. The circumstances under which the hybrid instrument was issued or acquired; for example, considering issuer-specific characteristics such as whether the issuer is thinly capitalized, or profitable and well-capitalized; and

c. The potential outcomes of the hybrid financial instrument (for example, whether a preferred share will be settled with the issuance of a fixed number of common stock or with transfer of cash, or will remain legal- form equity) and considering the likelihood of those potential outcomes.

For example, R Company has callable, puttable and convertible preferred stock. For R Company's instrument, the conversion option, the put, and the call are all separately compared to the callable, puttable, convertible preferred stock. Based on the relevant facts and circumstances, R Company determines that the call and put heavily weigh R's instrument and make it more akin to debt. The call and put are determined to be clearly and closely related to R's debt-like instrument. The conversion option is determined not to be clearly and closely related to R's debt-like instrument.

ASC 815-15-25-17D provides examples of common terms and features included within a hybrid instrument along with assessment considerations. It states:

a. **Redemption rights**. The ability for an issuer or investor to redeem a hybrid financial instrument issued in the form of a share at a fixed or determinable price generally is viewed as a debt-like characteristic. However, not all redemption rights are of equal importance. For example, a noncontingent redemption option may be given more weight in the analysis than a contingent redemption option. The relative importance (and, therefore, weight) of redemption rights among other terms and features in a hybrid financial instrument may be evaluated on the basis of information about the following (among other relevant) facts and circumstances:

1. Whether the redemption right is held by the issuer or investors
2. Whether the redemption is mandatory
3. Whether the redemption right is noncontingent or contingent
4. Whether (and the degree to which) the redemption right is in-the-money or out-of-the-money
5. Whether there are any laws that would restrict the issuer or investors from exercising the redemption right (for example, if redemption would make the issuer insolvent)
6. Issuer-specific considerations (for example, whether the hybrid financial instrument is effectively the residual interest in the issuer [due to the issuer being thinly capitalized or the common equity of the issuer having already incurred losses] or whether the instrument was issued by a well-capitalized, profitable entity)
7. If the hybrid financial instrument also contains a conversion right, the extent to which the redemption price (formula) is more or less favorable than the conversion price (formula), that is, a consideration of the economics of the redemption price (formula) and the conversion price (formula), not simply the form of the settlement upon redemption or conversion.

b. **Conversion rights**. The ability for an investor to convert, for example, a preferred share into a fixed number of common shares generally is viewed as an equity-like characteristic. However, not all conversion rights are of equal importance. For example, a conversion option that is noncontingent or deeply in-the-money may be given more weight in the analysis than a conversion option that is contingent on a remote event or deeply out-of-the-money. The relative importance (and, therefore, weight) of conversion rights among other terms and features in a hybrid financial instrument may be evaluated on the basis of information about the following (among other relevant) facts and circumstances:

1. Whether the conversion right is held by the issuer or investors
2. Whether the conversion is mandatory
3. Whether the conversion right is noncontingent or contingent
4. Whether (and the degree to which) the conversion right is in-the-money or out-of-the-money
5. If the hybrid financial instrument also contains a redemption right held by the investors, whether conversion is more likely to occur before redemption (for example, because of an expected initial public offering or change-in-control event before the redemption right becoming exercisable).

c. **Voting rights**. The ability for a class of stock to exercise voting rights generally is viewed as an equity-like characteristic. However, not all voting rights are of equal importance. For example, voting rights that allow a class of stock to vote on all significant matters may be given more weight in the analysis than voting rights that are only protective in nature. The relative importance (and, therefore, weight) of voting rights among other terms and features in a hybrid financial instrument may be evaluated on the basis of information about the following (among other relevant) facts and circumstances:

1. On which matters the voting rights allow the investor's class of stock to vote (relative to common stock shareholders)
2. How much influence the investor's class of stock can exercise as a result of the voting rights?

d. **Dividend rights**. The nature of dividends can be viewed as a debt-like or equity-like characteristic. For example, mandatory fixed dividends generally are viewed as a debt-like characteristic, while discretionary dividends based on earnings generally are viewed as an equity-like characteristic. The relative importance (and, therefore, weight) of dividend terms among other terms and features in a hybrid financial instrument may be evaluated on the basis of information about the following (among other relevant) facts and circumstances:

1. Whether the dividends are mandatory or discretionary
2. The basis on which dividends are determined and whether the dividends are stated or participating
3. Whether the dividends are cumulative or noncumulative.

e. **Protective covenants**. Protective covenants generally are viewed as a debt-like characteristic. However, not all protective covenants are of equal importance. Covenants that provide substantive protective rights may be given more weight than covenants that provide only limited protective rights. The relative importance (and, therefore, weight) of protective covenants among other terms and features in a hybrid financial instrument may be evaluated on the basis of information about the following (among other relevant) facts and circumstances:

   1. Whether there are any collateral requirements akin to collateralized debt
   2. If the hybrid financial instrument contains a redemption option held by the investor, whether the issuer's performance upon redemption is guaranteed by the parent of the issuer
   3. Whether the instrument provides the investor with certain rights akin to creditor rights (for example, the right to force bankruptcy or a preference in liquidation).

ANALYZE CONVERTIBLE PREFERRED STOCK

Facts

Preferred Stock

On October 10, 2018, R Company issued 2,000,000 of Series C Preferred Stock at $10 per share.

DIVIDENDS – From and after the date of the issuance of any shares of R Company Series B Preferred Stock and for so long as any such shares remain outstanding, dividends shall accrue on such shares of Series C Preferred Stock on the same basis as dividends accrued on common shares. This is subject to appropriate adjustment in the event of any stock dividend, stock split, combination or other recapitalization with respect to the Series C Preferred Stock.

REDEMPTION – Shares of Series C Preferred Stock shall be redeemed by R Company on October 10, 2028, at a price equal to the Series C original issue price per share, plus any accruing dividends accrued but unpaid thereon.

CONVERSION OPTION – The holders may convert the Series C Preferred Stock or a portion thereof at its election at any time after issuance, at a Conversion Price equal to $10/share.

VOTING RIGHTS – Each Series C Preferred Stockholder is entitled to the number of common stock votes associated with their conversion shares.

Analysis of Step A

Is the Series C Preferred Stock within the scope of ASC 480- 10?

NO – The preferred stock is not within the scope of ASC 480- 10 as the redemption of the preferred stock is *conditional upon* the conversion option not being exercised.

Consequently, the instrument is not mandatorily redeemable.

Analysis of Step B1

Is the conversion option embedded in the Series C Preferred Stock clearly and closely related to its host instrument? Is the host instrument a debt-like or equity-like instrument?

The conversion option is compared to the convertible redeemable preferred stock. First, we consider the instrument's debt-like characteristics: it is redeemable on October 10, 2028. Next, we consider the instrument's equity-like characteristics: it shares in common dividends, it has common stock voting rights, and it includes an option to convert to common stock. Finally, we weigh each of the debt-like and equity-like features. Based on the relevant facts and circumstances (including, but not limited to, for example the time period before which the preferred stock can be redeemed, and the likelihood of the preferred stock being converted before the redemption date), we conclude that the host is equity.

Is the conversion option a debt-like or equity-like instrument?

Since the conversion option is convertible into common shares, we conclude that the conversion option is equity-like. This would be true even if the conversion option included price reset features.

What is the conclusion?

We conclude that the conversion option and the host are clearly and closely related and that the conversion option is not required to be bifurcated from its host instrument. We note that the instrument includes a redemption option that will also need to be analyzed.

If the host instrument were debt-like with a 10% annual contractual interest rate, with no voting rights, and a due date of October 10, 2028, is the conversion option clearly and closely related to its debt host instrument?

NO – As noted on page 12, ASC 815-15-25-51 states that conversion options and debt are NOT clearly and closely related.

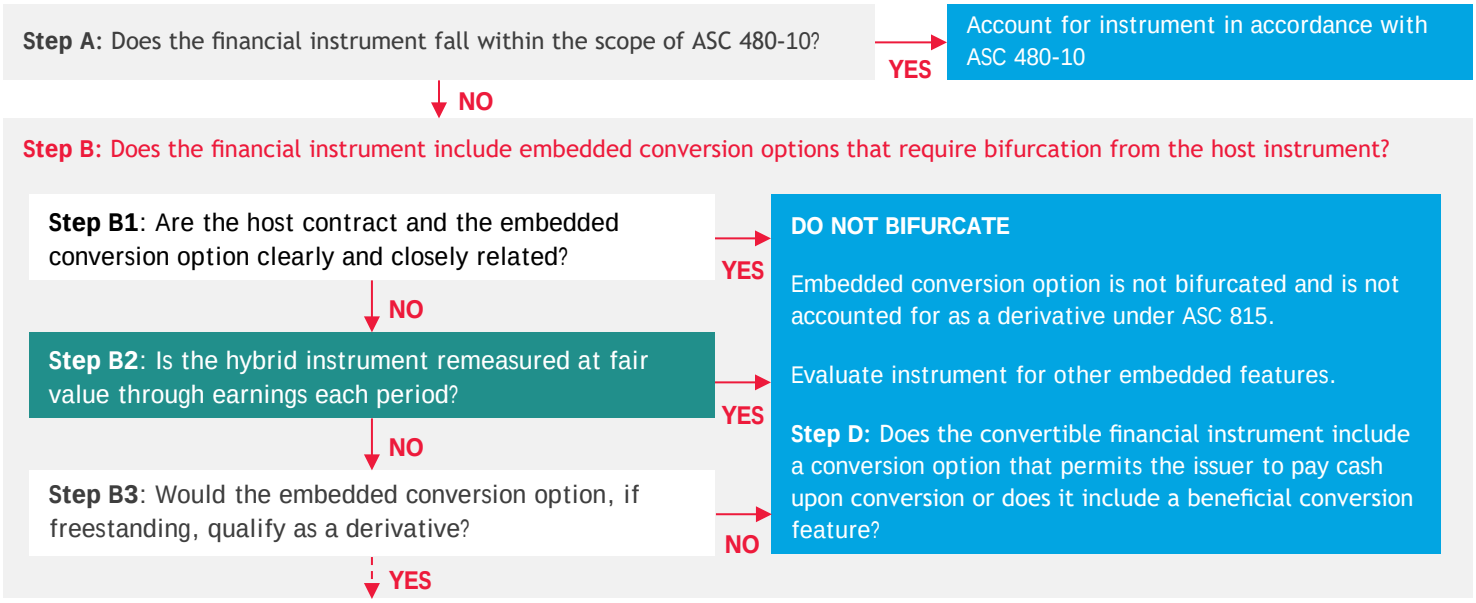
Is the conversion option a debt-like or equity-like instrument?

Since the conversion option is convertible into common shares, we conclude that the conversion option is equity-like.

What is the conclusion?

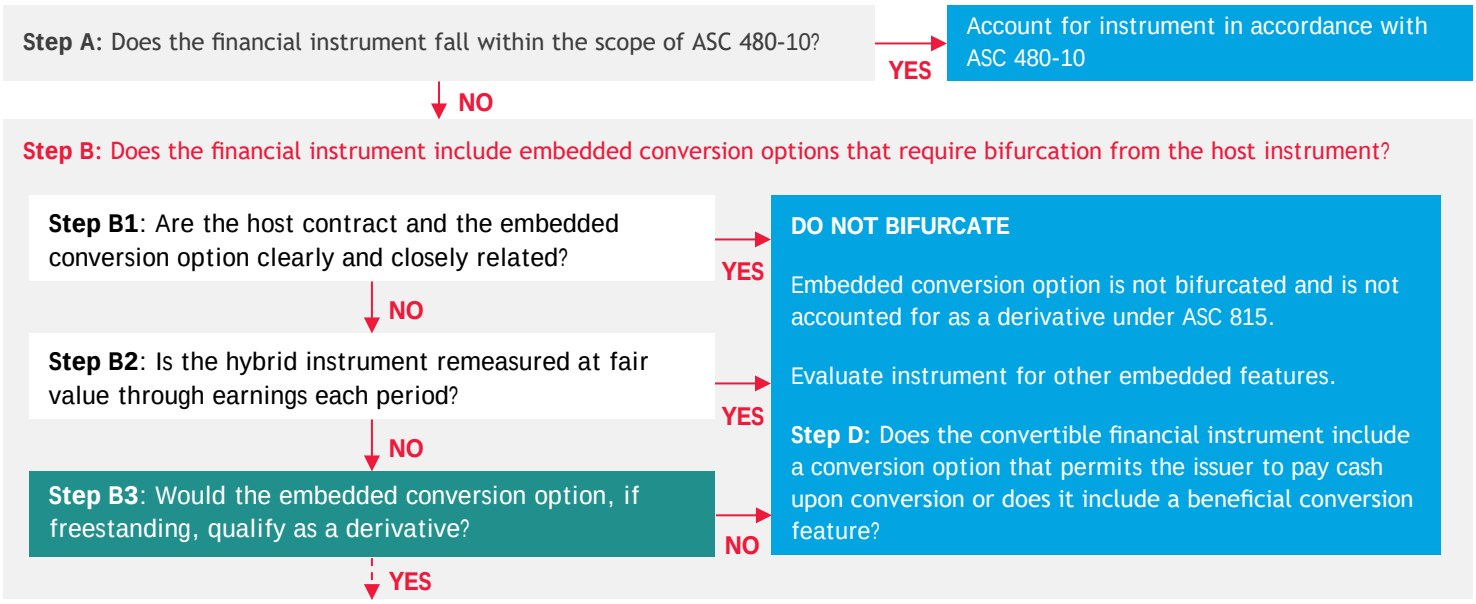
We conclude that the conversion option and the host instrument are NOT clearly and closely related and that the conversion option must be analyzed under Steps B2 and B3.

STEP B2: IS THE HYBRID INSTRUMENT REMEASURED AT FAIR VALUE THROUGH EARNINGS EACH PERIOD?



Under ASC 815-15 and 825-10, companies have an option to carry certain hybrid instruments at fair value with remeasurement at each balance sheet date and changes in fair value reported in the income statement. We discuss this in greater detail in the Practice Aid section, **Electing the Fair Value Option**.

STEP B3: WOULD THE EMBEDDED CONVERSION OPTION, IF FREESTANDING, QUALIFY AS A DERIVATIVE?



Often the determination of whether to bifurcate an embedded conversion option comes down to the criterion that a separate instrument with the same terms as the embedded conversion option would be a derivative. Generally, an option to convert the instrument into the issuer's shares would meet the definition of a derivative for a public company and would not meet the definition for a private company. ASC 815-10-15-83 defines a derivative as a contract having the following three characteristics. (ASC 815-10-15-15 through 74 provide exceptions to the following definition, the most important of which we will examine at length in Step C.):

1. It has one or more underlyings and one or more notional amounts or payment provisions or both.
2. 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 have a similar response to changes in market factors.
3. Its terms require or permit net settlement, it can readily be settled net by a means outside the contract, or it provides for delivery of an asset that puts the recipient in a position not substantially different from a net settlement.[5]

In a typical conversion option, the price of the stock to be issued upon conversion represents the underlying and the number of shares to be issued upon conversion represents the notional amount. Therefore, an embedded conversion option meets the first characteristic of a derivative.

The initial net investment in the convertible debt instrument represented by the loan proceeds theoretically relates to both the debt instrument and the conversion option. However, ASC 815-15-25-1(c) specifically states the initial net investment for the hybrid instrument shall not be considered to be the initial net investment for the embedded derivative (i.e., the conversion option). Accordingly, an embedded conversion option meets the second characteristic of a derivative.

Generally, a conversion option on shares that are traded in a public market possesses the net settlement characteristic because the shares are readily convertible into cash as discussed in ASC 815-10-15-110 and 111. Accordingly, for a public company an embedded conversion option generally meets the third characteristic of a derivative. When a public company's shares are thinly-traded, companies should assess whether the number of shares to be converted may be sold rapidly without significantly affecting share price. If so, the third characteristic would be met, as discussed in ASC 815-10-55-101 Case A.

Shares in private companies generally are not readily convertible into cash and typically would not meet the net settlement criterion. Similarly, warrants for shares in private companies that require physical settlement do not meet the net settlement criterion. However, warrants for shares in private companies that permit cashless exercise *do meet* the net settlement criterion.

[5] ASC 815-10-15-99 describes three ways in which the net settlement criterion can be satisfied. For example, ASC 815-10-15-110 and 111 state that a contract requiring one of the parties to deliver an asset that is readily convertible into cash, such as an exchange-traded share, satisfies the requirement.

ANALYZE CONVERTIBLE DEBT

Facts

On June 14, 2018, R Company issues debt for $2,000,000. The debt matures on June 14, 2023.

INTEREST – From and after June 14, 2018, and for so long as any such debt remains outstanding, interest shall accrue on such debt at 10% annually.

CONVERSION OPTION – The holder may convert the debt or a portion thereof at its election at any time after issuance, at a conversion price equal to $10/share. This is subject to appropriate adjustment in the event of any stock dividend, stock split, combination or other recapitalization with respect to the conversion price.

VOTING RIGHTS – Each convertible debt holder is entitled to the number of common stock votes that are associated with their conversion shares.

Analysis of Step A

Is the Debt within the scope of ASC 480-10?

NO – This debt instrument does not fall within any of the three categories of liabilities in the scope of ASC 480-10.

Analysis of Step B1

Is the conversion option embedded in the Debt clearly and closely related to its host instrument?

NO – As noted on page 12, ASC 815-15-25-51 states that conversion options and debt are NOT clearly and closely related.

Analysis of Step B2

Is the convertible debt (the hybrid instrument) remeasured at fair value through earnings each period?

NO – R Company has not elected to carry the instrument at fair value.

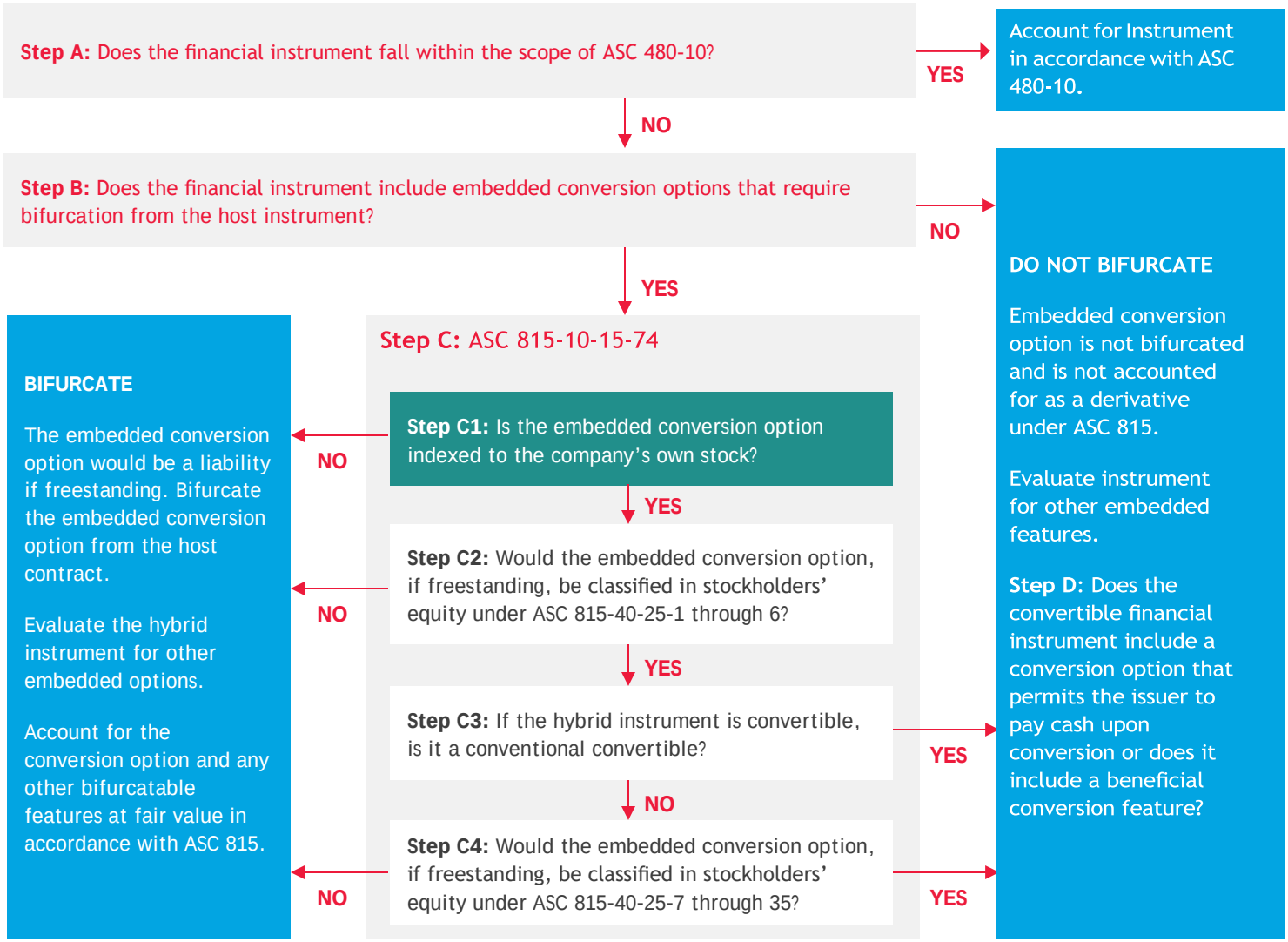
Analysis of Step B3

Would the embedded conversion option, if freestanding, qualify as a derivative?

NO – If R Company is private, the conversion option typically would not qualify as a derivative and the conversion option would not be required to be bifurcated from the host contract. Our analysis would stop here.

YES – If R Company is public, the conversion option would qualify as a derivative as net settlement generally would be available outside of the contract, and our next step would be to analyze the conversion option under STEP C.

STEP C: DOES THE EMBEDDED CONVERSION OPTION MEET THE ASC 815-10-15-74 SCOPE EXCEPTION?



Typically for a public company, a conversion option embedded within debt or a freestanding warrant would possess the three characteristics of a derivative discussed in Step B3. However, ASC 815-10-15-74 states that contracts that are both (1) indexed to a company's own stock and (2) classified in stockholders' equity in the company's balance sheet are not considered derivative instruments.

Important Exception – Instruments are NOT considered derivatives if they are indexed to a company's own stock and classified in stockholders' equity (See ASC 815-10-15-74)

STEP C1: IS THE EMBEDDED CONVERSION OPTION INDEXED TO THE COMPANY'S OWN STOCK?

Generally, an embedded conversion option or freestanding warrant that is a right to a fixed number of shares would be considered indexed to the issuer's stock, because the value of the financial instrument is based upon the value of the underlying shares. In the simple case of a debt instrument convertible into 100 shares of the issuer's stock or a freestanding warrant entitling the holder to 100 shares of the issuer's stock, this point is clear. However, in other circumstances, the determination of whether an instrument is indexed to a company's own stock is less clear. ASC 815-40-15-7 provides a two-step test to determine if an embedded feature or a freestanding warrant is indexed to a company's own stock:

The Two-Step Test

Step 1, Evaluate Contingency Provisions – This step focuses on exercise contingencies that affect whether or when an instrument can be exercised. An instrument passes Step 1 (and would be analyzed under Step 2) if the instrument's contingent exercise provisions, if any, are not based on an observable market or observable index, other than those for the company's stock or operations, and once any contingent events occur, the instrument's settlement is based solely on the company's stock.

For example, a company issues an instrument that becomes convertible only upon an IPO. That instrument is considered indexed to the company's own stock because 1) the contingent event (the IPO) is not based on an observable market other than that for the company's own stock and 2) once the IPO occurs, the conversion option's value is based solely on the company's stock.

Conversion options with contingency provisions based upon the company's results (such as sales, EBITDA, or net income) generally would be considered indexed to the company's own stock. Contingency provisions that are based on external markets or indices (such as the S&P 500 Index, an index of peer company stocks, or the price of a commodity) generally would not be considered indexed to a company's own stock.

Step 2, Settlement Provisions – This step focuses on the settlement of the instrument upon exercise or conversion. The instrument passes Step 2 when either of the following is met:

A. If 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, R Company 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 this instrument is always the fair value of 100 shares at the settlement date less $1,000.

B. If the strike price or settlement amount is variable, 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. These inputs are generally the same as the inputs to the Black-Scholes model and include:
   - Strike price of the instrument;
   - Term of the instrument;
   - Expected dividends or other dilutive activities such as the purchase of stock at above-market prices;
   - Stock borrow cost;
   - Interest rates;
   - Stock price volatility;
   - Company's credit spread; and
   - Ability to maintain a standard hedge position in the underlying shares (this last input is an implicit rather than an explicit input, unlike the other inputs above).

However, if the instrument's settlement calculation incorporates variables other than those used to determine its fair value or if there are features, such as a leverage factor, that increase exposure to the variables listed above in a manner that is inconsistent with the fixed-for-fixed model, the instrument would *not* be considered indexed to the company's own stock.

In practice, standard pricing models for these instruments contain certain implicit assumptions. For example, the Black-Scholes-Merton 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, non-recurring cash dividend violate this implicit assumption. Accordingly, for purposes of 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.

Antidilution Provisions and Down Round Features

Many investors demand antidilution protection in convertible loans and warrant agreements. These 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 it is frequently found in securities purchase and loan agreements.

In July 2017, the FASB issued ASU 2017-11, *Accounting for Certain Financial Instruments with Down Round Features* that changes the application of Step 2 on settlement provisions. ASU 2017-11 is effective for public business entities for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. For all other entities, the amendments are effective for fiscal years beginning after December 15, 2019, and interim periods within fiscal years beginning after December 15, 2020. Early adoption is permitted for all entities, including adoption in an interim period.

Accordingly, the application of Step 2 on settlement provisions depends on whether companies adopted the amendments in ASU 2017-11.

Companies that have not adopted ASU 2017-11

Down round adjustments should be evaluated carefully to determine whether they are triggered by dilutive activities initiated by the company and compensate only to the extent of dilution suffered because of these activities or events.

Since "dilution" does not have a precise meaning, many investors believe that the subsequent sale of shares at a lower price, even when that price reflects the then-current fair value, causes dilution. However, this kind of market driven "dilution" is an economic risk that the holder of a fixed-for- fixed instrument bears, and any provision that would insulate them from such a loss, even under remote circumstances, fails Step 2.

The key element, which ASC 815-40-15 does not articulate well, is that the holder of a fixed-price-for-fixed-number-of-shares instrument bears the risk of loss if the fair value of the shares decreases because of changes in the market. Provisions that allow

the holder of an instrument to recoup part or all of a loss caused by a market-driven decline in the value of the shares, even in remote circumstances, are not consistent with a fixed-price-for-fixed-number-of-shares instrument and will frequently cause the instrument to fail Step 2. By contrast, a change in the value of the shares that is *directly attributable to a company-initiated transaction*, such as a stock split, a stock dividend, or a sale of shares at less than current fair value or share repurchases for an amount exceeding the fair value, are events that would permit an adjustment of the exercise/ conversion price of a fixed-price-for-fixed-number-of-shares instrument without violating Step Two.

For example, assume R Company 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 conversion price will be adjusted for stock splits and stock dividends. If the Company's stock splits (2 shares for 1), the conversion price is reduced to $5 and the number of shares is increased to 200. Since the post-split settlement amount of this instrument is the fair value of 200 shares at the settlement date less $1,000, which is economically the same as before the split, these types of adjustments would generally be considered inputs to the fair value of a "fixed- for-fixed" forward or option on equity shares.

Even for a company-initiated transaction, it is important to assess whether the adjustment to the exercise/conversion price is limited to the change in the value of the shares that is directly attributable to the company's dilutive activities.

Continuing the above example, assume that one year after issuance, when the post-split current fair value of the shares has declined to $3 per share, R Company sells shares at a below-market price of $2 per share. An adjustment to the conversion price for the expected effect[6] of the sale of shares at a $1 below-market discount would pass ASC 815-40-15. However, an adjustment to the conversion price for the effect of the decline in market value from $5 to $3 would fail ASC 815-40-15 as this is a market-based decline not directly attributable to a company-initiated transaction.

As stated earlier, a *company-initiated* share repurchase offer for an amount exceeding the fair value is an example of a dilutive transaction, for which adjustments to the conversion or exercise price of outstanding instruments would pass Step 2, if it protects only to the extent of dilution suffered. In informal discussions, the SEC staff has noted that there may be limited circumstances in which third-party initiated activities such as a tender offer also may pass Step 2. In a *third-party initiated* tender offer, protection provisions may pass Step 2 if they protect against stock price discontinuity, the amount of protection is commensurate with the dilution suffered and the tender offer was available to all common stockholders on a proportionate basis.

Down round protection provisions that work

In general, equity-linked financial instruments (or embedded features) that have antidilution provisions that adjust the exercise or conversion price only to the extent of any dilution directly attributable to a company-initiated transaction would qualify as being indexed to a company's own stock.

These provisions work since the variables driving the adjustment are generally inputs to the fair value of a "fixed-for-fixed" forward or option on equity shares.

For example, R Company issues convertible debt for $1,000 convertible at a fixed conversion price of $10 or 100 shares. The conversion price is subject to a *weighted-average adjustment* (also known as a weighted average ratchet down round provision) if the company subsequently sells shares *at a price lower than the then current fair value*. Note, selling shares below their fair value represents a stock price discontinuity because standard pricing models assume stock price changes will be continuous.

[6] The adjustment to the strike price must be based on a mathematical calculation that determines the direct effect that the occurrence of such dilutive events should have on the price of the underlying shares; it may not adjust for the actual change in the market price of the underlying shares upon the occurrence of those events, which may increase or decrease for other reasons.

As a result of the discontinuity, a *weighted-average* ratchet down round provision (i.e., a formula) adjusts the conversion/exercise price on an earlier round of financing to the weighted-average price after future financings. For example, the investors in an earlier round of financing have a conversion price of $5.00. Upon a subsequent financing, the new investors receive common stock for a price of $4.50, which is less than the current fair value of $4.75. To adjust for the dilution suffered because of the new investors obtaining a price below the current fair value, the earlier investors receive a reduced conversion price of $4.80, as determined by the formula.

Through informal discussions with the FASB staff, we understand there are two acceptable approaches for assessing whether the adjustments to an instrument's settlement amount would qualify as being indexed to a company's own stock. Companies are only required to apply one of the two views to their instruments, not both:

VIEW A: Compare (i) the adjusted instrument's fair value immediately after the stock price discontinuity to (ii) the unadjusted instrument's fair value immediately before the dilutive event.

VIEW B: Compare (i) the ratio of the adjusted instrument's fair value and the entity's enterprise value immediately after the dilutive event to (ii) the ratio of the unadjusted instrument's fair value and the entity's enterprise value immediately before the dilutive event.

Under either view, if (i) is less than or equal to (ii), the instrument is considered indexed to the entity's own stock. If (i) is greater than (ii), the instrument is precluded from being indexed to the entity's own stock. Said differently, the adjustment more than neutralizes the effect of the discontinuity.

Of the two views, we understand View A is more common in practice. We would expect either view to be consistently applied.

Down round protection provisions that do not work

Equity-linked financial instruments (or embedded features) that have antidilution adjustments that can be triggered for market driven events (no matter how remote the possibility of the trigger) and/or those for which the holder is compensated for more than the dilution suffered, are generally not considered indexed to a company's own stock.

An example of a provision that does not work is a *full* ratchet down round provision. In a full ratchet down round, if the company issues equity subsequent to a convertible loan issuance at a price lower than the conversion price, the conversion price is reduced to the price of the new issuance.

> For example, assume Investor X purchases R Company's Series B Convertible Preferred Stock at a price of $5 per share, which is convertible into common stock at that price. If R Company subsequently issues Series C Convertible Preferred Stock to Investor Y, convertible into common stock at $2 per share, the conversion price for the earlier Investor X's Series B Convertible Preferred Stock would drop to $2 per share. If the fair value of the underlying shares at the time of issuance of the Series C Convertible Preferred Stock was also $2 or lower, no dilution occurs; however, the earlier investor still gets compensated.

Therefore, full ratchet provisions cause the instrument (or embedded feature) not to be considered indexed to a company's own stock, since they may compensate the holder for a nondilutive event or for an amount greater than the dilution suffered.

Although certain weighted average provisions are acceptable as stated in the section above on "Down round protection provisions that work," they could still cause the equity-linked instrument (or embedded feature) not to be considered indexed to the company's own stock under ASC 815-40-15, if these adjustments are (1) triggered by market-driven declines in the stock price; or (2) directly attributable to a company- initiated transaction but the weighted average formula compensates for more than any dilution suffered.

> For example, R Company adjusts (using a weighted average) the conversion price on its convertible preferred stock if it subsequently sells shares at a price lower than the conversion price available to the current investors. The subsequent sale of shares at a price lower than the conversion price available to the current investors is not necessarily a dilutive event, since the conversion price may be at or above the current fair value and consequently, the conversion option would not be considered indexed to the company's own stock.

In Summary (Before Adoption of ASU 2017-11)

- Antidilution protection provisions that compensate the investor only for a dilutive (triggering) event directly attributable to a company-initiated transaction and only to the extent of dilution suffered, would generally be compatible with considering an instrument (or embedded feature) to be indexed to a company's own stock.
- Any possibility, however remote, of triggering an antidilution adjustment for a non-dilutive event or for an amount greater than the amount of dilution suffered would generally preclude the instrument (or embedded feature) from being indexed to a company's own stock.
- Not all financial instruments (or embedded features) have antidilution protection or other adjustment provisions; the absence of such provisions does not cause the instrument to fail ASC 815-40-15. For those that do contain adjustment provisions, an evaluation under ASC 815-40-15 must be carried out to determine whether the instrument (or embedded feature) is considered indexed to a company's own stock.
- The evaluation under ASC 815-40-15 should be carried out on a unit of account by unit of account basis. Generally, each instrument would be considered a unit of account, unless two or more instruments should be combined as a single unit of account under other applicable GAAP.

Next Steps

Embedded conversion options and/or freestanding warrants that are not indexed to a company's own stock cannot meet the ASC 815-10-15-74 exception and would be derivative assets or liabilities subject to ASC 815 if they meet the conditions in Step B3.[7] Financial instruments that are indexed to a company's own stock must be analyzed further, continuing at Step C2, to determine whether they would be classified as stockholders' equity.

[7] If the freestanding warrants do not meet the conditions of Step B3, and are not derivatives, they would be reported as liabilities at fair value. See further information on these instruments in the Warrant section of the Practice Aid.

ANALYZE CONVERTIBLE DEBT (BEFORE ADOPTION OF ASU 2017-11)

Facts

Antidilution Features of the Embedded Conversion Options

R Company issues $2,500 Senior A debt that is convertible into 100 shares of common stock exercisable at any time at the option of the holder. Under the terms of the Securities Purchase Agreement, if R Company (1) distributes a stock dividend, or (2) executes a stock split, spinoff, rights offering, or recapitalization through a large nonrecurring cash dividend, the conversion price of the conversion option would be adjusted to offset the resulting dilution (except for issuances and repurchases that occur upon settlement of outstanding conversion options and warrants).

Analysis

Are R Company's embedded conversion options considered indexed to the Company's own stock?

YES, the conversion options are considered indexed to R Company's stock based on the following:

STEP 1: The Senior A convertible debt instruments do not contain an exercise contingency. Proceed to Step 2.

STEP 2: The only circumstances in which the settlement amount will not equal the difference between the fair value of 100 shares and $2,500 ($25 per share) are upon the (1) distribution of a stock dividend, or (2) execution of a stock split, spinoff, rights offering, or recapitalization through a large, nonrecurring cash dividend. An implicit assumption in standard pricing models for equity options is that such dilutive events will not occur or the strike price of the instrument will be adjusted to offset the dilution caused by such events. Consequently, the only variables that could affect the settlement amount in this example would be inputs to the fair value of a fixed-for-fixed option on equity shares.

Facts

Make Whole Provision upon Acquisition

R Company issues a Senior B convertible debt instrument with a face value of $1,000 that is convertible into 100 shares of its common stock. The Senior B convertible debt instrument has a 10-year term and is convertible at any time. The terms of the Senior B convertible debt instrument also include a "make whole" provision. Under that provision, if R Company is acquired for cash before a specified date, the holder of the Senior B convertible debt instrument can convert into a number of shares equal to the sum of (a) the fixed conversion ratio (100 shares per bond) and (b) the make-whole shares. The number of make-whole shares is determined by reference to a table with axes of stock price and time. That table was designed such that the aggregate fair value of the shares deliverable (that is, the fair value of 100 shares per bond plus the make-whole shares) would be expected to approximate the fair value of the Senior B convertible debt instrument at the settlement date, assuming no change in relevant pricing inputs (other than stock price and time) since the instrument's inception.

Analysis

Are R Company's embedded conversion options considered indexed to the company's own stock?

YES, the embedded conversion options are considered indexed to R Company's stock based on the following:

STEP 1: The Senior B convertible debt instruments do not contain an exercise contingency. Proceed to Step 2.

STEP 2: An acquisition for cash prior to the specified date is the only circumstance in which the settlement amount will not equal the difference between the fair value of 100 shares and a fixed strike price ($1,000 fixed par value of the debt). The settlement amount if R Company is acquired for cash prior to the specified date is equal to the sum of (a) the fixed conversion ratio (100 shares per bond) and (b) the "make whole" shares. The number of make-whole shares is determined based on a table with axes of stock price and time, which would both be inputs in a fair value measurement of a fixed-for-fixed option on equity shares.

ANALYZE CONVERTIBLE DEBT (BEFORE ADOPTION OF ASU 2017-11)

Facts

Price Adjustment Features for Sales of Common Stock Below Conversion Price

R Company issues a Junior A convertible debt instrument with a face value of $2,000 that is convertible into 200 shares of its common stock, with a conversion price of $10/share. The Junior A convertible debt instrument has a 10-year term and is convertible at any time. If R Company, at any time or from time to time while any of this Junior A debt is outstanding, issues or sells (i) any common stock at a price per share that is less than the conversion price or (ii) any common stock equivalents that entitle the holder thereof to subscribe for, purchase or exercise a conversion or exchange rights for, shares of common stock at price per share of common stock that is less than the conversion price, then in each case, the applicable conversion rate shall be adjusted based on the following formula:

CR'= CR0* (OS0 + X)/ (OS0 + Y) where

CR0 = the applicable conversion rate in effect immediately prior to such issuance or sale;

CR' = the applicable conversion rate in effect immediately on and after such issuance or sale;

OS0 = the number of shares of common stock outstanding immediately before such issuance or sale;

X = (i) the total number of shares of common stock issued (in the case of an issuance or sale of common stock) or (ii) the total number of shares of common stock issuable upon exercise, conversion or exchange of common stock equivalents issued or sold (in the case of an issuance or sale of common stock equivalents); and

Y = the number of shares of common stock equal to the quotient of (A) the aggregate price payable (i) in respect of such shares of common stock issued or sold (in the case of an issuance or sale of common stock) or (ii) in respect of the shares of common stock issuable upon exercise, conversion or exchange of the common stock equivalents issued or sold (in the case of an issuance or sale of common stock equivalents) divided by (B) the common stock trading price.

Analysis

The embedded conversion options are not considered indexed to R Company's stock based on the following:

STEP 1: The Junior A debt does not contain an exercise contingency. Proceed to Step 2.

STEP 2: The only circumstances in which the settlement amount will not equal the difference between the fair value of 200 shares and $2,000 ($10 per share) are upon R Company issuing or selling (i) common stock at a price per share that is less than the conversion price or (ii) any common stock equivalents that entitle the holder thereof to subscribe for, purchase or exercise a conversion option at a price per share that is less than the conversion price. Such a transaction is not necessarily dilutive. That is, if the price R Company sells stock for is less than the conversion price but greater than market price, the transaction is not dilutive. If a financial instrument can be adjusted for a transaction that is not dilutive, the instrument is not indexed to the entity's own stock. That is, the mere presence of the feature in the contract causes it to fail, irrespective of how likely the adjustment is to occur. Consequently, the conversion option on R Company's Junior A debt issuance is not considered indexed to the Company's own stock.

ANALYZE CONVERTIBLE DEBT (BEFORE ADOPTION OF ASU 2017-11)

Facts

Price Adjustment Features for Sales of Common Stock Below Market Price

R Company issues a Junior B convertible debt instrument with a face value of $5,000 that is convertible into 500 shares of its common stock. The convertible debt instrument has a 10-year term and is convertible at any time. If R Company, at any time or from time to time while any of the Junior B debt is outstanding, issues or sells (i) any common stock at a price per share that is less than the common stock trading price or (ii) any common stock equivalents that entitle the holder thereof to subscribe for, purchase or exercise a conversion or exchange rights for, shares of common stock at price per share of common stock that is less than the common stock trading price, then in each case, the applicable conversion rate shall be adjusted based on the following formula:

CR'= CR0* (OS0 + X)/ (OS0 + Y) where

CR0 = the applicable conversion rate in effect immediately prior to such issuance or sale;

CR' = the applicable conversion rate in effect immediately on and after such issuance or sale;

OS0 = the number of shares of common stock outstanding immediately before such issuance or sale;

X = (i) the total number of shares of common stock issued (in the case of an issuance or sale of common stock) or (ii) the total number of shares of common stock issuable upon exercise, conversion or exchange of common stock equivalents issued or sold (in the case of an issuance or sale of common stock equivalents); and

Y = the number of shares of common stock equal to the quotient of (A) the aggregate price payable (i) in respect of such shares of common stock issued or sold (in the case of an issuance or sale of common stock) or ii) in respect of the shares of common stock issuable upon exercise, conversion or exchange of the common stock equivalents issued or sold (in the case of an issuance or sale of common stock equivalents) divided by (B) the common stock trading price.

Analysis

The embedded conversion options are considered indexed to R Company's stock based on the following:

STEP 1: The Junior B convertible debt instruments do not contain an exercise contingency. Proceed to Step 2.

STEP 2: The only circumstances in which the settlement amount will not equal the difference between the fair value of 500 shares and $5,000 ($10 per share) are upon R Company issuing or selling (i) common stock at a price per share that is less than the common stock trading price or (ii) any common stock equivalents that entitle the holder thereof to subscribe for, purchase or exercise a conversion option at a price per share that is less than the common stock trading price. If such a dilutive transaction occurs, the exercise price of the option is adjusted based on a weighted average formula that adjusts for the dilution. Consequently, the conversion option is considered indexed to R Company's own stock.

If the financial instrument was not considered indexed to the company's own stock, then the instrument is accounted for as a derivative asset or liability, and the analysis ends. However, because the financial instrument is considered indexed to the company's own stock, the analysis proceeds to Step C2 to determine if the instrument can be classified in stockholders' equity.

Companies That Have Adopted ASU 2017-11

Down round provisions permitting equity classification

ASU 2017-11 changes the classification analysis of certain equity-linked financial instruments, such as warrants and embedded conversion features, such that a down round feature (as defined) is now disregarded when assessing whether the instrument is indexed to an entity's own stock under Step 2. As a result, a down round feature, by itself, no longer requires an instrument to be remeasured at fair value through earnings each period, although all other aspects of the indexation guidance under Subtopic 815-40 continue to apply.

ASU 2017-11 defines a down round feature as follows:

> "A feature in a financial instrument that reduces the strike price of an issued financial instrument if the issuer sells shares of its stock for an amount less than the currently stated strike price of the issued financial instrument or issues an equity-linked financial instrument with a strike price below the currently stated strike price of the issued financial instrument.
>
> A down round feature may reduce the strike price of a financial instrument to the current issuance price, or the reduction may be limited by a floor or on the basis of 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 may reduce the strike price to below the current issuance price. A standard antidilution provision is not considered a down round feature."

Standard antidilution provisions are defined as those that result in adjustments to the conversion ratio in the event of an equity restructuring transaction (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, such as a stock dividend, stock split, spinoff, rights offering, or recapitalization through a large, nonrecurring cash dividend) that are designed to maintain the value of the conversion option.

ASU 2017-11 requires entities to disclose the existence of down round features in the instruments they issue, when the down round features result in a strike price adjustment, and the amount of any such adjustment.

Down round adjustments accompanied by a reciprocal increase in number of shares – Exception permitted

The definition of a down round feature is expressed in terms of "reducing" the strike price of an issued financial instrument, as noted in the definition above.

Since the definition of a down round feature and the basis for conclusions are expressed in terms of "reducing" the strike price, a question arises as to whether a simultaneous increase in the number of shares causes such an adjustment feature to go beyond the scope of the ASU, thereby precluding equity classification. The basis for conclusions in the ASU explicitly contemplates a strike price adjustment and also implicitly allows for the number of underlying shares to change in a reciprocal fashion. BC29 states "[t]he definition is not limited to situations in which the strike price is reduced to equal the current issuance 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." In addition, BC15 considers the impact of the amendments in the ASU on convertible preferred shares and convertible debt instruments, i.e., hybrid instruments. This confirms that conversion features embedded in host instruments are eligible for the new down round exemption because the number of shares in those instruments necessarily changes in response to a strike price adjustment.

The following example illustrates a simple reciprocal relationship between a decreasing strike price and increasing share count that has no net effect on the investor's aggregate consideration. For instance, R Company issues a single warrant that otherwise allows Investor Y to purchase a fixed number of 1,000 shares of R Company's common stock for a total of $10,000, or $10 per share. A down round provision embedded in that instrument could provide for adjusting both the number of shares and the strike price in varying combinations, instead of adjusting only the strike price. For example, assume R Company issues a round of common stock at $8.00 per share, triggering the down round. If the strike price adjustment is a "full ratchet" (Scenario 1), it results in a new strike price of $8.00 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 2), it may result

in a new strike price of $9.00 per share. Then the number of shares referenced in the warrant would change to 1,111, also for total proceeds of $10,000. See the scenarios below:

	Original	Scenario 1	Scenario 2
Strike price	$10.00	$8.00	$9.00
Shares	1,000	1,250	1,111
Total proceeds	$10,000	$10,000	$10,000

We believe that the reciprocal increase in the number of issuable shares resulting from a down round feature is permitted under the ASU. Specifically, a down round feature with a reciprocal increase in the number of issuable shares is within the scope of the ASU as long as:

- The down round is caused by the sale of stock or issuance of an equity-linked financial instrument at a price or strike price lower than the exercise price, and
- The resulting change does not increase the total proceeds due under the instrument upon exercise or conversion.

Through discussions with the FASB staff, we understand they share this view. (However, we are also aware of an alternative view in practice that an increase in the number of shares is not permitted under the ASU based upon a literal reading of the definition of a down round feature, which refers only to a reduced strike price.)

The following example illustrates a common down round formula that provides for a decreased strike price and increased share count.

Example

R Company issues a warrant for 2,000,000 shares with an exercise price of $7.08 and a five-year term to Lender D in association with debt financing. The warrant is exercisable in whole or in part.

The warrant provides down-round protection such that during the term of the warrant, if R Company issues or sells common stock for a consideration per share less than the exercise price, the exercise price will be reduced to equal the quotient obtained by dividing:

- The sum of (i) the product obtained by multiplying the common stock outstanding immediately prior to such issuance or sale (#CS) by the exercise price then in effect (EP) plus (ii) the aggregate consideration (AC = SP1*#CS1), if any, received by R Company upon such issuance or sale; by
- The sum of (i) #CS plus (ii) the aggregate number of shares of common stock issued or sold by R Company in such issuance or sale (#CS1).

In addition, the warrant agreement increases the number of warrant shares to be issued to a number of shares (#N1) equal to the quotient obtained by dividing:

- The product of (i) the exercise price multiplied by (ii) the number of warrant shares (#N) issuable upon exercise of the warrant immediately prior to any such adjustment; by
- The exercise price resulting from such adjustment.

During the term of the warrant, assume R Company issues 1,000,000 shares (#CS1) at $5.00 per share (SP1) for an aggregate consideration (AC) of $5,000,000. Since the issuance price is below the original exercise price of the warrant, the following strike price adjustment is triggered:

Common shares outstanding #CS	23,815,216
Number of shares sold below exercise price #CS1	1,000,000
Original exercise price per warrant EP	$7.08
Share price for shares sold below original exercise price SP	$5.00
Original number of warrants before down round #N	2,000,000
Exercise price adjustment:	
Adjusted exercise price	EP1 = ((EP *#CS) +AC)/(#CS+#CS1)
(EP*#CS)	$168,611,729
(SP1*#CS1)= AC	$5,000,000
(EP*#CS) + AC	$173,611,729
#CS+#CS1	24,815,216
EP1 = ((EP*#CS)+AC)/#CS+#CS1	$7.00

The warrant agreement also adjusts the number of warrant shares as follows:

Number of warrant shares adjustment:	
Adjusted number of warrant shares (#N1)	#N1 = EP*#N/EP1
Original number of warrant shares (#N)	2,000,000
Original exercise Price (EP)	$7.08
Adjusted exercise price (EP1)	$7.00
#N1 = EP*#N/EP1	2,022,857*

* The adjusted exercise price (EP1) has been rounded up to $7.00.

The purpose of including both a stock price adjustment and an adjustment to the number of warrant shares in this example is to maintain the original value for the warrant holder, while still allowing the holder to participate in the lower stock price, as illustrated below:

	Original	As adjusted
Number of warrants	2,000,000	2,022,857
Exercise price	$7.08	$7.00
Total value	$14,160,000	$14,160,000

Down round adjustments accompanied by a reciprocal increase in number of shares – Exception not permitted

Certain down round price adjustments may occur in a financial instrument (e.g., Warrant Y) because a company has modified the exercise/conversion price of a different financial instrument (e.g., Convertible debt A) that was previously issued by the company. In these circumstances, the adjustment to Warrant Y is not associated with the company's sale of shares of its stock or issuance of its equity-linked financial instruments. Consequently, the adjustment to Warrant Y's exercise price, or to any financial instrument in such a fact pattern with an adjustment, is outside the scope of the ASU and would not be eligible for equity classification.

EPS

For a freestanding equity-classified financial instrument such as a warrant, the ASU requires companies that present EPS to recognize the effect of the down round feature when it is triggered, i.e., when the exercise price is adjusted downward because of the down round feature. For warrants, the amount of the EPS adjustment is determined as the difference between the fair value (without considering the down round feature) of the unadjusted instrument (unadjusted exercise price and number of shares) immediately before and the fair value (without considering the down round feature) of the adjusted instrument (adjusted exercise price and number of shares) immediately after the strike price is adjusted. In practice, entities typically are not able to use a Black-Scholes valuation model for this purpose because it does not contemplate all of the relevant terms and conditions of the warrant. As such, a more sophisticated lattice or binomial model is used. That amount is recorded as a dividend (as a reduction of retained earnings and an increase in additional paid in capital) and presented as a reduction of income available to common shareholders in basic EPS. Diluted EPS will be similarly reduced. Refer to Practice Aid section, Earnings Per Share for additional details.

Convertible instruments with embedded conversion options that have down round features will be accounted for under existing guidance, e.g., as a contingent beneficial conversion feature in Subtopic 470-20, including the related EPS guidance, assuming the embedded conversion options also would be classified in stockholders' equity (see Step C2).

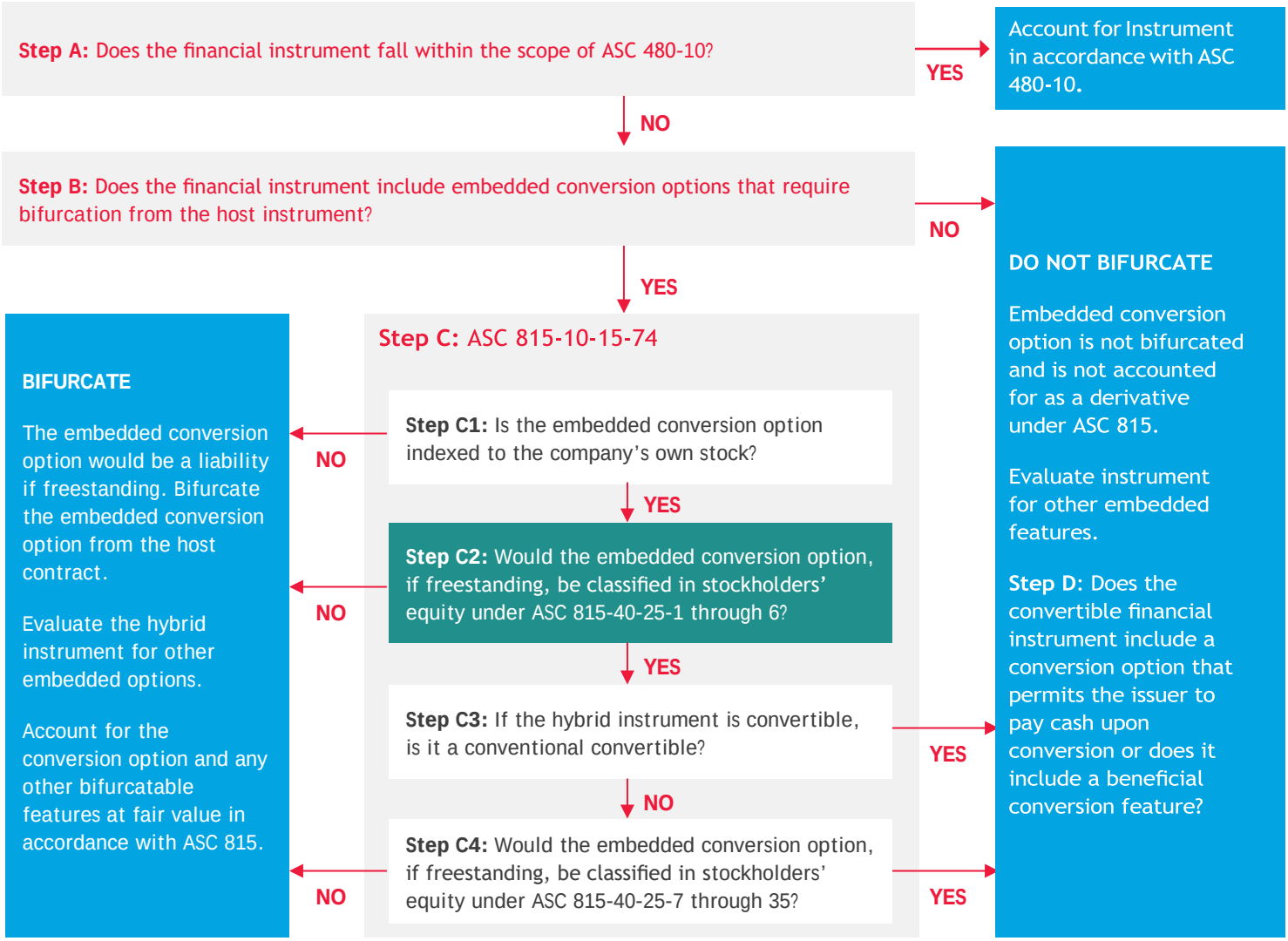
- If a convertible debt instrument has both a down round feature and a cash conversion feature within the scope of Subtopic 470-20, the accounting guidance for cash conversion features applies. If not, the specialized guidance for contingent beneficial conversion features in Subtopic 470-20 applies.
- If a convertible preferred share (deemed to be a debt host) has a down round feature, the current accounting guidance for contingent beneficial conversion features in Subtopic 470-20 applies.

Refer to Step D for additional guidance on the specialized guidance in Subtopic 470-20.

Next Steps

Embedded conversion options and/or freestanding warrants that are not indexed to a company's own stock cannot meet the ASC 815-10-15-74 exception and would be derivative assets or liabilities subject to ASC 815 if they meet the conditions in Step B3. Financial instruments that are indexed to a company's own stock must be analyzed further, continuing at Step C2, to determine whether they would be classified as stockholders' equity.

STEP C2: WOULD THE EMBEDDED CONVERSION OPTION BE CLASSIFIED IN STOCKHOLDERS' EQUITY?



The next step is to determine if the embedded conversion option or warrant would be classified in stockholders' equity according to ASC 815-40.[8] This step also should be applied to determine the balance sheet classification of freestanding warrants. The basic model in ASC 815-40-25 regarding whether an embedded conversion option or freestanding warrant requires or may require net cash settlement must be considered to determine if equity classification is appropriate.

[8] This step only applies if the embedded conversion option or warrant is considered indexed to the company's own stock.

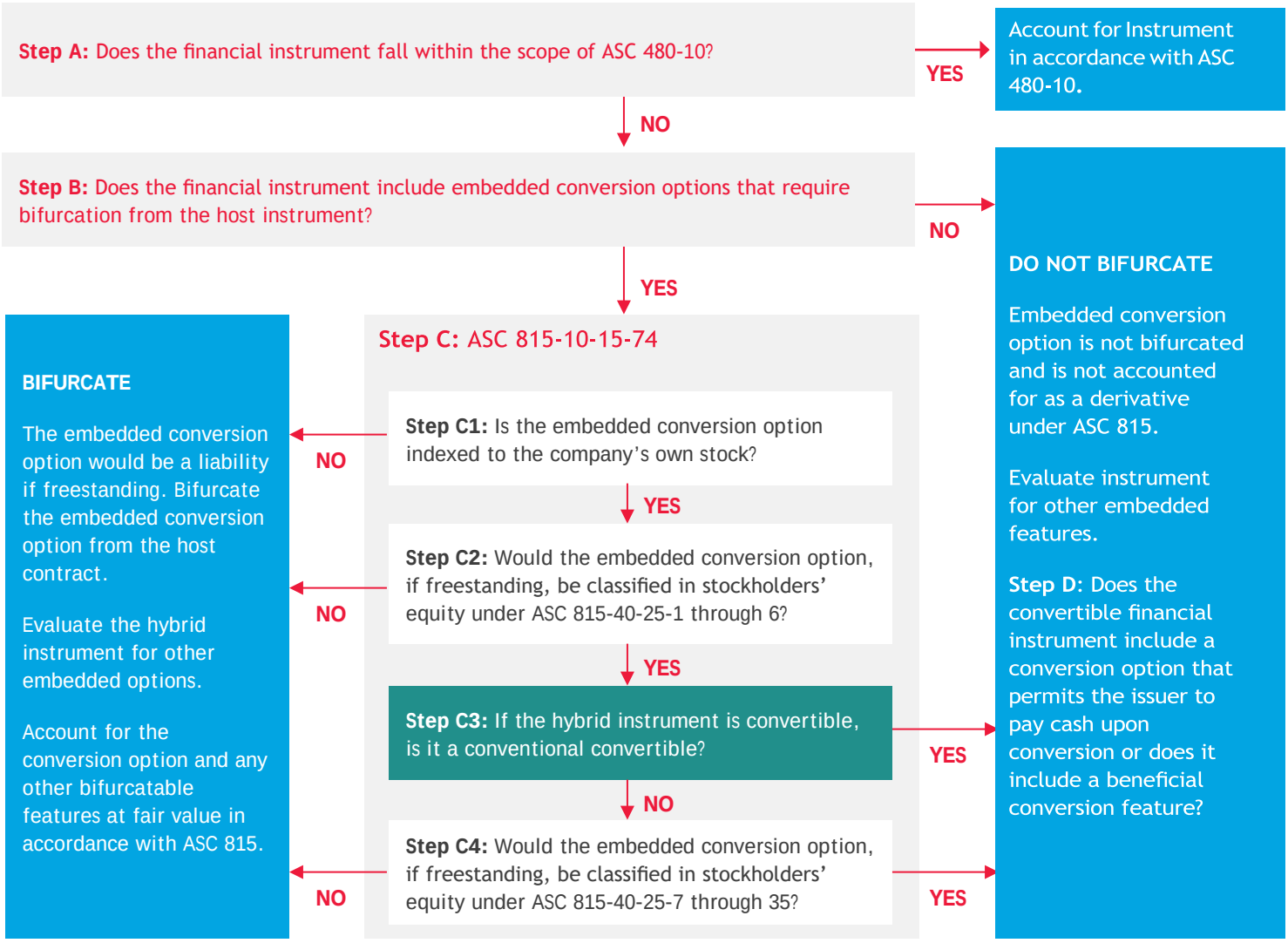
ASC 815-40-25 defines three settlement methods as follows:

1. Physical settlement – The buyer delivers the full contractually stated amount in cash to the seller, and the seller delivers the full stated number of shares to the buyer.
2. Net-share settlement – The party with the loss on the contract delivers to the party with the gain the number of shares with a current fair value equal to the gain.
3. Net-cash settlement – The party with the loss on the contract delivers to the party with the gain a cash payment equal to the gain, and no shares are exchanged.

Under ASC 815-40-25-1, contracts that require or may require the issuer to settle the contract for cash are liabilities, and contracts that require settlement in shares are equity instruments. If the contract offers a choice of settlement to the issuer, settlement in shares is assumed. If the contract offers a choice of settlement to the holder, settlement in cash is assumed.

If net cash settlement is not required, the embedded conversion option or freestanding warrant also must meet the further detailed criteria of ASC 815-40-25-7 through 35 in order for equity classification (versus liability, or sometimes asset) to be appropriate. However, those criteria do not need to be applied if the hybrid instrument qualifies as "conventional convertible debt," as defined in ASC 815-40-25-39 through 42. Next, we will consider the meaning of conventional convertible debt in Step C3 and then move to Step C4 to discuss the ASC 815-40-25-7 through 35 requirements for equity classification.

STEP C3: IF THE HYBRID INSTRUMENT IS CONVERTIBLE, IS IT A CONVENTIONAL CONVERTIBLE?



Introduction

The analysis of whether an embedded conversion option would be equity if freestanding is simplified for certain "plain vanilla" convertible hybrid instruments if they meet the definition of conventional convertible in ASC 815-40-25-39 through 42. A convertible instrument is considered conventional if the holder can only realize the value of the conversion option by exercising the option and receiving the **entire conversion proceeds** in a **fixed number of shares**, or the equivalent amount of cash (at the discretion of the issuer). If the number of shares could change for any reason (other than as a result of standard antidilution provisions as discussed below), whether under the issuer's control or not, then the hybrid instrument is not conventional convertible. In addition to debt instruments, convertible preferred stock with a mandatory redemption date may also qualify for the exception if the economic characteristics indicate that the instrument is more akin to debt than equity.

If the convertible instrument is considered conventional convertible and ASC 815-40-25-1 through 6 are satisfied (i.e., net cash settlement is not required), then the embedded conversion option does not have to be analyzed further under ASC 815-40. However, the convertible instrument must then be evaluated for optional cash settlement features upon conversion under ASC 470-20 and for optional beneficial conversion features under ASC 470-20 under Step D.

If the convertible instrument is not considered conventional convertible, the conversion option must be further evaluated under ASC 815-40-25-7 through 35 to determine whether the conversion option would be classified as equity if it were freestanding, as described in the next Step, C4.

The following discussion focuses on key points in determining whether an instrument is considered conventional convertible.

Fixed Number of Shares

A convertible instrument agreement that allows the holder to convert into common shares at any time based upon a fixed conversion price (e.g., $12/share) is conventional because the entire proceeds are received in a fixed number of shares. An agreement with a conversion price that varies is not conventional because the number of shares to be issued upon conversion is not fixed.

In some cases, convertible agreements include a reset provision, whereby the conversion price might be adjusted under certain conditions (such as subsequent sale of securities at a lower price). Convertible instruments with conversion prices that are adjusted upon subsequent sale of securities to the subsequent sale price are not considered indexed to the company's own stock prior to adoption of ASU 2017-11 (see Step C1). Consequently, the analysis of that conversion feature would have ended at Step C1 when the issuer determined that the feature should be bifurcated. In contrast, upon adoption of ASU 2017-11, the analysis would have continued to this Step C3. Regardless, a convertible financial instrument with a conversion option that passes Step C1 because price adjustments are made for dilutive events or down rounds (as defined in ASU 2017-11), is not conventional convertible because the number of shares to be issued upon conversion is variable.

The SEC staff has stated that factors such as the issuer's control over the events triggering the price reset or the likelihood of the price reset occurring are not relevant to the determination of whether the hybrid contract is conventional convertible. If the number of shares to be issued upon conversion is dependent upon a contingent future event (regardless of probability), the convertible debt or convertible preferred stock contract is not conventional.

The determination of whether a convertible arrangement is conventional also is not dependent upon the timing of the holder's ability to exercise the conversion option. For example, consider a convertible agreement that allows a holder to convert into shares at a fixed conversion price any time after the earlier of a) the passage of one year or b) the completion of a secondary share offering. In this case, the hybrid contract is convertible into a fixed number of shares and is considered conventional even though the holder cannot immediately exercise the conversion option.

Antidilution Provisions

ASC 815-40-25-41 clarifies that "standard antidilution" provisions do not preclude an instrument from being conventional. It defines standard antidilution provisions as "those that result in adjustments to the conversion ratio in the event of an equity restructuring transaction" (as defined in ASC 718-10). 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.

For example, R Company effects a 2-for-1 stock split and the conversion price for conversion options embedded in debt drops from $10 per share to $5 per share in an equity restructuring that is a standard antidilution provision. This convertible debt contract would be considered conventional because a stock split is an event included in the definition of a standard antidilution provision.

We discussed certain antidilutive activities that do not prohibit the instrument from being considered indexed to the company's own stock in Step C1 (prior to adoption of ASU 2017-11). While consistent with the notion of being indexed to the company's own stock, adjustments to the conversion price as a result of cash dividends, purchases of shares above market value, or sales of shares below market value prohibit the financial instrument from being considered conventional convertible because these adjustments are not included in the definition of a standard antidilution provision.

Entire Proceeds

The definition of "conventional" allows for the issuer to choose to settle the conversion option by paying cash rather than issuing the fixed number of shares, as long as the conversion value is settled either entirely in cash or entirely in shares. This is consistent with the provisions of ASC 815-40- 25-1 through 6 in which net-share settlement is assumed if the company has the choice of settling in cash or in shares.

If the issuer of a conventional convertible financial instrument can only settle the conversion value in a fixed number of shares, the issuer is not required to bifurcate the conversion option under ASC 815-40-25-1 through 6, and should analyze the instrument under Step D for beneficial conversion features per ASC 470-20. If the issuer of a conventional convertible financial instrument can settle the entire proceeds of conversion value of a fixed number of shares in cash, then the analysis proceeds to ASC 470-20, Step D. As a reminder, if the *holder* can elect net-cash settlement, liability classification of the convertible financial instrument is required under ASC 815- 40-25.

Interest Payments

The manner (i.e., cash or shares) in which a company pays interest does not determine whether a convertible instrument arrangement is conventional or not. That is, if the issuer can pay the interest in shares, or has the choice of paying the interest in shares, this attribute does not affect the determination of whether the instrument is conventional. If the holder converts between interest payment dates and loses interest, this attribute also does not affect the determination of the instrument as conventional. We believe that the principal, not how the interest is paid, determines if an instrument is conventional.

ANALYZE CONVERTIBLE DEBT

Assume for each of the following examples that the financial instrument is to be settled only by issuance of unregistered shares and no registration rights are provided. No provisions requiring the issuer to make cash payments are present.

Facts

R Company issues Senior Debt Tranche A for $1,000,000 that is convertible into common shares at the holder's option. The instrument has the following additional features:

CONVERSION PRICE – The conversion price on the Senior Debt Tranche A is $5 per share, so that the holder shall receive 200,000 shares ($1,000,000/$5 per share) upon conversion.

CONVERSION SETTLEMENT – R Company is obligated to settle the conversion option by issuing 200,000 shares of common stock.

CONVERSION TERMS – The conversion option can be exercised after either a) the passage of one year or b) the completion of a secondary share offering.

COMMON STOCK OWNERSHIP LIMITS – The conversion option may not be exercised if, after conversion, the holder would beneficially own in excess of 4.99% of the number of common shares outstanding. To meet this requirement, the holder could sell currently owned shares in order to exercise the conversion options.

ANTIDILUTION PROTECTION – 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 R Company 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.

Analysis

Does R Company's Senior Debt Tranche A represent conventional convertible debt?

YES – None of the above features would preclude the instrument from being considered conventional convertible debt. The instrument is convertible into a fixed number of shares.

CONVERSION PRICE – 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 anti-dilution provision.

CONVERSION TERMS – Restrictions on the exercisability of the conversion option do not affect the determination of whether the debt is conventional convertible debt.

COMMON STOCK OWNERSHIP LIMITS – The restriction affects only the holder's ability to exercise the conversion option so it does not affect the determination of whether the debt is conventional convertible debt.

ANTIDILUTION PROTECTION – Standard antidilution provisions do not preclude an instrument from being considered conventional.

In this case, the conversion price (and the number of shares to be issued upon conversion) adjusts only in situations where all shareholders will remain on equal footing.

Since the instrument is conventional convertible debt that is convertible only into shares, the embedded conversion option does not need to be bifurcated from the debt host. However, the instrument must be analyzed for other embedded options, as well as for beneficial conversion features under ASC 470-20. Since this instrument can only be settled in shares, it will not be affected by the cash conversion guidance in ASC 470-20.

How would the answer change if R Company had the option of settling the conversion value of the Senior Debt Tranche A entirely in cash?

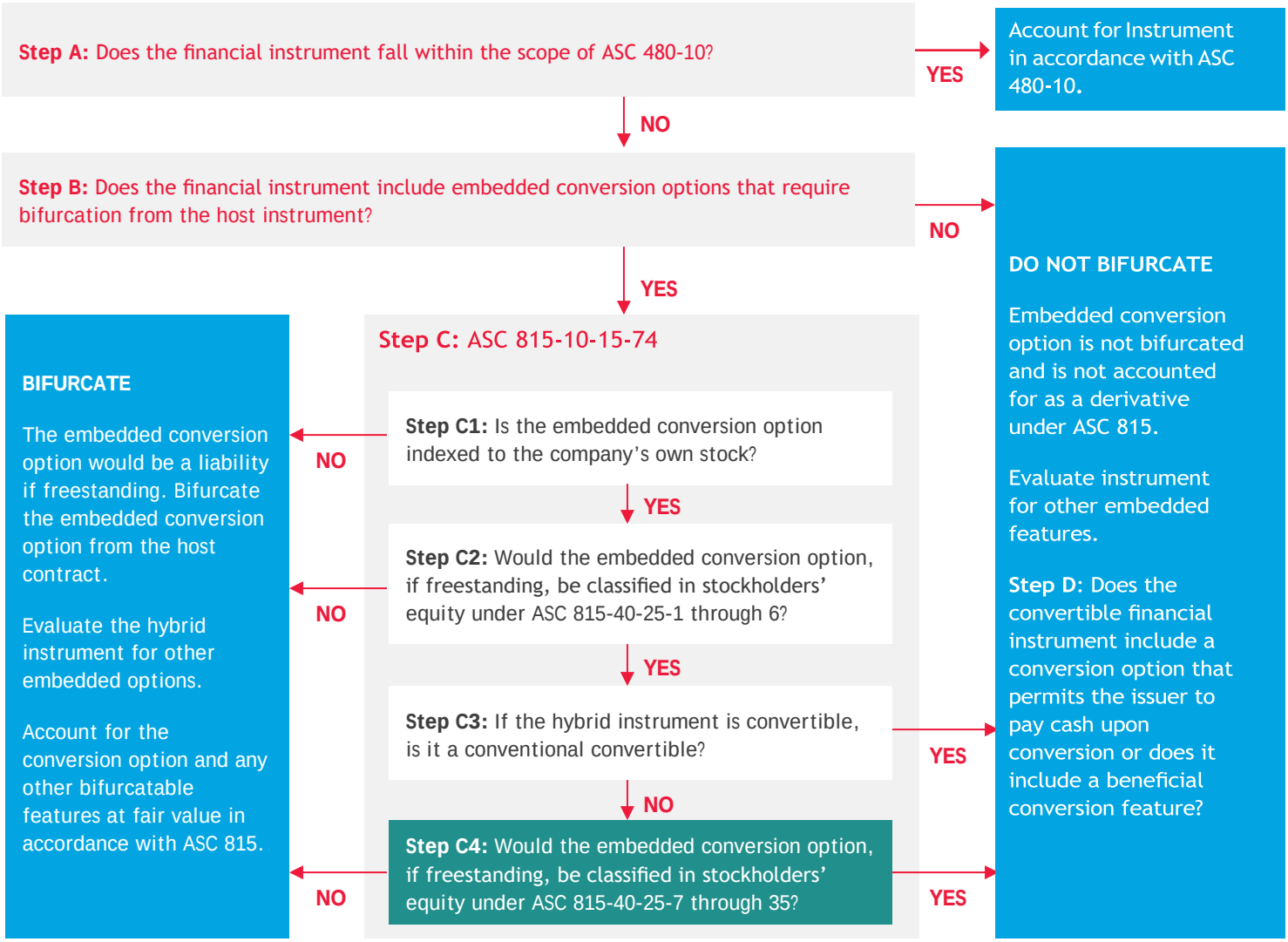
The Senior Debt Tranche A would still be conventional convertible. However, the debt must now be analyzed under the cash conversion guidance in ASC 470-20, Step D.

TABLE 1: Examples of Application of the Definition of Conventional Convertible Debt[9]

	Facts	Conventional or Nonconventional	Analysis
1.	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.	Conventional	The number of shares to be issued upon conversion is fixed and will never change.
2.	Debt is convertible at any time 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 (e.g., subsequent sale of issuer securities at a price lower than market price, subsequent purchase of issuer securities at a price greater than market price).	Nonconventional	Since the number of shares to be issued upon conversion is subject to change under certain conditions, the instrument does not meet the definition of conventional convertible debt.
3.	Debt is convertible by the holder after one year, or if the company completes a subsequent offering of shares, into a fixed number of common shares based on a conversion price that does not change.	Conventional	The definition of conventional does not depend upon the ability to immediately exercise the conversion option. Even though the holder is not able to immediately convert, after passage of time (or occurrence of the event), the holder will be able to convert.

[9] This table also applies to mandatorily redeemable preferred stock that is convertible.

STEP C4: WOULD THE EMBEDDED CONVERSION OPTION BE CLASSIFIED IN STOCKHOLDERS' EQUITY?



ASC 815-40-25 provides guidance for determining whether an embedded conversion option in a nonconventional convertible instrument or a freestanding warrant would qualify for classification as stockholders' equity (versus a liability or, in some cases, an asset). ASC 815-40-25-7 through 35 provide the criteria that must be met for such instruments to qualify for equity classification.

TABLE 2: ASC 815-40 Additional Conditions Necessary for Equity Classification

QUESTIONS FOR CONSIDERATION Refer to the following pages for detail
Does the contract permit delivery of unregistered shares?
Does the company have sufficient authorized and unissued shares?
Does the contract have an explicit limit on shares issuable to settle?
Does the contract require a cash penalty for untimely SEC filings?
Does the contract require cash settled "top-off" or "make-whole" arrangements?
Does the contract require net cash payments only in situations in which all shareholders receive cash?
Does the counterparty have rights any higher than a stockholder?
Does the contract require any cash collateral?

If the conversion option passes Steps A and B, and meets the criteria of Step C, then:

- The conversion option would be classified in stockholders' equity if it were freestanding; and
- The conversion option is not required to be bifurcated from the host contract and accounted for as a derivative.

In this case, if the conversion value of a convertible instrument can be settled in shares or cash at the issuer's option, the instrument must also be analyzed under the cash conversion guidance in ASC 470-20. If the conversion value of a convertible instrument can't be settled in cash, the financial instrument must then be analyzed for beneficial conversion features under ASC 470-20. See the discussion in Step D of this section of the Practice Aid.

If a company has arrived at this point in the flowchart and its conversion option does not meet the criteria of ASC 815-40 in Step C4, then

- The conversion option would not be classified in stockholders' equity;
- The conversion option does not meet the scope exception of ASC 815-10-15-74; and
- The conversion option must be bifurcated from the host contract and accounted for as a derivative liability.

In this situation, there is no analysis for a beneficial conversion feature.

Please note that while the following discussion focuses on the evaluation of embedded conversion options, the criteria in ASC 815-40-25-7 through 35 also apply to the determination of the proper balance sheet classification of freestanding warrants (e.g., equity or liability classification). This determination must be performed at each balance sheet date, and makes it possible for certain instruments to be reclassified between debt and equity at different points in their life.

Criteria for Equity Classification

Settlement permitted in unregistered shares.

Convertible debt, convertible preferred stock, and freestanding warrants are often accompanied by a registration rights agreement. A typical registration rights agreement in a private placement requires the issuer to use its best efforts to register the shares underlying the conversion option or freestanding warrants. If the agreement simply requires the company to use its

"best efforts" or "commercially reasonable efforts" to register the shares with no deadline, the requirement may be under the control of the company, and if so, the criterion is satisfied and no accounting is required for the agreement. This means that the issuer can classify the conversion options or freestanding warrants as equity assuming all other requirements are met.

Certain registration rights agreements require the issuer to use its best efforts to register the shares underlying the conversion option or warrant by a certain date or else pay a penalty (sometimes referred to as liquidated damages). Agreements with such clauses include wording such as, "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." The liquidated damages should be accounted for based on an ASC 450-20 model (accounting for contingencies). Also, ASC 825-20-30-5 and 35-1 indicate:

- If a liability for registration payments is probable and can be reasonably estimated *at inception*, the contingent liability must be included in the allocation of proceeds from the related financing transaction using the measurement guidance in ASC 450-20.
- If the registration payment becomes probable and can be reasonably estimated *after the inception* of the arrangement or if the measurement of a previously recognized contingent liability increases or decreases in a subsequent period, the initial recognition of the contingent liability or the change in the measurement of the previously recognized contingent liability (in accordance with Subtopic 450-20) must be recognized in earnings.

The guidance does not apply if the registration rights agreement is silent as to penalties. ASC 825-20 also does not apply to the liquidated damages that are defined as a change in a conversion ratio.[10]

Separately, careful consideration should be given to the specific terms of the transaction and to the application of the securities law in a registered (public) offering when determining whether settlement is permitted in unregistered shares. At the 2006 AICPA-SEC Conference, an SEC staff member gave remarks on the determination of whether a contract can be settled in unregistered shares. Accordingly, the evaluation of this criterion may be complex and may require the assistance of securities or legal counsel. If it is ultimately determined that an equity-linked contract must be settled in registered shares, equity classification would generally be precluded because a registrant cannot control all future actions or events to settle in registered shares.

[10] ASC 470-20 provides guidance on accounting for convertible instruments with contingently adjustable conversion ratios.

ANALYZE CONVERTIBLE DEBT

Facts

Scenario 1: Prior to the consideration of the registration rights agreement, R Company has concluded that the conversion options and freestanding warrants issued in the private placement discussed below meet the requirements for equity classification. The conversion shares and the warrants are subject to a registration rights agreement.

- R Company completes the private placement of Convertible Series A Preferred Stock for $100 million.
- The investor also receives freestanding warrants to purchase common stock.
- In connection with the financing, R Company is required to use its best efforts to register the shares underlying the conversion options and the warrants.

Analysis

How should R Company account for its conversion options, freestanding warrants, and the registration rights agreement?

The conversion options and warrants can be classified as equity. The Company is only obliged to use its best efforts to register the shares underlying the conversion options and warrants, and consequently there is no accounting for the registration rights agreement.

Scenario 2: Same as scenario 1, except that R Company is required to use its best efforts to register the shares underlying the conversion options and freestanding warrants, but in no event should the registration occur later than 180 days from the closing. There is no mention of penalties for failure to register. What is R Company's accounting given these facts?

Since the contract is silent with regard to penalties, the registration rights agreement is not within the scope of ASC 825-20.

The liquidated damages are not specified, and no amounts are recorded for the registration rights agreement.

Scenario 3: Same as scenario 1, except that R Company is required to use its best efforts to file a registration statement for the shares underlying the conversion options and freestanding warrants no later than March 31, 2019, and to have it declared effective no later than June 30, 2019. There is a penalty associated with the agreement of 1% of the capital transaction for each month the company is delinquent. The liquidated damages maximum is 25%. What is R Company's accounting if the Company believes that it will miss the deadline by 5 months?

The conversion options and warrants can be classified as equity. Since the payment is probable and reasonably estimable, R Company should accrue the penalty of $5 million ($100 million *1% * 5 months). The $5 million must be included in the allocation of proceeds from the offering, and the $95 million of remaining proceeds will be allocated between the preferred stock and warrants.

Entity has sufficient authorized and unissued shares.

Contract contains an explicit share limit.

Both of these criteria reflect the point that the company must be able to satisfy the share settlement provisions of the agreement in order for equity classification to be appropriate. The logic is that if the company is unable to deliver the required shares, the holder would be entitled to other remedies, such as cash settlement, which would cause the instrument to be classified as a liability.

For example, if R Company enters into a convertible debt agreement that allows the holder to convert the debt instrument in $1,000 increments into 500,000 shares of common stock at a time when no authorized and unissued shares are available, then R Company will be unable to satisfy the requirements of the agreement. As a result, the conversion option would be considered a liability if freestanding. If R Company had 300,000 authorized and unissued shares available, then R Company would be able to classify a portion of the contract (i.e., 300,000 of the 500,000 shares) as equity as long as the Company had a written policy sequencing the use of the authorized and unissued shares. The remaining 200,000 shares represented by the remaining 40% of the conversion option would be liability-classified.

The above two criteria are related in that, without an explicit limit on the number of shares to be delivered in share settlement, it is impossible for a company to conclude that it has sufficient authorized and unissued shares available to settle the contract. However, certain reset provisions that cause a convertible security to be nonconventional because the conversion price changes might not fail these two criteria in ASC 815-40. For example, consider a convertible debt instrument with a reset provision that provides for adjustments for dilution to the conversion price if the company issues additional securities below market price. As noted above, this convertible debt is indexed to the company's own stock (before ASU 2017-11, only if the resets compensate for dilution), but is not conventional because the number of shares is not fixed. The company could issue more shares at a price lower than market price, thus changing the conversion price and the shares to be issued upon conversion. However, we note that the number of shares is variable only with respect to potential actions of the company. Thus, assuming that the company currently has sufficient shares to settle the contract, the ability to settle in shares is within control of the company because the company has control over the event that would trigger the adjustment to the conversion price.

In many cases the conversion rate set forth in an instrument does establish the maximum number of shares that could be required in share settlement. The analysis of available shares must consider *all existing instruments* that could be settled in shares, including employee options and other embedded and freestanding instruments. It is not always obvious if the number of shares is capped.

For example, R Company issues $20 million of debt that can be converted at any time into common stock based upon a conversion price equal to the lower of $5 per share or 80% of the daily average share price. If the share price is $9, then the conversion price would be $5 per share and R Company would issue 4 million shares upon conversion. If the share price decreased, and the conversion price became $1 per share, 20 million shares would be issued. If the conversion price became $0.01 per share[10], R Company would be required to issue 2 billion shares to settle the conversion option. In this example, since there is no limit on the number of shares that might be needed to settle the conversion option, R Company cannot conclude that it has sufficient authorized and unissued shares available and the embedded conversion option would be classified as a liability. Additionally, this instrument and all other instruments analyzed under ASC 815-40 would have to be classified as liabilities unless R Company has adopted a written policy as discussed below.

A key implication is that if a single contract has no limit on the number of shares that might have to be issued, then the company will not be able to conclude that sufficient authorized and unissued shares exist to settle all contracts subject to ASC 815-40. In 2008, the SEC staff informally indicated that it would permit a sequencing approach based on the use of ASC 815-40-35 which provides guidance for contracts that permit partial net share settlement. The sequencing approach may be applied in one of two ways: contracts may be evaluated based on (1) earliest issuance date or (2) latest maturity date.

[11] The SEC staff has stated that the likelihood of the share price falling to such a low level is not relevant to the analysis.

APPLY THE SEQUENCING APPROACH

Facts

R Company has 500,000 authorized common shares, of which 300,000 are issued and outstanding;

R Company issued debt on January 10, 2010 that matures on January 10, 2015 and is convertible into common stock based on the stock's fair market value at the date of conversion;

R Company has the following equity linked instruments outstanding:

- 50,000 employee stock options granted December 15, 2009, and expiring December 15, 2019;
- 100,000 A warrants issued January 5, 2007, and expiring January 5, 2012; and
- 25,000 B warrants issued on March 30, 2010, and expiring on March 30, 2017.

Analysis

If R Company adopts the sequencing approach based on the earliest issuance date, which financial instruments qualify as equity and which do not?

The A warrants would continue to qualify as equity despite the issuance of the convertible debt, a security potentially settleable in an unlimited number of shares. The B warrants, issued subsequent to the issuance of the convertible debt, however, would be classified as liabilities. Employee stock options are not within the scope of ASC 815-40, and their classification would be determined by reference to ASC 718-10.

If R Company adopts the sequencing approach based on the latest maturity date, which financial instruments qualify as equity and which do not?

The A warrants would be classified as equity on the issuance of the convertible debt. The B warrants, however, would be classified as liabilities while the debt is outstanding because their expiration date is after the maturity date of the convertible debt. Employee stock options are not within the scope of ASC 815-40 and their classification would be determined by reference to ASC 718-10.

No required cash payment if entity fails to timely file.

This requirement and the one following both address the possibility that the issuer will be required to make cash payments to the holder under certain conditions. These cash payments represent a type of cash settlement and preclude equity classification for the conversion options or warrants.

With respect to the first criterion, a company does not have control over its ability to make timely filings with the SEC. Based on this requirement, the size of any cash penalties should be assessed. If the maximum cash penalties are so onerous that the company would be economically compelled to redeem (net cash settle) the instrument, the criterion is not met, and the instrument is considered a liability. If the maximum cash penalties are "reasonable" and would not be equivalent to net cash settlement, the criterion is met, and the instrument is eligible for equity classification if it meets all of the other tests.

The definition of reasonable is a judgment call. One way to determine if the penalties are reasonable would be to compare the value of an instrument with this feature to the value of an instrument without the feature. If the penalty exceeds the difference in value, the company would be economically compelled to cash settle the instrument rather than paying the penalty.

No cash-settled top-off or make-whole provision.

This requirement relates to provisions under which the holder is entitled to cash payments in the event that a certain level of return on investment is not achieved. Often these provisions effectively guarantee the holder a defined return. If such a provision can be net-share settled and the maximum number of shares that could be required to be delivered under the contract (including "top-off" or "make-whole" provisions) is fixed and less than the number of available authorized shares (including the number of shares that could be required to be delivered during the contract period under existing commitments), a top-off or make-whole provision would not preclude equity classification. Without such a net-share settlement, these provisions represent cash settlement, the agreement would fail the criterion and would be considered a liability.

ASC 815-40-25-7 notes that the requirement prohibiting cash settlement does not apply to certain cash payments available to all shareholders, such as a liquidation or distribution payment.

No counterparty rights rank higher than shareholder rights.

There are no provisions in the contract that indicate that the counterparty has rights that rank higher than those of a shareholder of the stock underlying the contract.

No collateral required.

Many debt instruments require collateral. A convertible debt instrument collateralized by certain assets of the company generally would not fail these criteria if the collateral is contractually required only for the host contract, e.g., collateral sufficient for the principal amount of the debt. In the analysis of the embedded conversion option, only the provisions related specifically to the conversion feature are relevant. Consequently, conversion options collateralized by the shares underlying the conversion options would pass these criteria. However, a provision that might require the issuer to post additional cash collateral associated with the conversion options if the stock price falls below a certain level would fail these criteria.

Recap of the Analysis of Embedded Conversion Options

The key considerations in analyzing embedded conversion options follow:

- Is the conversion option indexed to the company's own stock?
- Would the conversion option, if freestanding, be considered liability or equity under ASC 815-40-1 through 6?
- Does the hybrid contract represent a conventional convertible instrument?
- Would the conversion option, if freestanding, be considered liability or equity under ASC 815-40-7 through 35?

On the basis of the above tests, if the embedded conversion option would be classified as equity if it were freestanding, further work is required. If the convertible financial instrument includes a conversion option that permits the issuer to pay cash upon conversion, then it must be assessed under ASC 470-20 (cash conversion guidance). If the convertible financial instrument does not include an option that allows the issuer to pay cash upon conversion, then the instrument must be assessed for a beneficial conversion feature. See the discussion in Step D in this section of the Practice Aid.

APPLY ASC 815-40 TO CONVERTIBLE DEBT EXAMPLES

Facts

R Company issues $1,000,000 of junior debt convertible into common shares at the holder's option based upon a conversion price of $5 per share or 80% of the stock's fair market value, whichever is lower. At issuance of the convertible debt instrument, the stock is trading at $10 per share and the company has 50 million authorized and unissued shares.

Analysis

Is R Company's junior convertible debt subject to ASC 480-10 (Step A)?

NO – Although the convertible debt is convertible into a variable number of shares, its monetary value is not based solely or predominantly on a fixed monetary amount, a variable other than the issuer's shares such as a market index, or a variable inversely related to the value of the company's shares. If the convertible debt was convertible into a variable number of shares and a fixed amount, it would be subject to ASC 480-10.

Are the conversion options embedded in R Company's junior debt indexed to R Company's stock?

First, R Company determined that the conversion option and the debt host are not clearly and closely related (Step B1), and the company did not elect the fair value option (Step B2). R Company is public and consequently, the conversion option is a derivative (Step B3).

Then, R Company concluded that the conversion option was indexed to the company's own stock based on the following (Step C1):

STEP 1: The financial instrument does not contain an exercise contingency. Proceed to Step 2.

STEP 2: The only circumstance in which the settlement amount will not equal the difference between the fair value of 200,000 shares and $1,000,000 is if the share price is less than $6.25 ($5.00/80%) because the conversion price was either fixed ($5) or based on the company's fair market value (80% of the stock's fair value). Consequently, the only variable that will change the conversion price is the fair market value of the stock, which is an input to the fixed- for-fixed model.

What is the conclusion if R Company's junior convertible debt is analyzed under ASC 815-40-25-1 through 6 (Step C2)?

R Company noted that the securities purchase agreement for the junior convertible debt did not require net cash settlement, only share settlement is allowed under the contract. Also, the Company noted that the securities purchase agreement allowed for the delivery of unregistered shares at settlement.

Is R Company's debt conventional convertible (Step C3)?

NO – The number of shares delivered at settlement is variable. Consequently, the convertible debt is not conventional.

What is the conclusion if R Company's junior convertible debt is analyzed under ASC 815-40-25-7 through 35 (Step C4)?

R Company analyzes if the company has sufficient authorized and unissued shares. With the stock price of $10, the effective conversion price is $5 (since it is lower than $8 = 80% * $10), and 200,000 shares would be issued if the debt were converted today. Therefore it would seem that the Company has ample authorized and unissued shares to share settle the conversion option. However, if the stock price were to drop, the number of shares issued would increase. If the stock price dropped to $1 a share, 1.25 million shares would be issued, and R Company would still have plenty of shares to settle the contract. If the price dropped to $0.01, 125 million shares would be issued, and R Company would not have sufficient shares to settle the contract.

Since the number of shares is not explicitly limited, R Company is unable to conclude that enough authorized and unissued shares are available to share settle the conversion option. The result is that the conversion option would be classified as a liability if freestanding and must be bifurcated from the debt host and accounted for as a derivative liability in accordance with ASC 815.

Furthermore, we note that since the number of shares to be issued to settle the conversion option is potentially unlimited, R Company would be unable to conclude that it has sufficient authorized and available shares to satisfy other commitments to issue shares if it did not have a sequencing policy. However, R Company has adopted, documented and disclosed a sequencing approach that allows its other equity linked financial instruments and conversion options to be classified as equity if they meet the requirements of ASC 815.

APPLY ASC 815-40 TO CONVERTIBLE DEBT EXAMPLES

Would the answer change if R Company's $1,000,000 of junior debt is convertible into common shares at the holder's option based upon a conversion price of 80% of the stock's fair market value, but no lower than $5 per share? As above, at issuance, R Company's stock is trading at $10 per share and the company has 50 million authorized and unissued shares.

The analysis would be the same until R Company analyzed if there were an adequate number of shares. Unlike above, this instrument contains a cap on the number of shares that will be issued upon conversion in that no matter how low the stock price goes, the holder will receive no more than 200,000 shares ($1,000,000 / $5).

Since the number of shares to be issued upon conversion will never exceed 200,000 shares, and the company currently has ample shares available, the ASC 815-40-25 criteria are satisfied. As a result, the conversion option is classified as equity and the financial instrument does not need to be bifurcated. The instrument should be analyzed for beneficial conversion features under ASC 470- 20.

STEP D: DOES THE CONVERTIBLE FINANCIAL INSTRUMENT INCLUDE A CONVERSION OPTION THAT PERMITS THE ISSUER TO PAY CASH UPON CONVERSION OR THAT INCLUDES A BENEFICIAL CONVERSION FEATURE?

Conversion Options that Permit the Issuer to Pay Cash upon Conversion (Cash conversion guidance)

Convertible debt instruments that permit the issuer to pay cash or other assets upon conversion and for which the conversion option is not required to be bifurcated from the debt host are accounted for under ASC 470-20 (referred to in this section as the cash conversion guidance). If an instrument is accounted for under the cash conversion guidance, the beneficial conversion feature literature under ASC 470-20 does not apply. This is because the conversion option is already accounted for separately from the liability component. An example of such an instrument and the accounting required by ASC 470-20 follows. The accounting requirements are discussed in detail below.

R Company issues convertible debt and the conversion feature does not require bifurcation. When a convertible debt holder decides to convert, the Company may settle in stock, cash, or a combination of the two, as it chooses. At issuance, R Company measures the fair value of the liability component first, and the difference between the proceeds from the instrument and the fair value of the liability without the conversion option represents the residual equity component. R Company's debt was issued with the following features in thousands of dollars:

- R Company issued $1,500 of 2% convertible debt on November 22, 2018, with a due date of November 22, 2023.
- Without the conversion feature, R Company would have paid a coupon rate of 8% on the debt.
- Interest on the $1,500 will be 2%, $30, payable annually. The principal is due November 22, 2023.
- The entire $1,500 note will be convertible at $15 per share.

R Company selected the income method to value the liability component. The Company estimated the fair value of the liability component without the conversion option by calculating the present value of its cash flows using a discount rate of 8%, the market rate for similar notes with no conversion features, as follows in thousands of dollars:

The present value of the principal and interest payments over the 5 year life at 8% =	$1,140
The residual allocated to equity =	$360
Total =	$1,500

During the 5-year life of the note, R Company recognizes $510 in interest expense, consisting of $150 of cash interest payments ($30*5=$150) and $360 of discount amortization. The present value of the annual interest payments of $30 for 5 years and the principal payment of $1,500 at the end of the 5th year at the company's nonconvertible borrowing rate of 8%=$1,140. The residual allocated to equity is $1,500-$1,140=$360; this $360 represents the discount resulting from the application of the cash conversion guidance that is amortized over the 5-year life.

Instruments in the Scope of the Cash Conversion Guidance

Convertible financial instruments within the scope of the cash conversion guidance include convertible debt instruments that have the following features upon conversion:

- The issuer may satisfy the entire obligation in either stock or cash equivalent to the conversion value (i.e., commonly referred to in the previously applicable accounting literature as Instrument B);[12]
- The issuer must satisfy the accreted value[13] of the obligation in cash and may satisfy the conversion spread in either cash or stock (i.e., commonly referred to in the previously applicable accounting literature as Instrument C); and
- The issuer may satisfy the entire obligation in any combination of cash and shares at the issuer's option (i.e., commonly referred to as Instrument X).

Preferred shares that are mandatorily redeemable financial instruments are classified as liabilities under ASC 480-10 because they require a cash settlement at maturity. If these instruments may be converted for cash (in whole or in part), they are also within the scope of the cash conversion guidance. For example, an instrument in the form of a mandatorily redeemable preferred share, in which the issuer must satisfy the accreted value of the obligation in cash and may satisfy the conversion spread in either cash or stock, is within the scope of the cash conversion guidance.

Instruments outside the scope of the cash conversion guidance include:

- Convertible debt instruments with embedded conversion options that are accounted for separately as derivatives under ASC 815;
- Convertible preferred shares that are accounted for in equity or in temporary equity;
- Convertible debt that requires settlement only in the issuer's own stock;
- Convertible debt that requires or allows settlement of fractional shares in cash;
- Convertible debt that allows for settlement in cash or shares in circumstances in which holders of the underlying shares also would receive the same form of consideration, for example, in a change-of-control transaction; and
- Convertible debt that settles in cash at maturity at its principal amount.

The Fair Value of the Liability Component of Convertible Debt

For instruments within the scope of the cash conversion guidance, companies are required to determine the carrying amount of the liability component of convertible debt at issuance by measuring the fair value of a similar liability, without the conversion option, but including any other embedded features that may be present in the instrument. This represents the measurement of the nonconvertible liability at fair value using information available at the issuance date. Once determined, this fair value is not subject to revaluation at a later date. Only embedded features that are substantive should be included in the initial measurement of the liability component. Embedded features are considered nonsubstantive if, at issuance, the company concludes that it is probable that the embedded feature will not be exercised.

[12] Conversion value is defined as the market value of the underlying shares into which convertible debt can be exchanged. Conversion value is calculated by multiplying the number of shares that can be obtained by the market price per share. Debt that can be converted into 50 shares of stock with a market price of $10 each has a conversion value of $500.

[13] Accreted value is defined as the current carrying value of debt with an original-issue discount that takes into account imputed interest that has accumulated since issuance.

Determining fair value is not necessarily straight forward especially since embedded put and call options are very common in these instruments. Companies may therefore have trouble determining which options are substantive, calculating the fair value of a loan with these features, and determining the effect of the options on the expected life of the liability component. Information such as the price of a similar liability, or inputs to valuation techniques, are not always readily available and may be particularly challenging to obtain if the company's credit rating is below investment grade. A best practice is to begin the valuation process early and to consider using a valuation specialist.

The company may use the following approaches, available under both ASC 820-10 and preexisting GAAP[14], to determine the fair value of a nonconvertible liability:

Market approach – Identify the fair value of comparable liabilities

In practice, companies may find it difficult to use a market approach to determine the fair value of a similar liability because debt with the same rights and obligations (e.g., call/put rights, other embedded features, maturity date, specific covenants, etc.) might not exist at date of issuance of those instruments. Under this approach, companies should consider the differences in the nature of the nonconvertible debt being fair valued when compared with the debt being used to determine the fair value. These can include features such as seniority, issuance date, put or call options, and collateral provisions. The rate differences associated with the differences in features should be determined using independent market data.

Income approach – Discount cash flows at the nonconvertible interest rate of comparable liabilities to determine the fair value

Companies can use an income approach and also can derive information for inputs to a valuation technique using a lattice model. As a result, it is possible for a company to determine the fair value of their convertible debt based on the fair value of a hypothetical instrument with similar features.

If the convertible debt includes embedded put and or call options that require bifurcation, after the company has valued the liability component with these features, it must bifurcate the options. The bifurcated put and or call options should then be recorded at fair value as a single compound derivative. The valuation of the liability component and the embedded put and call features may be complicated and may require a valuation specialist. Bifurcation of an embedded put and or call option from the liability component does not affect the accounting for the equity component.

The Nonconvertible Borrowing Rate

One key factor for determining the fair value of the liability at the date of issuance is the nonconvertible debt borrowing rate. The rate may be estimated by one or a combination of the following methods:

- Determining the borrowing rate of the company's other financing arrangements on existing nonconvertible debt. These rates would only be appropriate if the borrowings and the convertible debt had comparable attributes such as issuance date, term, seniority of the debt, and substantive embedded features such as put or call options;
- Considering the borrowing rate for nonconvertible debt with comparable attributes such as those listed above issued by peer companies. Peer companies should be similar in size, nature and financial profile (e.g., creditworthiness). A company could obtain this information from the market based on trading prices, investment bank data, and possibly from other unrelated parties; and/or
- Generating the rate using a model such as a lattice model. Companies that use models to derive the nonconvertible borrowing market rate should consider factors similar to those mentioned in the preceding paragraphs.

[14] For financial instruments that were issued before ASC 820-10 (Statement 157) became effective, companies can use preexisting GAAP to measure fair value that is generally entity-specific and based on entry price.

The Expected Life of the Debt

Determining the expected life of the debt is important for the following reasons:

- The debt discount and debt issuance costs are amortized over the expected life. The debt discount includes the amount allocated to the equity component (the residual of the proceeds at issuance after fair valuing the debt component) plus the fair value of any bifurcated embedded derivatives.
- If the income approach is used to measure the fair value of the liability component at initial recognition, the expected life is a necessary input.

The cash conversion guidance requires companies to match the amortization period for the debt discounts and debt issuance costs to the expected life of similar debt that does not have a conversion right. The cash conversion guidance further notes that if the income approach was used, this expected life should be consistent with the period over which the discounted cash flow was measured.

The company should identify all substantive embedded features in the debt at issuance, other than the conversion option, to determine if they affect the expected life in addition to determining whether the feature requires bifurcation under ASC 815 and ASC 815-40.

The company may determine that the expected life of the debt is shorter than the contractual life if the debt includes a substantive put option. Generally, companies conclude that the expected life is through the first put date unless interest rates are expected to drop significantly such that it would be beneficial for holders to continue to hold onto the debt. Companies generally do not shorten the debt's expected life for a call option because there is a low coupon rate associated with these instruments.

In accordance with the cash conversion guidance, companies do not reassess the expected life of the liability in periods subsequent to issuance unless the terms of the instrument are modified. Therefore, the reported interest expense for an instrument should be determined based on the stated interest rate (i.e., coupon payments) once the debt discount is fully amortized (e.g., when the debt remains outstanding after the first put date).

Allocation of Transaction Costs

The cash conversion guidance requires direct transaction costs incurred with third parties other than investors, such as attorney fees, to be allocated between the liability and equity components. The allocation should be based on the proportion that each component represents of total proceeds at issuance.

> In the example above, R Company issued $1,500 of convertible debt; $1,140 (76%) was allocated to liability, and $360 (24%) was allocated to equity. If transaction costs were $100, the Company would capitalize $76 as debt issuance costs and would treat $24 as equity issuance costs that reduce equity at the time of the transaction.

Income Taxes

When companies recognize both a debt and an equity component, there is generally a basis difference associated with the liability component that represents a temporary difference for purposes of applying ASC 740-10. The cash conversion guidance directs companies to recognize the initial deferred taxes for the tax effect of that temporary difference as a charge to additional paid-in capital and a credit to deferred tax liability.

This accounting only applies if the company does not have a full valuation allowance under (ASC 740-10).[15] The cash conversion guidance like ASC 740-10 directs companies to recognize a deferred tax liability on the difference between the tax and accounting basis of debt.

Over the life of convertible debt, the company's deferred tax liability is reduced, and a deferred tax benefit is recognized as the debt discount is amortized. The company's total income tax benefit includes not only the deferred tax benefit from the reversal of the deferred tax liability, but also the current tax benefit of deducting the contractual interest.

If a company settles convertible debt, a book gain or loss is recognized upon extinguishment. At the same time, the company should record a deferred tax benefit and reverse any residual deferred tax liability that had been recorded.

Derecognition

Companies with convertible debt instruments within the scope of the cash conversion guidance should account for conversions into common stock or extinguishments as settlements in which the liability component is extinguished and the equity component is reacquired. Consequently, regardless of the form of the consideration transferred in the settlement (e.g., conversion to equity shares, repayment in cash, etc.), the fair value of that consideration is attributed to the liability and equity components in the same manner as the initial proceeds were allocated. In other words, the consideration is measured at fair value and allocated to the liability component based on the liability's fair value at the settlement date. Any remaining consideration is attributed to the reacquisition of the equity component and recognized as a reduction of stockholders' equity. The result is that a gain or loss is recognized upon conversion, or upon any other settlement, equal to the difference between the fair value and the carrying amount of the liability component at the conversion/settlement date.

Transaction costs incurred from third parties other than investors that relate directly to the settlement of a convertible debt instrument within the scope of the cash conversion guidance should be allocated to both the liability and equity components. The costs should be allocated in proportion to the settlement amount allocated to each component. The costs allocated to the debt component should be charged to expense in the period of derecognition and those allocated to the equity component should reduce equity.

[15] If the company does have a full valuation allowance, the company's tax provision disclosure will now include increased amounts for deferred tax liabilities and valuation allowance, and the statutory rate reconciliation will show an adjustment in the valuation allowance rather than nondeductible interest expense.

APPLICATION TO CONVERTIBLE DEBT

Facts

R Company issues 15-year convertible debt at par for proceeds of $2,000 on January 1, 2009. The debt is convertible at any time into shares of R Company's common stock at a stated conversion price of $10 per share. The quoted market price of R Company's common stock is $7 per share on the date of issuance. The par value of R Company's common stock is $1. Upon conversion, R Company can elect to settle the entire if-converted value (the principal amount of the debt plus the conversion spread) in cash, common stock, or any combination thereof.

The debt is callable and puttable at par after the 10th year. The Company pays interest annually at the end of each year at a rate of 2% on the principal amount or $40 per year. The Company's nonconvertible borrowing rate is 9% which is the rate it would pay for debt with terms similar to the convertible debt that is callable, puttable, and without a conversion feature. The maturity date is December 31, 2023.

On January 1, 2014, when the quoted market price of R Company's common stock is $14, all holders of the convertible notes exercise their conversion options. The investors are entitled to aggregate consideration of $2,800. At settlement, the market interest rate for debt with similar terms and features but without a conversion option is 8%.

For purposes of the example, issuance costs and income taxes have been ignored. The only features embedded in the debt are the put, call, and conversion options.

Analysis

What is the accounting for the liability component and the conversion option component of the convertible debt at issuance by the issuer?

Step 1 – R Company concludes that the embedded conversion option, the embedded put, and the embedded call do not require bifurcation, and that the convertible debt is within the scope of the cash conversion guidance.

Step 2 – R Company applies the cash conversion guidance in ASC 470-20 and calculates the liability component of the convertible note first, by calculating the expected present value of 10 years of $40 interest payments and the payment of $2,000 at the end of the 10th year at the Company's nonconvertible interest rate of 9%. The Company uses the expected life of 10 years rather than the contractual life of 15 years. The Company's nonconvertible debt has terms and features that are similar to the convertible debt, including embedded put and embedded call options, and consequently the Company concludes that 9% is the most appropriate rate to use in the computation. The Company has decided to use an income approach to measure the liability; it could also have chosen to use a market approach. The fair value of the liability component at January 1, 2009, is $1,102. The $898 difference between the proceeds from the issuance of the notes and the fair value of the liability is assigned to the equity component.

Step 3 – R Company records the following entry at initial recognition:

Entry at January 1, 2009:

Cash	$2,000	
Debt discount	$ 898	
Debt		$2,000
APIC		$ 898

APPLICATION TO CONVERTIBLE DEBT (CONTINUED)

R Company's convertible notes contain an embedded call and put that can be exercised at the end of the tenth year. As discussed above, if a company concludes that features embedded in convertible debt are nonsubstantive because it is probable that they will not be exercised, then these features should not be included in the determination of the expected life of the convertible debt. R Company concludes that the put is substantive and consequently that the expected life is the same as the life of the put, ten years. The Company uses the ten-year period to measure the fair value of the liability, and also uses the ten-year period for calculating interest using the effective interest method. During the ten years ending December 31, 2018, the Company recognizes $1,298 of interest expense consisting of $400 of cash interest payments and $898 of discount amortization under the effective interest method. The subsequent accounting is summarized in the following table assuming no conversion:

	Reported Interest Expense for the Year Ended	Carrying Amount of Debt at the Balance Sheet Date
January 1, 2009		$1,102
December 31, 2009	$99	$1,161
December 31, 2010	$105	$1,226
December 31, 2011	$110	$1,296
December 31, 2012	$117	$1,373
December 31, 2013	$124	$1,457
December 31, 2014	$130	$1,547
December 31, 2015	$139	$1,646
December 31, 2016	$148	$1,755
December 31, 2017	$158	$1,873
December 31, 2018	$168	$2,000
Total Interest Expense Jan 1, 2009, to Dec 31, 2018	**$1,298**	

Note: In this example, Step 3 would have changed if the embedded put and call features required bifurcation. After a company identifies the fact that the embedded features require bifurcation, the order of the steps is as follows:

a. Apply the cash conversion guidance to separate the liability component, including the put and call features other than the conversion option, from the equity component.

b. Separate the put and call from the liability component in accordance with ASC 815-10. These put and call option derivatives would be allocated their full fair value and bifurcated from the liability component as a single compound derivative. The valuation of the liability component and the embedded put and call features may be complicated and may require a valuation specialist. Separation of an embedded derivative from the liability component does not affect the accounting for the equity component.

APPLICATION TO CONVERTIBLE DEBT (CONTINUED)

What is the accounting for the liability component and the conversion option component by the issuer at conversion on January 1, 2014?

R Company settles the note on January 1, 2014, and consequently derecognizes the debt component and reacquires the equity component. The Company's first step is to measure the fair value of the liability component immediately prior to extinguishment by calculating the expected present value of 5 years of $40 interest payments and the payment of $2,000 at the end of the fifth year at the Company's nonconvertible interest rate of 8% or $1,520. The Company's nonconvertible debt has terms and features that are similar to the convertible debt, including embedded put and embedded call options, and consequently the Company concludes that 8% is an appropriate rate to use in determining fair value.

As noted above, the fair value of the aggregate consideration due to the investors is $2,800. The amount attributable to the equity component is $2,800 - $1,520 or $1,280. Whether the consideration is cash, common stock, or a combination of the two, $1,520 will be attributed to the extinguishment of the liability and $1,280 will be attributed to the reacquisition of the equity. Since R Company was carrying the debt at $1,457 on December 31, 2013, the Company would incur a loss of $63 ($1,520 - $1,457) upon settlement of the debt.

At settlement, R Company would record the following assuming it elects to transfer consideration to the convertible debt holder in the form of $2,000 in cash and 57 shares of common stock with a fair value of $800 (par of $57 and APIC of $743). The $1,280 decrease to APIC for the reacquisition of the conversion option and the $743 increase to APIC from the issuance of common stock at conversion are presented gross in this journal entry for clear presentation.

Entry at January 1, 2014:

Debt	$1,457	
APIC – conversion option	$1,280	
Loss on extinguishment	$63	
Cash		$2,000
Common stock at par		$57
APIC – share issuance		$743

Beneficial Conversion Features

If an issuer is not required to bifurcate the conversion option in its convertible financial instrument under ASC 815 and cannot settle the instrument partially or wholly in cash, then the issuer should test the instrument for a beneficial conversion feature.

A convertible financial instrument includes a beneficial conversion feature if the effective conversion price is less than the company's market price of common stock on the commitment date.[16] The effective price paid for a common share is the amount allocated to the convertible instrument, divided by the number of shares the holder is entitled to upon conversion. If the convertible financial instrument is issued with warrants and/or other detachable instruments, the amount allocated to the convertible instrument is the face amount less the allocation to the detachable instruments. (If the warrants are equity, the allocation between the convertible instrument and the warrants is on a relative fair value basis. If the warrants are liabilities, the amount allocated to the convertible instrument is the face amount less the fair value of the warrants.)

[16] The commitment date is the date that the contract is binding on both parties and usually legally enforceable. At this date, the agreement specifies all significant terms and includes a disincentive for nonperformance that is sufficiently large to make performance probable.

If the convertible financial instrument includes embedded derivatives other than the conversion option that are separately accounted for as embedded derivatives under ASC 815, these embedded derivatives do not affect the effective conversion price for purposes of measuring a beneficial conversion feature. That is, the proceeds received for or allocated to a convertible instrument include the proceeds ascribed to embedded derivatives that are accounted for separately from the host contract under ASC 815.

An issuer's beneficial conversion feature on a convertible instrument is equal to the difference between the company's market price of common stock on the measurement date and the effective conversion price multiplied by the number of shares the holder is entitled to upon conversion.

Refer to Debt Issue Costs, Debt Discount or Premium, and Preferred Stock Discounts for a discussion on subsequent amortization of BCFs.

ANALYZE CONVERTIBLE DEBT FOR A BENEFICIAL CONVERSION FEATURE

Facts

R Company has a senior convertible debt instrument that has an effective conversion price that is $12 on the commitment date when the fair value of the shares is $10; therefore, the instrument does not include a beneficial conversion feature.

R Company has a junior convertible debt instrument that has an effective conversion price that is $8.63 on the commitment date when the fair value of the shares is $10. This second instrument includes a beneficial conversion feature. We will analyze this beneficial conversion feature further.

On R Company's junior convertible debt instrument, the debt had proceeds of $1,000 and it was issued with warrants, accounted for as equity, with a relative fair value of $180. The amount allocated to the convertible debt is $820. The conversion price of the junior convertible debt is $10.50 per share. The par amount of the debt is $1,000. The market price of the common stock on the measurement date is $10.

Analysis

R Company calculates the effective conversion price by:

- Dividing the amount allocated to the convertible instrument ($820) by the number of shares the holder is entitled to upon conversion ($1,000/$10.50 = 95 shares); $820/95 = $8.63.

R Company calculates the beneficial conversion feature by:

- Calculating the difference between the company's market price of common stock on the commitment date ($10) and the effective price of a common share ($8.63); $10 - $8.63 = $1.37; and
- Multiplying $1.37 by the number of shares the holder is entitled to upon conversion ($1000/$10.50 = 95 shares); 1.37*95 = $130.

An alternative method is to calculate the beneficial conversion feature as the difference between the fair value of the shares issuable upon conversion and the amount allocated to the convertible instrument.

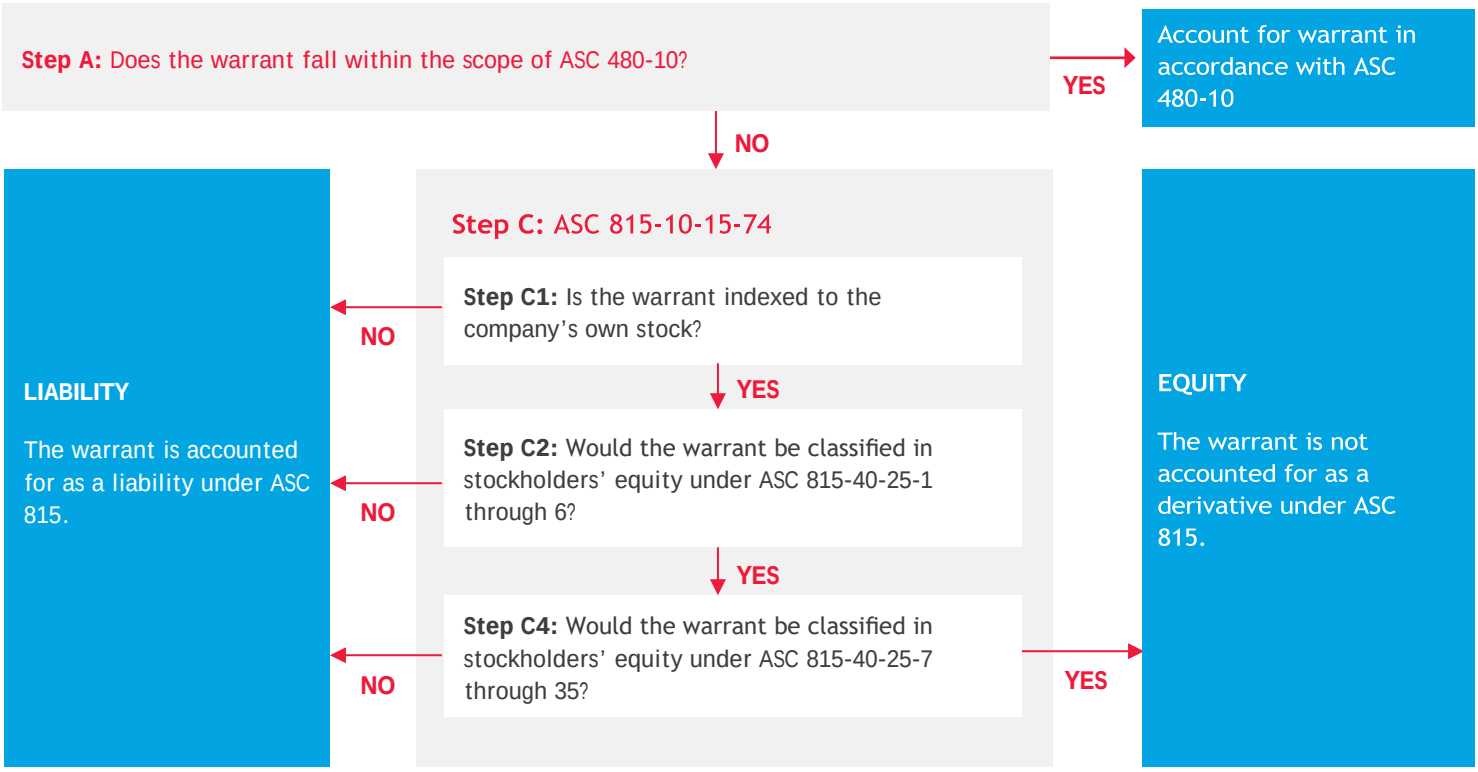
Under this alternative, R Company calculates the beneficial conversion feature by:

- Calculating the fair value of the shares issuable upon conversion as the number of shares issuable upon conversion ($1,000/$10.50 = 95 shares) multiplied by the fair value of the common stock at the measurement date ($10); 95 * $10 = $950; less
- The amount allocated to the convertible instrument of $820; equals
- $950 – $820 = $130.

Note: After determining the proper accounting for convertible equity instruments, public companies must still consider the guidance in ASC 480-10-S99 (EITF Topic D-98, *Classification and Measurement of Redeemable Securities*). See section entitled Balance Sheet Classification of Shares at page 69.

WARRANTS

FLOWCHART #2



INTRODUCTION

Companies must first determine whether the warrant is within the scope of ASC 480-10 (flowchart step A). Refer to page 6 for a discussion of the types of warrants that represent liabilities under ASC 480-10. If the warrant is not within the scope of ASC 480-10, companies should consider whether the warrant meets the scope exception of ASC 815-10-15-74.

STEP C: DOES THE WARRANT MEET THE ASC 815-10-15-74 SCOPE EXCEPTION?

ASC 815-10-15-74 states that contracts that are both (1) indexed to a company's own stock and (2) classified in stockholders' equity in the company's balance sheet are not considered derivative instruments. This means that if a freestanding warrant meets the scope exception, it can be accounted for as stockholders' equity. In this section, we discuss the meaning of the scope exception as it applies to freestanding warrants.

STEP C1: IS THE WARRANT INDEXED TO THE COMPANY'S OWN STOCK?

Read the discussion of the meaning of indexed to the company's own stock that begins on page 21 of the Practice Aid. If the warrants are indexed to the company's own stock, then they should be tested under Steps C2 and C4.

Warrants that Are Not Derivatives

A warrant is a derivative if it meets the three requirements of a derivative in Step B3 of the Practice Aid on pages 17-19. Such warrants are accounted for as derivative liabilities if they are not indexed to a company's own stock.

As discussed previously, warrants of private companies that require physical settlement (i.e., can only be exercised for the full amount of cash in exchange for shares) typically do not meet the definition of a derivative because net settlement does not exist. In contrast, warrants of private companies that can be net-share settled (commonly described as cashless exercise) do meet the net settlement test. Both types of instruments are subject to a two-step test in ASC 815-40 to determine whether they are considered indexed to the company's own stock. ASC 815-40 precludes instruments that are not indexed to the company's own stock from equity classification, and as a result such instruments are outside the scope of ASC 815-40.

In the absence of other specific accounting literature, we believe that these instruments should generally be recorded at fair value and marked to fair value through earnings each subsequent reporting period, which is consistent with the SEC staff's longstanding view for written options.

ANALYZE A WARRANT WITH A RESET FEATURE

Facts

R Company issues warrants that permit the holder to buy 200 shares of its common stock for $5 per share. The warrants have 5-year terms and are exercisable at any time. The terms of the warrants are that (1) if the company sells shares of its common stock for an amount less than $5 per share, the strike price of the warrants is reduced to equal the issuance price of those shares, and (2) if the company issues additional warrants with a strike price below $5 per share, the strike price of these warrants is reduced to equal the strike price of the newly issued warrants.

Analysis

Are these warrants considered indexed to R Company's stock?

Scenario 1: R Company has not adopted ASU 2017-11

No, the warrants are not considered indexed to R Company's stock based on the following:

STEP 1: The instruments do not contain an exercise contingency. Proceed to Step 2.

STEP 2: The settlement amount would not equal the difference between the fair value of a fixed number of R Company's equity shares and a fixed strike price.

The strike price would be adjusted if R Company (1) sells shares of its common stock for less than $5 per share or (2) issues warrants with a strike price below $5 per share. Consequently, the settlement amount of the warrants can be affected by future common stock offerings by R Company at the then-current market price of these shares or the contractual terms of at-the-money warrants issued in a subsequent period. The occurrence of a sale of common stock by R Company at market is not an input to the fair value of a fixed-for-fixed option on common shares. Also, the occurrence of a sale of an at-the-money warrant is not an input to the fair value of a fixed-for-fixed option on equity shares, if the transaction was priced at market.

R Company would account for the warrants as liabilities and record them at fair value with the changes reported in the income statement. This answer would be correct whether R Company was public or private. Although we concluded that the warrants failed Step C1 and are liabilities, the flowchart steps that would be applicable if the warrants had passed Step C1 are summarized below (Steps C2 and C4).

Scenario 2: R Company has adopted ASU 2017-11

Yes, the warrants are considered indexed to R Company's stock because the terms of the price adjustments to the strike price meet the definition of down round features and therefore are excluded from the evaluation. Proceed to step C2.

STEP C2: WOULD THE FREESTANDING WARRANT BE CLASSIFIED IN STOCKHOLDERS' EQUITY, PART 1?

In general, warrants that require or may require the issuer to settle the warrant for cash are liabilities, and warrants that require settlement in shares are equity instruments. Read the discussion of the requirements to be classified in stockholders' equity under ASC 815-40-25-1 through 6 beginning on page 33 of the Practice Aid.

STEP C4: WOULD THE FREESTANDING WARRANT BE CLASSIFIED IN STOCKHOLDERS' EQUITY, PART 2?

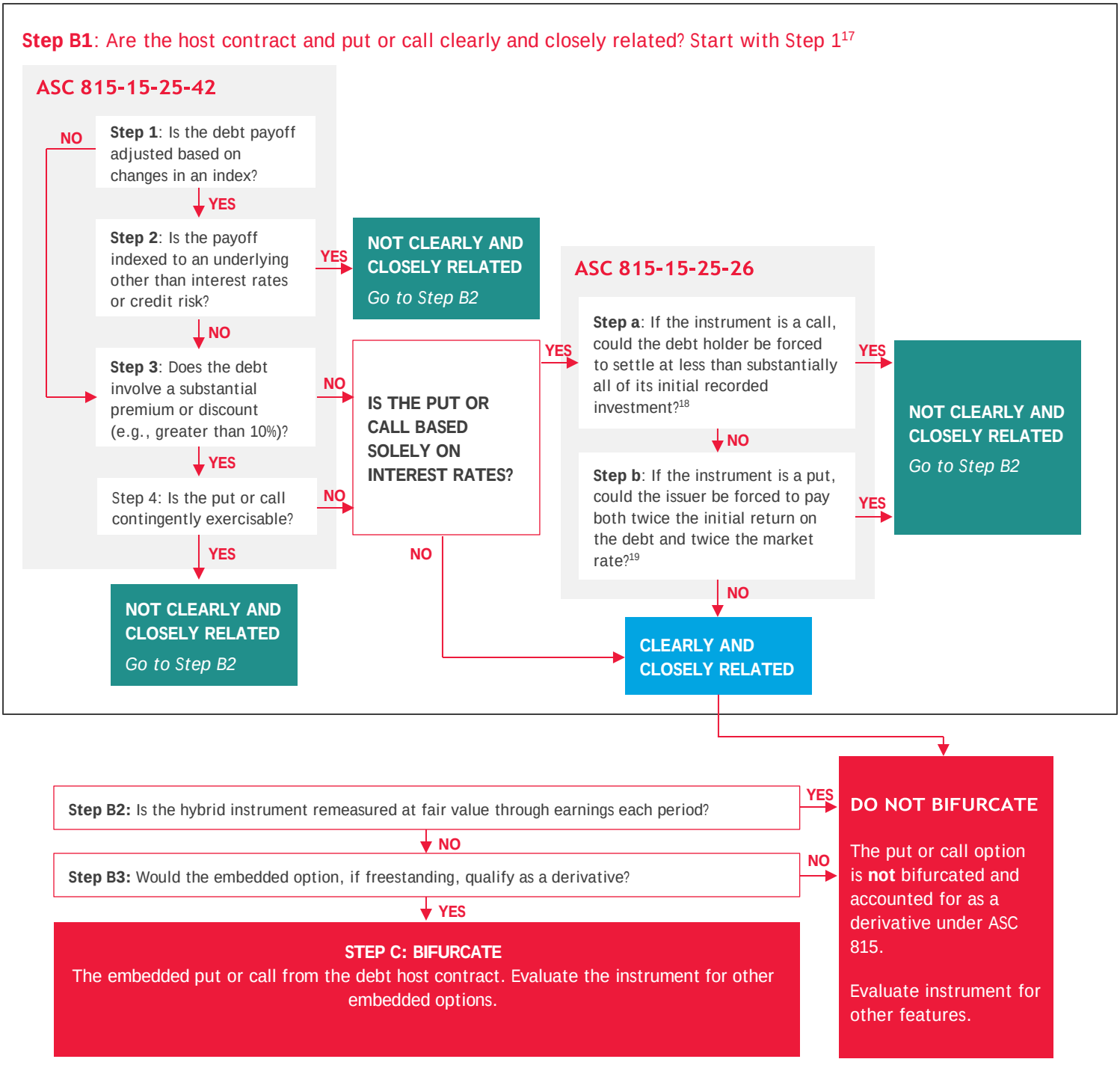
Warrants that do not meet the requirements of part 2, such as the issuer lacking the ability to settle in registered shares in certain circumstances or having an insufficient number of authorized and unissued shares, result in the assumption of cash settlement of the warrant. Read the discussion of the requirements to be classified in stockholders' equity under ASC 815-40-25-7 through 35 beginning on page 40 of the Practice Aid.

If the warrant passes Steps C1, C2 and C4, the issuer can account for the warrants as equity.

PUTS AND CALLS EMBEDDED IN DEBT

A company's accounting for puts and calls embedded in debt is dependent on whether the features are considered clearly and closely related to the host contract. We have summarized the required analysis in Step B and in the following flowchart.

FLOWCHART #3 – STEP B



[17] Step 1 applies only if the put or call option accelerates repayment of the contractual principal amount. Otherwise, the put or call is not clearly and closely related to its debt host.

[18] Step a is not applicable to put options exercisable by the lender because the lender cannot be forced into a loss by the issuer.

[19] Step b does not apply to call options. The reason for the relief is that the call option is within the issuer's control and the debt holder will not receive a high rate of return if the issuer exercises its right to call the debt.

PUTS AND CALLS

Put features allow a debt holder to demand repayment, and call features allow the issuer to redeem the debt. Put and call features that are clearly and closely related to debt hosts are not required to be bifurcated. ASC 815-15-25-41 through 43 provide guidance on whether the economic risks and characteristics of embedded put and call options are clearly and closely related to the economic characteristics and risks of a debt host. ASC 815-15-25-42 provides a four-step decision sequence to follow in determining whether puts and calls are clearly and closely related to a debt host.

Explanations of the four steps follow and are on Flowchart #3.

Step B1: Are the host contract and put or call clearly and closely related?

The following four-step process should be followed.

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.

Examples of payoff amounts based on changes in an index include:

a. Market value of the number of shares of an unrelated company's common stock

b. Par amount of the debt adjusted for the percentage increase in the S&P 500

These amounts are not examples of payoff amounts based on an index:

a. Par amount of the debt plus any unpaid and accrued interest

b. 120% of the par amount of the debt

Step 2: Is the payoff indexed to an underlying other than interest rates or credit risk? If yes, the put or call is not clearly and closely related to the debt. If no, go to Step 3.

Examples of a payoff indexed to an underlying other than interest rates or credit risk include indices associated with market value of equities, including the S&P 500 index.

Step 3: Does the debt involve a substantial premium or discount? If yes, go to Step 4. If no, and the instrument is not contingently exercisable, further analysis is required under ASC 815-15-25-26.

We believe that a substantial premium or discount is one that is greater than 10%. This includes discounts and premiums that represent substantial discounts are:

a. Discounts resulting from warrants or other freestanding instruments issued with the debt.

b. Premiums or discounts resulting from puts or calls that require payoff at more than 110% of par or less than 90% of par.

Discounts that are *excluded* from the determination of whether or not the debt involves a substantial discount are those resulting from beneficial conversion features or other embedded derivative features that are bifurcated.

Step 4: Is the put or call contingently exercisable? If yes, the put or call is not clearly and closely related to the debt. If no, further analysis is required under ASC 815-15-25-26 if the put or call is based solely on interest rates.

Examples of contingently exercisable puts and calls include:

a. Puttable if the S&P increases by at least 20%

b. Puttable in the event of a change in control

c. Callable in the event of a change in control

d. Puttable in the event of an IPO

e. Puttable in the event the price of the common stock of the company changes by 20%

f. Callable if the stock price increases by 10%

Call and put options that do not involve a substantial discount or premium or that involve a substantial discount or premium but are not contingently exercisable, must pass the criteria of ASC 815-15-25-26 to be clearly and closely related to the debt host.[20] The puts and calls would not meet these criteria if the options include a provision that could:

Step a. Result in a settlement in a manner that the holder would not recover substantially all of its initial recorded investment.

Step b. At least double the investor's initial rate of return on the host debt and at the same time result in a rate of return that is at least twice what otherwise would be the then-current market return for a similar contract that involves a debt with a similar credit quality.

ASC 815-15-25-29 indicates Step a is not applicable to put options exercisable by the lender because the lender cannot be forced into a loss by the issuer.

ASC 815-15-25-37 indicates call options are not required to be analyzed under Step b. The reason for the relief is that the call option is within the issuer's control and the debt holder will not receive a high rate of return if the issuer exercises its right to call the debt.

If the put or call options are not clearly and closely related to their debt host based on Step B1, the options should be tested under Steps B2 and B3. Summaries of Steps B2 and B3 follow.

Step B2: Is the hybrid instrument remeasured at fair value through earnings each period?

If the hybrid instrument is remeasured at fair value each period, the put and/or call options do not need to be bifurcated.

If the hybrid instrument is not remeasured, Step B3 must be considered.

Step B3: Would the embedded option, if freestanding, qualify as a derivative?

If the put or call option were freestanding and would be considered to be a derivative, bifurcation would be required. ASC 815-10-15-83 defines a derivative (see page 17 for further detail) as follows:

a. It has one or more underlyings and one or more notional amounts or prepayment provisions or both.

b. It has 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 have a similar response to changes in market factors.

c. Its terms require or permit net settlement, it can readily be settled net by a means outside the contract, or it provides for delivery of an asset that puts the recipient in a position not substantially different from a net settlement.

Criteria a and b did not raise implementation issues for put and call options, but criterion c did, and is discussed in ASC 815-10-15-107 through 109. This issue specifies that the potential settlement of the debtor's obligation to the creditor upon exercise of an embedded put option or call option *does meet* the net settlement criterion of ASC 815. The guidance in this paragraph also

[20] ASC 815-15-25-26 applies to debt with embedded put or call options that include only a single underlying such as an interest rate or an interest rate index.

applies to freestanding call options held by a debtor on its own debt instruments and freestanding put options issued by the debtor on its own debt instruments.

ASC 815-10-15-107 through 109 indicates that when a debtor settles its own debt upon exercise of a put or a call option, the settlement does not involve the delivery of an asset that is associated with the underlying. Even if the creditor returns evidence to the debtor upon settlement such as a cancelled note payable, the conclusion remains that the settlement does not involve the delivery of an asset.

Also, the debtor's payment to the creditor to settle the debt obligation is not associated with the underlying because cash paid currently and denominated in the company's functional currency is not related to any underlying for the embedded put option or call option. Since the debtor does not receive an asset when it settles the debt obligation in conjunction with the exercise of the put or call option and the creditor does not receive an asset associated with the underlying, the net settlement criterion in ASC 815 is met. This conclusion is based on the fact that an asset associated with the underlying is not delivered; it is not based on whether the debt instrument is readily convertible to cash. Consequently, it is irrelevant if the debt is publicly traded or not.

ANALYZE PUT AND CALL OPTIONS EMBEDDED IN CONVERTIBLE DEBT

Facts

R Company issues $7 million of 10% convertible debt with Series A warrants for the purchase of the company's common stock. The Securities Purchase Agreement includes a call option which allows R Company to prepay the principal and accrued interest on the note at any time without penalty, and a put option that the holder can exercise if the Company defaults on the debt or if there is a change in control.

The Securities Purchase Agreement specifies that the holder can put the debt to R Company in the following situations:

A. If the Company defaults on the debt by allowing a lapse in effectiveness of the registration statement required by the Registration Rights Agreement for the shares underlying the convertible debt. In this event, the holder can put the debt to the Company for principal plus accrued interest.

B. If there is a change of control, the holder can put the debt to the Company for 120% of the principal plus accrued interest.

The Company analyzes the warrants and determines that they should be classified in stockholders' equity. The relative fair value of the warrants is $1 million (14%).

Analysis

Should R Company bifurcate the call option?

NO – The call option is not bifurcated. The analysis follows the steps in Flowchart #3

Step B1 (ASC 815-15-25-42)

Step 1: The payoff is simply par plus accrued interest. Go to Step 3.

Step 3: The debt involves a discount of 14% and consequently the discount is substantial. Go to Step 4.

Step 4: The call is not contingently exercisable. Go to ASC 815-15-25-26, Step a since the call is based solely on interest rates.

Step B1 (ASC 815-15-25-26)

Step a: The debt holder could not be forced to settle at less than its initial investment. Go to Step 2.

Step b: The instrument is a call and consequently Step 2 can be skipped.

Conclusion: The call is clearly and closely related to the host contract. Do not bifurcate.

Should the put options be bifurcated?

YES – The put options should be bifurcated. The analysis follows the steps in Flowchart #3

Put A:

Step B1 (ASC 815-15-25-42)

Step 1: The payoff is simply par plus accrued interest. It is not adjusted based on changes in an index. Go to Step 3.

Step 3: The debt involves a discount of 14%, consequently the discount is substantial. Go to Step 4.

Step 4: The put is contingently exercisable. The put is not clearly and closely related to the debt host. Go to Step B2.

Step B2: The hybrid debt instrument is not remeasured at fair value through earnings each period. Go to Step B3.

Step B3: The embedded put option, if freestanding, would qualify as a derivative. Under ASC 815-10-15-107, the potential settlement of the debtor's obligation to the creditor that would occur upon exercise of the put option or call option meets the net criteria settlement of ASC 815.This means that the put should be bifurcated.

Conclusion: The put should be bifurcated.

Put B:

Step B1 (ASC 815-15-25-42)

Step 1: The payoff is 120% of par plus accrued interest. The payoff is not based on an index. Go to Step 3.

Step 3: The debt involves a discount of 14% and a premium of 20%, consequently both the discount and the premium are substantial. Go to Step 4.

Step 4: The put is contingently exercisable. The put is not clearly and closely related to the debt host. Go to Step B2.

Step B2: The hybrid debt instrument is not remeasured at fair value through earnings each period. Go to Step B3.

Step B3: The embedded put option, if freestanding, would qualify as a derivative. Under ASC 815-10-15-107, the potential settlement of the debtor's obligation to the creditor that would occur upon exercise of the put option or call option meets the net criteria settlement in ASC 815.This means that the put should be bifurcated.

Conclusion: The put should be bifurcated.

ELECTING THE FAIR VALUE OPTION

ASC 815-15-25 allows companies to elect to carry certain hybrid financial instruments at fair value. ASC 825-10 allows companies to elect to carry certain financial instruments at fair value.

Under 815-15-25, the election can be made for most hybrid contracts that would otherwise require bifurcation under ASC 815.[21] These hybrid contracts include both assets and liabilities, except the election cannot be taken if the derivative is embedded in the kinds of instruments described in ASC 825-10-50-8, (e.g., stock option and stock purchase plans, lease contracts, and pension plans).

The fair value election under ASC 815-15-25 and 825-10 cannot be made for financial instruments classified as equity (in full or in part), including beneficial conversion features. Therefore, we do not believe it is available for convertible preferred stock instruments classified as temporary equity (i.e., reported in the mezzanine section of the balance sheet) or as permanent equity.

The fair value election under ASC 815-15-25 and ASC 825-10 can be made only when a financial instrument is initially recorded or when certain events occur such as a business combination, significant modification of debt as defined in ASC 470-50 or another event designated in the accounting literature as requiring a financial instrument to be remeasured at fair value at the time of the event.

If a company elects the fair value option for debt, the costs of debt issuance should be recognized in current earnings and should not be deferred. That is, the company's balance sheet should only reflect the fair value of the debt, not a separate asset for the unamortized costs of issuance, once the fair value option is elected.

The main advantage of choosing the fair value option is that it is perceived to be less complex to account for an instrument in its entirety at fair value, with the unrealized changes in value reported in earnings. Without the election, the company would need to bifurcate the derivative from the host contract, mark the derivative to fair value each accounting period, and account for it separately in accordance with ASC 815. Factors to weigh against the advantage of simplicity include the inability to designate the hybrid contract as a hedging instrument, less comparability with other companies (which might differ in their application of fair values), application of significant judgment needed to estimate fair value, and additional required documentation and disclosures including the relative reliability of the fair value measurements.

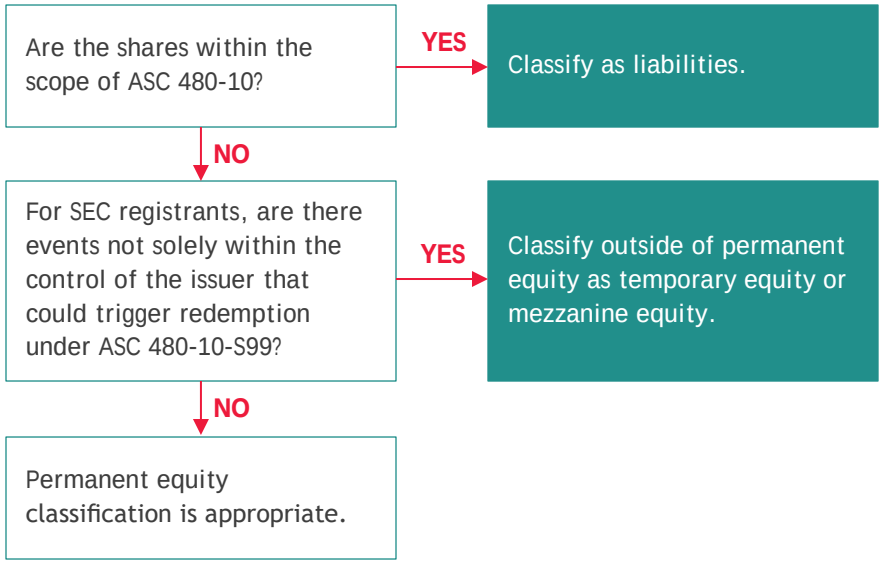
[21] ASC 815-15-25 requires an analysis to determine if an embedded feature would require bifurcation from the host contract before the fair value option can be elected.

BALANCE SHEET CLASSIFICATION OF SHARES

This section provides summary guidance for the balance sheet classification of shares.

The balance sheet classification is independent of the ASC 815-15 determination of whether a preferred share is more akin to debt or equity as discussed in Step B1.

FLOWCHART #4 – SHARES CLASSIFICATION



The SEC staff has considered whether equity instruments not in the scope of ASC 480-10 should be classified as permanent or temporary equity in accordance with ASR 268 and ASC 480-10-S99 (EITF Topic D-98). Under ASC 480-10-S99, equity securities are required to be classified outside of permanent equity in temporary equity if they are redeemable or may become redeemable for cash or other assets:[22]

- At a fixed or determinable price on a fixed or determinable date at the option of the security holder;
- Based upon the occurrence of an event that is not solely within the control of the issuer; or
- Based upon a deemed liquidation event.

[22] Although not required, we highly recommend this classification for private companies.

The SEC staff believes that securities with redemption features that are solely within the control of the issuer should be classified as part of permanent equity. The staff further noted that all of the events that could trigger redemption should be evaluated separately. That is, the possibility that any triggering event that is not solely within the control of the issuer could occur — without regard to probability — would require the security to be classified outside of permanent equity.[23] The redemption features that are not solely within the control of the issuer include:

- The failure to maintain compliance with debt covenants;
- The failure to achieve specified earnings targets; and
- A reduction in the issuer's credit rating.

Further, certain convertible preferred stock instruments are *not* redeemable for cash pursuant to their stated terms. Nonetheless, they may require temporary equity classification. For example, a perpetual preferred share may contain a conversion feature where the strike price floats based upon the current common stock price, and the conversion option is not bifurcated because it is clearly and closely related to the equity host. This results in a floating number of shares issuable upon conversion, meaning the number of shares to be issued is potentially limitless. The inability to demonstrate share settlement results in a presumption of cash settlement for an event (holder's conversion) that is outside of the company's control.

The SEC staff believes that ordinary liquidation events, which involve the redemption and liquidation of all of an entity's equity securities for cash or other assets of the entity, should not result in a security being classified outside of permanent equity. However, the staff notes that other transactions that may require redemption by the company such as the occurrence of a change-in-control that does not result in the liquidation of the company, a delisting of the company's securities from an exchange, or the violation of a debt covenant, are considered deemed liquidation events. Deemed liquidation events that require (or permit at the holder's option) the redemption of only one or more particular class of equity security for cash or other assets cause those securities to be classified outside of permanent equity in temporary equity. However, as a limited exception, a deemed liquidation event does not cause a particular class of equity instrument to be classified outside of permanent equity if all of the holders of equally and more subordinated equity instruments of the entity would always be entitled to also receive the same form of consideration (for example, cash or shares) upon the occurrence of the event that gives rise to the redemption (that is, all subordinate classes would also be entitled to redeem). We expect these situations to be infrequent.

The equity-classified components of the following instruments must be classified in temporary equity *only* in periods when the debt or other instrument associated with the component is currently redeemable:

- Convertible debt that can be settled completely or partially in cash upon conversion (ASC 470-20);
- Beneficial conversion features (ASC 470-20); or
- Conversion option embedded in convertible debt that is no longer required to be bifurcated (ASC 815-15 and ASC 470-50).

For these instruments, an assessment of the probability that the instrument will become redeemable or convertible at a future date is not relevant for classification purposes.

For the equity classified component of instruments in the above paragraph, if the instrument in which it is embedded is redeemable at the balance sheet date, the portion of the equity component presented in temporary equity is measured as the redemption or conversion amount less the current carrying amount of the liability-classified component of the convertible debt instrument. For example, if Company X's convertible debt is currently redeemable for $117, and the liability component is currently $90, the company should report its temporary equity at $27.

[23] Such events include the issuer not being able to control the actions necessary to issue the maximum number of shares that could be required to be delivered under share settlement of a contract. In such situations, the issuer should evaluate whether it controls the actions under ASC 815-40-25, and if it did not, the issuer should classify the instrument as a liability.

When a hybrid financial instrument that is not classified as an asset or liability under other applicable GAAP contains an embedded derivative, registrants should consider ASR 268 and ASC 480-10-S99 to determine whether:

- The hybrid financial instrument is required to be classified and measured as temporary equity when the embedded derivative *is not* separated under ASC 815-15, or
- The host contract is required to be classified and measured as temporary equity when the embedded derivative *is* separated under ASC 815-15.

In other words, when determining whether a hybrid instrument is within the scope of ASC 480-10-S99, the potential bifurcation of an embedded derivative from its host under ASC 815-40 is irrelevant; the hybrid instrument as a whole must be analyzed.

On another classification topic, the SEC staff believes, that although bifurcated for measurement purposes, embedded derivatives should be presented on a combined basis with the host contract. This means that if a company issued convertible debt and the conversion option was bifurcated as a derivative liability, the conversion option should be combined with the debt on the company's balance sheet. Facts and circumstances should be used to determine whether the liability is short or long-term. A freestanding warrant should be presented separately from the convertible debt. The staff observed that this presentation for conversion options is required except in circumstances where the embedded derivative is a liability and the host contract is equity.

ALLOCATION OF PROCEEDS AND JOURNAL ENTRIES

Often, convertible debt or equity securities are issued with detachable warrants to purchase the issuer's stock. In these cases, the issuer must allocate the proceeds received among the instruments issued. The method of allocation depends on whether the warrants are classified as liabilities or equity.

Through discussion with the SEC staff, we understand proceeds received in a financing transaction are allocated to the instruments issued, such as convertible debt and warrants, prior to evaluating hybrid contracts for bifurcation of embedded derivatives. If the warrants are classified as liabilities they must be recorded at fair value. If the warrants are classified as equity, they must be recorded at relative fair value. In either case, the remaining amount of the proceeds is then allocated to the convertible instrument and a debt discount is recorded to offset the amount of the proceeds allocated to the warrants.

The convertible instrument should then be analyzed to determine if there are any embedded features that require bifurcation. If so, the bifurcated features must be recorded at fair value. The amount initially allocated to the hybrid convertible instrument, less amounts attributed to the embedded derivatives that require bifurcation (if any), should be allocated to the host instrument.

If the fair value of the bifurcated embedded derivative(s) exceeds the amount originally allocated to the hybrid instrument less the warrants, issuers should reassess the valuation techniques used to develop the independent estimates of (relative) fair value and determine whether the model should be calibrated to equal the amount of cash received. If, after such a reconsideration, an excess remains, the difference may require a charge to earnings. Given the complexity of these arrangements, consultation with a subject matter expert is encouraged in these situations.

We have ignored transaction costs and taxes in the following examples.

Example 1 – Warrants are liabilities and conversion options are equity

Consider Company A that issues $1,000 of convertible debt and 1,000 detachable warrants to purchase the company's stock. Assume that the convertible debt has no embedded features that must be bifurcated, and if converted, settlement must be in shares. Additionally, assume the warrants are classified as liabilities under ASC 815-40 and have a fair value of $200.[24] Since the warrants are liabilities, they must be recorded at their fair value. The remaining value of $800 is then allocated to the convertible debt, via an offsetting discount[24] on the debt. The convertible debt does not include a beneficial conversion feature (BCF) under ASC 470-20.

Dr. Cash	$1,000	
Dr. Discount on Convertible Debt	200	
Cr. Convertible Debt		$1,000
Cr. Warrant liability		200

[24] The discount on the debt should be accreted through interest expense using the effective interest method.

Example 2 – Warrants and conversion options are liabilities

Consider Company B that issues $1,000 of convertible debt and 1,000 detachable warrants to purchase the company's stock. Assume that the convertible debt has a conversion option that must be bifurcated and classified as a liability under ASC 815-40 and has a fair value of $450. Additionally, assume the warrants are classified as liabilities under ASC 815-40 and have a fair value of $200. Since the warrants and conversion options are liabilities, they must be recorded at their fair value. The remaining value of $350 is then allocated to the debt, via an offsetting discount on the debt. Here, a BCF analysis is not required since the conversion option is bifurcated.

Dr. Cash	$1,000	
Dr. Discount on Convertible Debt	650	
Cr. Convertible Debt		$1,000
Cr. Convertible Debt (conversion option liability)		450
Cr. Warrant Liability		200

Example 3 – Warrants and conversion options are equity – No BCF

Consider Company C that issues $1,000 of convertible debt that if converted can only be settled in shares and 1,000 detachable warrants to purchase the company's stock. If the warrants are not liabilities, the proceeds are allocated based on the relative fair values of the financial instruments issued. If the warrants in this example are considered equity instruments rather than liabilities, then the accounting would be as follows.

Instrument	Fair Value	% of Total	Allocated Amount
Convertible Debt	$ 900	82%	$ 820
Warrants	200	18%	180
Total	1,100	100%	1,000

The journal entries would be the following:

Dr. Cash	$1,000	
Dr. Discount on Convertible Debt	180	
Cr. Convertible Debt		$1,000
Cr. Additional Paid in Capital (warrants)		180

The debt has a stated conversion price of $15 per share. The fair value of the common stock at issuance is $10 per share. Based on an analysis of the effective conversion price [$12.30 = ($15*$820/$1,000)], there is no beneficial conversion feature. Alternatively:

A.	Convertible debt face	$1,000
B.	Conversion price	$15 / share
C.	Shares issuable upon conversion A/B	66.67
D.	Fair value of shares	$10 / share
E.	Fair value of shares issuable C*D	$667
F.	Convertible Debt allocated proceeds	$820
G.	F>E, i.e., $820>$667	No BCF

Example 4 – Warrants and conversion options are equity – BCF

Consider Company D that issues $1,000 of convertible debt that if converted can only be settled in shares and 1,000 detachable warrants to purchase the company's stock. If the warrants are not liabilities, the proceeds are allocated based on the relative fair values of the instruments issued as in Example 3. However, the debt is convertible at $10.50 per share at issuance. The fair value of the common stock at issuance is $10 per share. Based on the effective conversion price, there is a beneficial conversion feature of $130 (see below). The journal entries would be the following:

Dr. Cash	$1,000	
Dr. Discount on Convertible Debt	310	
Cr. Convertible Debt		$1,000
Cr. Additional Paid in Capital (warrants)		180
Cr. Additional Paid in Capital (BCF)		130

A.	Convertible debt face	$1,000
B.	Conversion price	$10.50 / share
C.	Shares issuable upon conversion A/B	95
D.	Fair value of shares	$10 / share
E.	Fair value of shares issuable C*D	$950
F.	Convertible Debt allocated proceeds	$820
G.	E>F, i.e., $950>$820 BCF = $950-820 = 130	$130
H.	Warrant Discount	$180
I.	Total debt discount F+G	$310

EARNINGS PER SHARE

ASC 260-10 (*Earnings Per Share*) requires public companies and companies preparing to go public to present basic and diluted earnings per share (EPS). Basic EPS is computed by dividing reported earnings available to common stockholders by weighted average common shares outstanding. Basic EPS does not include dilution for any potentially dilutive common securities such as convertible debt or warrants. Diluted eps is computed by dividing reported earnings available to common shareholders by weighted average common shares outstanding assuming that potentially dilutive common securities are converted into common stock.

In general, diluted EPS should *not* include individual potential common stock instruments for any period in which they would have the effect of increasing the EPS amount or decreasing the loss per share amount (i.e., antidilutive securities are excluded from the EPS calculation). Convertible debt, convertible preferred stock, and warrants represent potential common stock instruments and consequently, unless antidilutive, affect the computation of diluted EPS.

The diluted EPS computation assumes that convertible debt and equity securities are converted under the if-converted method and warrants are converted using the treasury-stock method in which proceeds received are applied to purchase common stock. These methods are described in greater detail below.

CONVERTIBLE DEBT AND EQUITY SECURITIES AND THE IF-CONVERTED METHOD

Holders of convertible debt and equity securities can elect to convert the instruments into shares of the issuer's common stock. If the holder exercises his or her conversion rights, the earnings available to existing common shareholders would be diluted due to the increase in the number of common shares outstanding. ASC 260-10 requires that the potential dilutive effects be reflected on diluted EPS of convertible securities by using the if-converted method.

ASC 260-10-45-40 requires that issuers use the if-converted method of calculating diluted EPS by assuming that any convertible financial instruments have been converted into common shares at the beginning of the period (or at the time of issuance, if later). The issuer then adds the resulting common shares to the common shares in the denominator and adds back the following to the numerator for purposes of computing diluted EPS:

- Preferred dividends, declared or cumulative undeclared;
- Deemed dividends from the amortization of a beneficial conversion feature or inducement charges on convertible preferred stock;
- Accretion charged or credited to equity to accrete preferred stock classified as mezzanine equity to its cash redemption price; and/or
- The after-tax amount of interest expense including deemed interest from amortization of beneficial conversion features recognized in the period relating to debt convertible into common stock.

Certain debt instruments are convertible into a fixed number of common shares. Upon conversion, the issuer is either required or has the option to satisfy all or part of the obligation in cash, as follows:

- If, upon conversion, the issuer may satisfy the entire obligation in either stock or cash equivalent to the conversion value (Instrument B), then the instrument would be included in the computation of diluted EPS using the if-converted method if the effect is dilutive.

- If, upon conversion, the issuer must satisfy the accreted value of the obligation (the amount accrued to the benefit of the holder exclusive of the conversion spread) in cash and may satisfy the conversion spread (the excess conversion value over the accreted value) in either cash or stock (Instrument C), then the if-converted method should not be used to determine the EPS implications of this instrument. There would be no adjustment to the numerator in the EPS computation for the cash-settled portion because that portion of the instrument will always be settled in cash. The conversion spread should be included in diluted EPS based on the treasury stock guidance in paragraphs ASC 260-10-45-45 and ASC 260-10-55-32.

- If, upon conversion, the issuer may satisfy the entire obligation in any combination of cash and shares at the issuer's option (Instrument X), the facts and circumstances should be assessed following the guidance for contracts that may be settled in stock or cash in ASC 260-10-45-46. If it is reasonable to conclude settlement in cash considering the issuer's intent and past practice, the treasury-stock method should be applied to the conversion spread. If cash settlement cannot be assumed, then the if-converted method applies if dilutive.

CALCULATE EARNINGS PER SHARE – IF-CONVERTED METHOD

Facts

In 2008, R Company has 50,000 weighted average common shares outstanding during the year. During this year, the Company had a $200,000 5% note outstanding that is convertible into 10 common shares for each $1,000 note. R Company's net income for the year is $100,000 and its tax rate is 34%.

Analysis

What are R Company's basic and diluted EPS for 2008?

Basic EPS is $100,000/50,000 = $2.00/ share.

Diluted EPS is calculated as follows:

Number of if-converted shares: $200,000/$1,000*10 = 2,000

Addback to net income for interest on bonds after tax: $200,000*5 %*(1-.34) = $6,600

EPS calculation: ($100,000+$6,600)/ (50,000+2,000) = $2.05

Conclusion: Since $2.05 is greater than $2.00 (i.e., it is antidilutive), dilutive EPS is the same as basic EPS or $2.00

Facts

In 2010, R Company has 2,000,000 weighted average common shares outstanding during the year. R Company has a calendar year end. On June 30, 2010, R Company issued a $1,000,000 8% debenture that is convertible into 40 shares for each $1,000 note. During 2009, the Company issued 25,000 shares of 10% cumulative preferred stock at $5 par value. R Company declared and paid dividends on the preferred stock in 2009, and has not declared dividends in 2010. Each share of preferred stock is convertible into 10 shares of common stock. R Company earned $500,000 of net income during 2010 and its tax rate is 40%.

Analysis

What calculations are needed to compute R Company's diluted EPS for 2010?

We need to compute the dividends on the preferred stock, the number of common shares the preferred stock is convertible into, the interest expense on the convertible note, and the number of common shares the convertible note is convertible into, as follows:

a. Preferred dividends		
	25,000	Shares of preferred stock
	$5	Price
	$125,000	Face value
	x 0.10	Dividend rate
	$12,500	Dividends on preferred stock
		NOTE: Dividends not a tax deduction
b. Common shares issued upon conversion		
	25,000	Shares of preferred stock
	x 10	Conversion ratio
	250,000	Common shares

c. Convertible debt interest		
	$1,000,000	Face value of debt
	x 0.08	Interest rate
	$80,000	Interest expense before tax
	x 0.6	After tax rate (1 - .4)
	$48,000	Interest expense
	x 0.5	Pro rata for 6/30/10 issuance (.5 year)
	$24,000	Pro rated after tax interest expense
d. Convertible debt calculation of shares upon conversion		
	1,000	# of $1,000 bonds
	40	Conversion ratio
	40,000	Common shares
	0.5	Prorated for 6/30/10 issuance (.5 year)
	20,000	Weighted average common shares

What is R Company's basic and diluted EPS for 2010?

	Numerator	Denominator	EPS
Net Income / Weighted Average Common Shares	$500,000	2,000,000	
Adjustments			
Preferred dividends	$-12,500 a		
Basic EPS	**$487,500**	**2,000,000**	**$0.24**
Adjustments			
Preferred dividends	$12,500 a		
Preferred shares		250,000 b	
Conv Debt Interest	$24,000 c*		
Conv Debt Shares		20,000 d*	
Diluted EPS	**$500,000**	**2,250,000**	**$0.22**

*Antidilution must be assessed on an individual instrument basis. Since the if-converted effect of the debt would increase basic EPS, it is excluded from the calculation of diluted EPS.

EQUITY-CLASSIFIED WARRANTS AND THE TREASURY STOCK METHOD

Holders of warrants can elect to convert the equity linked instruments into shares of the issuer's common stock and generally will do so only when the average market price of the common stock during the period exceeds the exercise price of the warrant (i.e., the warrants are said to be in-the- money). Issuers are required to calculate the dilutive effect of outstanding warrants they have issued using the treasury stock method in computing dilutive EPS.

ASC 260-10-45-23 requires that under the treasury stock method:

- Exercise of warrants is assumed at the beginning of the period (or at the time of issuance, if later), and common shares are assumed to have been issued;
- Proceeds from the exercise of the warrants are assumed to be used to repurchase the issuer's common shares at their average market price during the period;
- The incremental shares calculated by the number of warrants assumed to be exercised in the first bullet less the number of common shares assumed to have been repurchased in the second bullet, are included in the denominator of the diluted EPS computation.

Companies that have issued convertible debt instruments that must satisfy the accreted value of the obligation in cash and may satisfy the conversion spread in either cash or stock (i.e., Instrument C) generally should use the treasury stock method for the conversion spread.

CALCULATE EARNINGS PER SHARE – TREASURY STOCK METHOD

Facts

In 2011, R Company has 100,000 weighted average common shares outstanding during the year. During this year, the Company had 5,000 common stock warrants outstanding with an exercise price of $5. The average market price of the common stock during the year is $10. Net income for 2011 is $50,000.

Analysis

What is R Company's basic and diluted EPS for 2011?

Basic EPS is $50,000/100,000 = $.50/share

Diluted EPS is calculated as follows:

Number of shares received upon exercise of the warrants:	5,000
Proceeds from exercise of the warrants:	$5,000*$5 = $25,000
Shares purchased with the proceeds:	$25,000/$10 = 2,500
Incremental shares from exercise of warrants:	5,000 – 2,500 = 2,500
Diluted EPS calculation:	($50,000/ (100,000+2,500)) = $.49
Conclusion:	Basic EPS is $.50 and Diluted EPS is $.49

Facts

In 2013, R Company has 2,000,000 weighted average common shares outstanding during the year. R Company has a calendar year end. On March 31, 2013, R Company issued a $2,000,000 10% debenture due in 10 years. For each $1,000 note purchased, R Company gave warrants for 5 shares of common stock at an exercise price of $10. On January 1, 2012, the Company issued 50,000 shares of 12% cumulative preferred stock at $10 par value. The preferred stock purchasers received 1 warrant with an exercise price of $8 with each preferred stock share. All these warrants are still outstanding. R Company declared and paid dividends on the preferred stock in 2012. The Company did not declare dividends on the preferred stock in 2013. R Company earned $750,000 of net income during 2013 and its tax rate is 40%. The average market price of the common stock during the year 2013 is $12; the average market price for the last three quarters of the year is $15.

Analysis

What calculations are needed to compute R Company's diluted EPS in 2013?

We need to compute the dividends on the preferred stock, the number of potential common shares associated with the preferred stock warrants, and the number of potential common shares associated with the debt warrants, as follows:

a. Preferred dividends		
	50,000	Shares of preferred stock
	$10	Price
	$500,000	Face value
	x 0.12	Dividend rate
	$60,000	Dividends on preferred stock
		NOTE: Dividends not a tax deduction

b. Warrants on debt		
	2,000	# of $1,000 bonds
	2,000* 5 = 10,000	# of warrants shares
	10,000*$10 = $100,000	Proceeds from warrant exercise
	$15	Average market price
	$100,000/$15 = 6,667	Assumed shares purchased from proceeds
	10,000 - 6,667 = 3,333	Incremental shares
	3,333*.75 = 2,500	Prorated for 3/31/13 issuance (.75 year)
c. Warrants on preferred stock		
	50,000	# of preferred shares
	50,000	# of warrants shares
	50,000*$8 = $400,000	Proceeds from warrant exercise
	$12	Average market price
	$400,000/$12 = 33,333	Assumed shares purchased from proceeds
	50,000 - 33,333 = 16,667	Incremental shares

What is R Company's basic and diluted EPS for 2013?

	Numerator	Denominator	EPS
Net Income	$750,000	2,000,000	
Adjustments			
Preferred dividends	$-60,000 a		
Basic EPS	$690,000	2,000,000	**$0.35**
Adjustments			
Warrants on debt		2,500 b	
Warrants on preferred stock		16,667 c	
Diluted EPS	$690,000	2,019,167	$0.25

Share Lending Arrangements

In accordance with ASC 260-10-45-2A, loaned shares are excluded from basic and diluted earnings per share unless default of the share-lending arrangement occurs. If dividends on loaned shares are not reimbursed, any amounts, including dividends and participation rights in undistributed earnings, attributed to the loaned shares are deducted in computing income available to common shareholders, in a manner consistent with the two-class method.[25]

Warrants With Down Round Features (After Adoption of ASU 2017-11)

In Step C1, we explained that ASU 2017-11 changed the classification analysis of certain equity-linked financial instruments, such as warrants and embedded conversion features, in that a down round feature (as defined) is now disregarded when assessing whether the instrument is indexed to an entity's own stock.

For those freestanding equity-classified financial instruments, ASU 2017-11 requires entities that present EPS to recognize the effect of the down round feature when it is triggered, i.e., when the exercise price of the related equity-linked financial instrument is adjusted downward because of the down round feature. The amount of the EPS adjustment is determined as the difference between the fair value of the instrument (without the down round feature) immediately before and after the strike price is adjusted. That amount is recorded as a dividend and as a reduction of income available to common shareholders in basic EPS. An entity may also be required to adjust its diluted EPS calculation under the treasury method.

Entities that do not report EPS will not recognize the effects of down-round features when triggered.

[25] The two-class method of determining EPS requires companies to allocate earnings to each class of common stock and securities that participate in earnings based on the rights of those securities to dividends and undistributed earnings.

WARRANTS WITH DOWN ROUND FEATURES (AFTER ADOPTION OF ASU 2017-11)

Facts

In 2016, R Company issued warrants that permit the holders to buy 1,000 shares of its common stock for $15 per share. The warrants have a 5-year term, are exercisable at any time, and contain a down round feature. R Company classifies the warrants as equity because they are indexed to the entity's own stock and meet the additional conditions necessary for equity classification in accordance with the guidance in Subtopic 815-40. R Company presents EPS in accordance with the guidance in ASC 260-10. The terms of the down round feature specify that if R Company issues additional shares of its common stock for an amount less than $15 per share or issues an equity-classified financial instrument with a strike price below $15 per share, the strike price of the warrants would be reduced to the most recent issuance price or strike price.

In 2018, R Company issues shares of its common stock at $12 per share. Because of the subsequent round of financing occurring at a share price below the strike price of the warrants, the down round feature in the warrants is triggered and the strike price of the warrants is reduced to $12 per share. The fair value of the warrants (without the down round feature) with a strike price of $15 per share immediately before the down round feature is triggered is $1,350 and the fair value of the warrants (without the down round feature) with a strike price of $12 per share immediately after the down round feature is triggered is $1,750.

R Company earned $50,000 of net income during 2018 and it has 200,000 weighted average common shares outstanding during the year. Assume that during 2018 the average market price of R Company's common stock is $13.

Analysis

The increase in the value of $400 ($1,750 - $1,350) is the value of the effect of the triggering of the down round feature. That $400 increase in value is recognized in equity as follows:

Dr. Retained Earnings	$400	
Cr. APIC		$400

R Company also should reduce income available to common shareholders in its basic EPS calculation by $400 in accordance with ASC 260-10-45-12B. In addition, R Company should apply the treasury stock method to calculate diluted EPS. Accordingly, the $400 is added back to income available to common shareholders when calculating diluted EPS.

Number of shares received upon exercise of the warrants:	1,000
Proceeds from exercise of the warrants:	$1,000*$12 = $12,000
Shares purchased with the proceeds:	$12,000/$13 = 923
Incremental shares from exercise of warrants:	1,000 – 923 = 77

Accordingly, R Company's basic and diluted EPS are calculated as follows:

	Numerator	Denominator	EPS
Net Income / Weighted Average Common Shares	$50,000	200,000	
Adjustments			
Dividend – down round feature	-$400		
Basic EPS	**$49,600**	**200,000**	**$0.25**
Adjustments			
Dividend – down round feature	$400*		
Incremental shares on exercise of warrants		77*	
Diluted EPS	$49,600	200,000	$0.25

* The treasury stock method is not applied because the effect is antidilutive.

Liability-Classified Warrants and the Treasury Stock Method

Under U.S. GAAP, net-cash settlement may be assumed if a contract requires settlement through the delivery of registered shares because that action is not controlled by the issuing company (ASC 815-40-25-10). In such situations the contract would typically be accounted for as a liability and marked to fair value through earnings each period. Similarly, an instrument would not be considered indexed to an entity's stock if its settlement amount is affected by variables that are extraneous to the pricing of a fixed-for-fixed option or forward contract on equity shares (ASC 815-40-15-7F). That warrant would fail the first part of the scope exception in paragraph 815-10-15-74 and would be required to be accounted for as a derivative liability and marked to fair value through earnings each period.

Changes in the fair value of such an instrument can cause significant fluctuations in a company's earnings, which must be considered when calculating diluted EPS. However, ASC 260 does not clearly address these types of contracts.

The following EPS guidance addresses such liability-classified equity-linked contracts for both interim and year-to-date periods. It does not apply to (a) contracts that require the entity to repurchase its own stock (e.g., written put options and forward purchase contracts other than forward purchase contracts accounted for under ASC 480) and (b) options held by the entity on its own stock (e.g., purchased put options and purchased call options). Both of these types of contracts are specifically addressed in paragraphs 260-10-45-35 through 45-37.

The views expressed in this section reflect discussions with members of the staff of both the FASB and SEC.

Accounting Considerations: Interim Periods

Generally, a reporting entity should incorporate liability-classified equity-linked contracts in the computation of diluted EPS via the treasury stock method in the following manner:

- The treasury stock method should be applied on a contract-by-contract basis and only to contracts that are in the money. As stated in 260-10-45-25 "warrants will have a dilutive effect under the treasury stock method only when the average market price of the common stock during the period exceeds the exercise price of the warrants (they are in the money)." This is consistent with the belief that the treasury stock method was only intended to capture instruments that a holder might actually convert into common shares.
- The treasury stock method should be considered regardless of whether a company has income or loss from continuing operations or whether the fair value change is a gain or a loss. The treasury stock impact may be dilutive under either scenario.

- Adjustments to the numerator – not only the denominator - should be considered when determining whether the effect of applying the treasury stock method is dilutive. That is, the EPS numerator should be adjusted for the reversal of any associated gain or loss. This is consistent with the chart in paragraph 260-10-55-36A which indicates that adjustments are required to both the numerator and the denominator when share settlement is assumed for EPS purposes and liability accounting is applied for book purposes:

Assumed settlement for EPS purposes	Accounting for book purposes	Adjustment required to book earnings (numerator) for purposes of computing diluted EPS?	Adjustment required to number of shares included in denominator?
Shares	Asset / Liability	Yes	Yes

In this context, it is not acceptable to assert a reporting entity should not make any adjustments to the numerator or denominator for such contracts if the entity reports a loss from continuing operations. This is based on a literal interpretation of paragraph 260-10-45-19 which states:

> …including potential common shares in the denominator of a diluted per share computation for continuing operations always will result in an antidilutive per share amount when an entity has a loss from continuing operations … no potential common shares shall be included in the computation of any diluted per share amount when a loss from continuing operations exists.

The underlying principle for diluted earnings per share is to reflect the "maximum potential dilution (260-10-45-18)." The guidance in paragraph 45-19 did not consider the types of instruments addressed here and a literal application would result in a less dilutive and inappropriate EPS calculation.

Accounting Considerations: Year-to-Date Periods

We believe there are two acceptable views for calculating YTD diluted EPS for liability-classified equity linked contracts:

View 1: Apply the YTD calculation guidance in ASC 260-10-55-3, which determines the number of incremental shares in the denominator based on the weighted average of incremental shares that were included in each quarterly diluted EPS calculation. As noted in ASC 260-10-55-87 in which year-to-date income exists (Case B), zero incremental shares are added to the denominator for any quarters in which the options were out of the money or antidilutive. The YTD numerator adjustment would correspond to the individual quarters included in the denominator calculation. So in an annual YTD calculation if warrant was dilutive only in Q1 and Q3, the YTD numerator adjustment would be based on those two quarters.

View 2: Apply the guidance in ASC 260-10-55-34. This suggests an independent assessment for the YTD period is made using the average share price for that period, e.g., 12 months. However, the number of shares repurchased would depend on the average stock price in the year to date period. Further, there is no concept of weighting individual quarters because paragraph 55-34 requires an independent calculation for the year-to-date period. If a contract is out of the money for the year to date period, diluted EPS would equal basic EPS.

Examples

The examples present the calculation of diluted EPS in interim periods (e.g., one quarter), followed by the calculation of diluted EPS for the YTD period (e.g., 12 months) using the same factual assumptions.

Diluted EPS Examples

(The effect of income taxes has been ignored for simplicity)

- Quarter 1: A company has basic earnings per share of $1.00 based on income from continuing operations of $100,000 and 100,000 weighted average common shares outstanding. The company has 40,000 warrants outstanding (all with identical terms) that are classified as liabilities, which are in the money. They equate to 10,000 incremental shares under the treasury stock method (i.e., the difference between the number of shares assumed issued and the number of shares assumed purchased with proceeds received from the exercise of the warrants) and their fair value has decreased during the period by $5,000, creating a gain for book purposes.
- Quarter 2: The fact pattern is the same as Q1 with one exception. The warrants are not in the money. As such, the $5,000 gain is not considered because a rational investor would not exercise the warrants.
- Quarter 3: The fact pattern is the same as Q1 with one exception. The warrants' fair value has increased during the period by $8,000, creating a loss for book purposes.
- Quarter 4: The fact pattern is the same as Q3 with one exception. The warrants' fair value has increased by $15,000, creating a loss for book purposes.

The diluted EPS calculation for each quarter would be as follows:

	Q1	Q2	Q3	Q4
Numerator				
Basic income (loss)	$ 100,000	$ 100,000	$ 100,000	$ 100,000
Reversal of gain/loss	(5,000)	-	8,000	15,000
EPS numerator	95,000	100,000	108,000	115,000
Denominator				
Weighted average shares	100,000	100,000	100,000	100,000
Incremental shares	10,000	-	10,000	10,000
Adjusted shares	110,000	100,000	110,000	110,000
Antidilutive?	$ 0.86	$ 1.00	$ 0.98	$ 1.05
Basic EPS	$ 1.00	$ 1.00	$ 1.00	$ 1.00
Diluted EPS, per FS	$ 0.86	$ 1.00	$ 0.98	$ 1.00

Diluted EPS for the annual YTD period is shown for both acceptable approaches. For purposes of View 2, two different scenarios are presented: the first in which the warrants are assumed to be in the money for the YTD annual period; the second in which the warrants are assumed to be out of the money for the YTD annual period:

	View 1	View 2 (In the $)	View 2 (Out of the $)
Numerator			
Basic income	$ 400,000	$ 400,000	$ 400,000
Reversal of gain/loss	3,000	13,000	-
EPS numerator	403,000	413,000	400,000
Denominator			
Weighted average shares	100,000	100,000	100,000
Incremental shares	5,000	10,000	-
Adjusted shares	105,000	110,000	100,000
Antidilutive?	$ 3.84	$ 3.75	$ 4.00
Basic EPS	$ 4.00	$ 4.00	$ 4.00
Diluted EPS, per FS	$ 3.84	$ 3.75	$ 4.00

Notes

View 1:

The denominator adjustment is 5,000 shares [(10,000 + 0 + 10,000 + 0)/4]. The shares for Q2 and Q4 were excluded from the denominator adjustment because they were antidilutive in those quarterly periods. The numerator adjustment is based on the quarters for which a denominator adjustment was made. As such, the year to date numerator adjustment is a loss of $3,000: $5,000 +$0 -$8,000 - $0.

View 2:

In the money – An independent calculation of diluted EPS for the year-to-date period requires a numerator adjustment equal to the cumulative adjustment of the warrant contract for the period, or $13,000: $5,000 + $5,000 - $8,000 - $15,000. The denominator adjustment assumes the contract is outstanding for the entire period, i.e., 10,000 incremental shares (the annual average stock price is assumed to result in 10,000 incremental shares for simplicity).

Out of the money - basic and diluted EPS are the same because the warrant is out of the money in the year to date period.

DEFERRED INCOME TAXES

CONVERTIBLE DEBT

ASC 740-10-55 observes that "the recognition of a beneficial conversion feature effectively creates two separate instruments—a debt instrument and an equity instrument—for financial statement purposes while it is accounted for as a debt instrument under the US Federal Income Tax Code. Consequently, the book basis in the debt instrument is different from the tax basis of the debt instrument." That basis difference has a future tax consequence because if the debt were settled at its book basis, the company would have taxable income (discharge of indebtedness gain). In accordance with ASC 740-10, the company is required to record a deferred tax liability equal to the basis difference multiplied by the appropriate tax rate. Additionally, in ASC 740-10-55-51, the EITF determined that the effect of the initial deferred tax liability should be charged to equity (rather than provision for income taxes or a deferred debit) in accordance with ASC 740-20-45-11(c). Similar entries should be recorded in the context of a convertible debt instrument for which the liability and the embedded conversion options (i.e., the equity component) are separately accounted for under ASC 470-20.

We believe that a bifurcated conversion feature treated as a derivative liability under ASC 815, together with the host contract, similarly requires the recognition of deferred taxes. At the instrument's inception, the combined book basis of the host contract and any bifurcated derivatives may equal the tax basis of the convertible debt. However, as the derivative instrument(s) is(are) adjusted to fair value each period, the combined book basis will likely differ from the instrument's tax basis (the proceeds received, as adjusted for amortization each period). The company is required to record a deferred tax asset or liability equal to the basis difference multiplied by the applicable tax rate, with an offset to deferred tax benefit or expense. To the extent the combined book basis exceeds tax basis, a deferred tax asset would be recorded. To the extent the combined book basis is less than tax basis, a deferred tax liability would be recorded.

CONVERTIBLE PREFERRED STOCK

Convertible preferred stock generally does not raise deferred tax issues. Because preferred stock is legally an equity security, generally there would be no income tax consequence to a settlement of the preferred stock at its carrying amount. Therefore, even if convertible preferred stock were classified as a liability under GAAP because of mandatory redemption features, the basis difference between GAAP and tax would not have future tax consequences and there would be no provision of deferred taxes.

DEBT ISSUE COSTS, DEBT DISCOUNT OR PREMIUM, AND PREFERRED STOCK DISCOUNTS

DEBT ISSUE COSTS

Debt issue costs include accounting and legal fees related to the financing, printing costs of the document, commissions, investment banking fees and expenses, underwriting fees, original issue taxes, registration and listing fees, and other third-party expenses paid to advisors that are directly associated with the issuance of the debt. Under ASC 835-30-45-1A, debt issue costs should be reported in the balance sheet as a direct deduction from the face amount of that note (they cannot be classified as a deferred charge).

Debt issue costs should be amortized using the effective interest method, and the issuer's amortization policy should be supported and documented. Generally, the period for amortization follows:

- Debt that is not puttable or callable – over the contractual life of the debt.
- Debt that is puttable by the holder – to the first put date.
- Debt that is callable by the issuer – over the contractual life or to the estimated call date.
- Debt that is contingently callable – same as callable debt.
- Debt that is convertible (outside the scope of ASC 470-20-35-13) – before the conversion, over the contractual life.
- Debt that is contingently convertible, and upon conversion, the issuer must satisfy the accreted value of the obligation in cash and may satisfy the conversion spread in either cash or stock (Instrument C, within the scope of ASC 470-20-35-13) – over the expected life, as discussed on page 52.

DEBT DISCOUNT OR PREMIUM

Debt discounts or premiums are paid by the debtor to the creditor or received by the debtor from the creditor as part of the debt issuance. Debt discounts can result from freestanding and embedded features such as warrants accounted for as stockholders' equity, warrants accounted for as liabilities, beneficial conversion features (BCFs), bifurcated conversion options, and bifurcated put options.

ASC 470-20 and ASC 835-30-25 require that the debt discount or premium be reported as a direct reduction from or addition to the face amount of the debt (they cannot be classified as a deferred charge or deferred credit). Under ASC 835-30-35, debt discounts or premiums should be amortized using the effective interest method. The issuer's amortization policy should be supported and documented. The period for amortization is the same as the periods noted for the debt issue costs above.

ASC 470-20-25-13 notes that it is not practicable to discuss all possible types of debt instruments with conversion features, debt instruments issued with stock purchase warrants, or debt instruments with a combination of such features. The standard requires that instruments that are not explicitly discussed should be accounted for in accordance with the substance of the transaction. When convertible debt is issued at a substantial premium, the standard states that there is a presumption that such premium represents additional paid-in capital.

ASC 470-20-35-7 provides guidance on the amortization of BCFs and distinguishes between:

- Convertible debt instruments and convertible preferred stocks that have stated redemption dates – BCFs for these instruments should be amortized using the effective interest method over the period from the issue date to the stated redemption date.
- Convertible debt instruments and convertible preferred stocks that do not have stated redemption dates – BCFs for these instruments should be amortized using the effective interest method over the period from the issue date to the first conversion date, which may be inception.

ASC 470-20-35-7 requires that convertible instruments with a stated redemption date that have a discount resulting from a BCF, accrete the discount from the issuance date to the stated redemption date of the convertible instrument. This is the case even if the earliest conversion date is prior to the redemption date. For convertible instruments with a stated redemption date and a put feature that enables the holder to put the debt to the issuer prior to the redemption date, the issuer should amortize the discount through the first put date.

For example, R Company issues debt on January 1, 2010, with a due date of December 31, 2019, with a face amount of $200 million and receives proceeds upon issuance of $180 million. The debt is puttable by the holder at the face amount after 7 years. R Company paid $1 million in debt issue costs that are recorded on the balance sheet as a direct deduction from the face amount of that note. R Company should amortize the debt discount and debt issue costs over 7 years through the first put date.

PREFERRED STOCK DISCOUNTS AND ACCRETION TO REDEMPTION VALUE

Increasing rate preferred stock is nonredeemable, cumulative preferred stock that initially bears a below-market dividend rate (if it carries any dividend rate at all). Over time, the dividend rate increases to approximate a market rate of return from the date of issuance of the stock. In ASC 505-10-S99 (SAB Topic 5Q), the SEC staff observed that when the consideration received for preferred stock reflects expectations of future dividends, any discount due to the gradually increasing dividends for an initial period represents prepaid, unstated dividend costs. The staff's position is that discounts on increasing-rate preferred stock should be amortized over the periods before the dividends commence by charging imputed dividend cost against retained earnings.[26] The carrying amount of the preferred stock should be increased by a corresponding amount.

Mandatorily redeemable preferred shares should be reported at redemption value no later than the date they become redeemable by the holder. Instruments that are currently redeemable should be adjusted to their redemption amount at each balance sheet date. If the instrument is not currently redeemable, adjustment to the redemption amount is not necessary until the redemption is probable. Once it is probable that the instrument will become redeemable, then the issuer should accrete the security to its redemption value over the period from the date of issuance (or the date redemption becomes probable) to the earliest redemption date using the effective interest method. Alternatively, the company can recognize the security at its redemption amount immediately. The accretion represents an imputed dividend cost that should be charged against retained earnings.

[26] If the accretion is material, the company should disclose income applicable to common shareholders separately on the face of the income statement.

CONVERSION ACCOUNTING AND CHANGES IN CONVERSION OPTION ACCOUNTING AFTER ISSUANCE

CONVERSION ACCOUNTING

Accounting for conversions depends on the accounting for the conversion feature (i.e., bifurcated, not bifurcated):

- Conversion option not bifurcated without a BCF – the carrying amount of the debt, including unamortized debt discount or premium and debt issue costs, is credited to the capital accounts upon conversion to reflect the stock issued. There is no gain or loss on the transaction based on ASC 470-20-40.
- Conversion option not bifurcated with a BCF – at the conversion date, unamortized discounts and premiums and debt issue costs associated with the debt, such as for BCFs, warrants, and bifurcated derivatives, are expensed to interest based on ASC 470-20-40. The carrying amount of the debt after the interest expense has been recorded is credited to the capital account.
- Convertible option within the scope of the cash conversion guidance – account for conversions into common stock or extinguishments as settlements in which the liability component is extinguished and the equity component is reacquired. See Step D above on page 53.
- Conversion option bifurcated from debt instrument – when the conversion features have been bifurcated from the convertible debt host and accounted for as liabilities, no equity conversion feature remains in the debt instrument. The liabilities for the debt and the conversion feature are extinguished in exchange for common shares, and the difference between the carrying amount of the liabilities and the fair value of the shares should be recorded as gain or loss.

ACCOUNTING FOR PREVIOUSLY BIFURCATED CONVERSION OPTIONS

For certain convertible instruments, the accounting for the embedded conversion option changes over time. At issuance, the company may be required to bifurcate the conversion option and account for it separately from the host contract as a liability. After issuance, the company's circumstances may change such that bifurcation and liability accounting are no longer required. Under ASC 815-15-35-4, at the time the company can account for the conversion option in stockholders' equity, the company should remove the conversion option from liabilities at fair value on that date, and increase stockholders' equity by this same amount.

When the company reclassifies the conversion option from liabilities to stockholders' equity, the unamortized discount or premium remaining from issuance of the convertible debt should continue to be amortized as should debt issuance costs. If a holder exercises a conversion option that was previously reclassified from liabilities to stockholders' equity, the issuer should recognize as interest expense any unamortized discount remaining at the date of conversion. If a debt instrument with a conversion option that had been reclassified from liabilities to stockholders' equity is extinguished for cash prior to its maturity date, cash paid equal to the fair value of the conversion option at the date of extinguishment should be debited to equity. The issuer should allocate the remaining reacquisition price to the extinguishment of the debt instrument to determine the gain or loss on the transaction.

For other convertible instruments, the company might not be required to bifurcate the conversion option at issuance, and circumstances later change resulting in bifurcation and liability accounting being required. We believe that the following accounting is appropriate.

- Instrument issued without warrants without a BCF – When the change in the accounting for the conversion option occurs, the issuer should record a derivative liability at the fair value of the conversion option on the date of the change with an offsetting discount that should be amortized over the remaining life of the debt.
- Instrument issued with warrants – When the change in the accounting for the conversion option occurs, the issuer should record a derivative liability for the fair value of the conversion option on the date of the change with an offsetting discount that should be amortized over the remaining life of the debt. The discount associated with the warrant should continue to be amortized.
- Instrument issued with a BCF – When the change in the accounting for the conversion option occurs, the issuer should record the derivative liability by either:
    - Relieving APIC for the original amount of the intrinsic value of the BCF, recording a discount to the debt for the difference between the fair value of the derivative liability at the date of the change and the intrinsic value, and crediting the derivative liability for the fair value of the conversion option at the date of the change; or
    - Relieving APIC for the fair value of the conversion option at the date of the change and crediting the derivative liability for the same amount.

ANALYZE PREVIOUSLY BIFURCATED CONVERTIBLE DEBT

Facts

On January 10, 2008, R Company issued ten-year convertible debt of $1 million with an 8% coupon, immediately convertible into 10,000 shares of common stock at $100/share with no price resets. There is no BCF as the price of the Company's stock at issuance date was $100/share. The Company has a call option on the debt that is exercisable any time during the life of the debt and that does not require bifurcation. At issuance, the Company did not have an adequate number of authorized shares to satisfy the conversion option in its publicly traded shares. Although the conversion option met all other ASC 815-40 requirements to be classified in stockholders' equity, R Company was required to account for the conversion option as a liability separate from the debt. The conversion option was valued at $75,000 at the date of issuance. On June 6, 2008, R Company authorized sufficient shares to satisfy the conversion option, and concluded that liability accounting was no longer required. The fair value of the conversion option on June 6 was $100,000.

Analysis

What is R Company's accounting for the conversion option when it changed the authorized number of shares?

The Company:

1. Accounted for the change in the fair value of the conversion option at June 6, a charge of $25,000.
2. Decreased the liability for the conversion option for $100,000 and increased APIC by $100,000.
3. Continued to amortize the debt discount of $75,000 over the life of the debt.
4. Made the following entries:

Dr Change in derivative liability (expense)	$25,000
Dr Derivative liability	$75,000
Cr APIC	$100,000

What is R Company's accounting if at January 10, 2009, holders convert $500,000 of debt into 5,000 shares of stock?

The Company:

1. Calculated the unamortized debt discount as $70,105.
2. Expensed the unamortized discount associated with the converted principal, or $35,053
3. Made the following entries:

Dr Interest expense	$35,053
Dr Debt	$464,947
Cr Common stock ($1 par)	$5,000
Cr APIC	$495,000

What is R Company's accounting if at January 10, 2009, the Company extinguishes all of the debt for $1 million of cash? At January 10, 2009, the conversion options have a fair value of $125,000.

The Company:

1. Calculated the unamortized debt discount as $70,105 and expensed it.
2. Allocated cash equal to the fair value of the conversion option, $125,000, to stockholder's equity
3. Allocated the remainder to debt, $929,895, and calculated the amount of the gain on extinguishment.
4. Made the following entries:

Dr Interest expense	$70,105
Dr APIC	$125,000
Dr Debt	$929,895
Cr Cash	$1,000,000
Cr Gain on debt	$125,000

TROUBLED DEBT RESTRUCTURING, DEBT MODIFICATION AND EXTINGUISHMENT

Only after the debtor has determined that the change in the debt does not represent a troubled debt restructuring should the debtor assess the change for debt modification and extinguishment accounting. Since the accounting for troubled debt restructuring, debt modification and debt extinguishments are different, it is important for the company to determine what type of change has occurred.

TROUBLED DEBT RESTRUCTURING

When debt is restructured, the issuer should first assess whether the change represents a troubled debt restructuring under ASC 470-60. The two key features of a troubled debt restructuring are that the debtor is experiencing financial difficulties and the creditor has provided concessions associated with the economic situation of the debtor.

All of the following factors are indicators that the debtor is experiencing financial difficulties:

- The debtor is currently in default on any of its debt;
- The debtor is the process of or has declared bankruptcy;
- There is significant doubt about the debtor continuing as a going concern;
- The debtor has securities that have been delisted, are in the process of being delisted, or are under threat of being delisted from an exchange;
- The debtor forecasts that its cash flows will be insufficient to service the existing debt (principal and interest); and
- The debtor does not have access to any other funds to service its debt.

The debtor is not considered to be experiencing financial difficulties if the company is both currently servicing its old debt and can obtain funds (at a rate equal to the current market interest rate for nontroubled debtors from other creditors) *and* the creditor agrees to restructure the debt solely to reflect decreases in market interest rates or improvement of creditworthiness of the debtor.

A creditor has granted a concession if the debtor's effective borrowing rate on the new debt is less than the effective borrowing rate of the old debt immediately prior to the restructuring. The effective rate is the rate that equates all the cash flows in the restructured debt to the carrying amount of the old debt.

A troubled debt restructuring may include, but is not necessarily limited to, one or a combination of the following:

- Transfer of assets or issuance of equity interest to payoff a portion or all of its debt;
- Modification of terms of the debt such as
    - Absolute or contingent reduction of the stated interest rate;
    - Extension of the maturity date or dates at a stated interest rate lower than the current market rate for new debt with similar risk;
    - Absolute or contingent reduction of the face amount or maturity amount of the debt; and/or
    - Absolute or contingent reduction of accrued interest.

If the debtor transfers assets to the creditor to payoff the debt in-whole or in-part, the company should account for both the gain representing the difference between the carrying amount and fair value of the assets *and* any gain on settlement of the debt. For example, if a company transfers a building with a net book value of $1,500,000 and a fair value of $2,000,000 to a creditor in full settlement of a $2,200,000 debt obligation, the company records a gain of $200,000 for the difference between the fair value of the building and the carrying amount of the debt. The company also recognizes a gain on disposition of $500,000 for the difference between the net book value of the building and its fair value. If the debtor issues equity interests to settle the debt, the company should account for the equity interests at fair value. The difference between the carrying amount of the debt settled and the fair value of the equity interests should be recognized as a gain.

The debtor in a troubled debt restructuring that involves only a modification of the terms of the debt should:

- If the future cash flows are greater than the carrying amount of the debt – account for the change in the debt prospectively, using the effective interest rate that equates the carrying amount to the future cash flows.
- If the future cash flows are less than the carrying amount of the debt:
    - Reduce the carrying amount to the total of future cash payments;
    - Record the reduction as a gain; and
    - Reduce the carrying amount of the note as each cash payment is paid and recognize no interest expense.

If the debt restructuring consists of the transfer of assets, the issuance of equity, and modification of terms, the company should first reduce the debt by the fair value of the assets and equity transferred. The company should account for the gain representing the difference between the carrying amount and fair value of the assets, the fair value of the assets and the partial debt settled, and the fair value of the equity and the partial debt settled. The modification of the terms should be accounted for as noted in the above paragraph.

For example, R Company has debt with a carrying amount of $5,000. After negotiations with the creditor, R Company will have debt with a face amount of $3,000, due in 10 years, with simple interest of 5% due annually. The future cash flows on the restructured debt total $4,500 ($3,000 of principal plus $1,500 interest ($150 per year for 10 years)). R Company will record a gain of $500 and reduce the carrying amount of the debt to $4,500. When R Company makes payments on the debt in the future, it will reduce the carrying amount of the debt and will not record any further interest expense on the debt.

S Company has debt with a carrying amount of $2,000. After negotiations with the creditor, S Company will have debt with a face amount of $1,500, due in ten years, with simple interest of 5% due annually. The future cash flows on the restructured debt total $2,250 ($1,500 of principal plus $750 interest ($75 per year for 10 years). S Company will not record a gain, and determines the interest expense by equating the future cash flows to equal a present value of $2,000.

DEBT MODIFICATION OR EXTINGUISHMENT

Debt modification or extinguishment accounting only applies to changes that occur in the terms of a single debtor-creditor relationship. If the creditor is different before and after the change, the change will generally meet the criteria for a debt extinguishment. If the debtor-creditor relationship is the same after the change in the debt, then the issuer should analyze the change based on the guidance in ASC 470-50.

ASC 470-50-40-10 establishes the criteria for debt extinguishment and modification. If the debt is substantially different, then the debt is extinguished, and a gain or loss is calculated and recorded. Substantially different is defined by the following three tests:

1. Ten percent or more difference in cash flows – The present value of the cash flow under the terms of the new debt instrument is at least 10% different from the present value of the remaining cash flows under the terms of the original instrument.
2. Embedded conversion option difference is 10% or more – The change in the fair value of the embedded conversion option (calculated as the difference between the fair value of the embedded conversion option immediately before and after the modification or exchange) is at least 10% of the carrying amount of the original debt instrument immediately prior to the modification or exchange; or
3. There is the addition or elimination of a substantive conversion option – A modification or an exchange of debt instruments that adds a substantive conversion option or eliminates a conversion option that was substantive at the date of the modification or exchange.

A substantive conversion option is defined in ASC 470-20-40-7 as a conversion feature that is reasonably possible of being exercisable in the future.

Reasonably possible is defined by reference to ASC 450-20. For purposes of determining whether a conversion feature is reasonably possible of being exercised, the holder's intent does not need to be considered.

If a company adds a substantive conversion option to a debt instrument, the difference is substantial and the change in debt should be accounted for as an extinguishment without the need to perform tests 1 and 2. If a company is required to perform the 10% test, ASC 470-50-40 provided the following guidance to be used to calculate the present value of cash flows for purposes of applying the test:

- The discount rate to be used to calculate the present value of the cash flows is the effective interest rate, for accounting purposes, of the original debt instrument.
- The cash flows of the new debt instrument include all cash flows specified by the terms of the new debt instrument plus any amounts paid by the debtor to the creditor less any amounts received by the debtor from the creditor as part of the exchange or modification (i.e., the change in the amount of the borrowing).
- If the original debt instrument and/or the new debt instrument has a floating interest rate, then the variable rate in effect at the date of the exchange or modification is to be used to calculate the cash flows of the variable-rate instrument.
- If either the new debt instrument or the original debt instrument is callable or puttable, then separate cash flow analyses are to be performed assuming exercise and nonexercise of the call or put. The cash flow assumptions that generate the smaller change would be the basis for determining whether the 10% threshold is met.
- If the debt instruments contain contingent payment terms or unusual interest rate terms, judgment should be used to determine the appropriate cash flows.
- If within a year of the current transaction the debt has been exchanged or modified without being deemed to be substantially different, then the debt terms that existed a year ago should be used to determine whether the current exchange or modification is substantially different.

The debtor should include in the analysis changes in the cash flow due to changes in the debt principal, interest rates, and or maturity dates. The analysis should also include fees paid to change debt recourse features, priority of the debt, collateral, covenants, waivers, guarantees, and option features. If the debtor or creditor pays noncash fees for the debt modification in stock, warrants, or other assets, these fees should be included in the analysis at fair value as a day one cash outflow or inflow.

If the debt modification includes a change in the principal amount, then the change in principal should be included as a day-1 cash inflow (for an increase in principal) or cash outflow (for a decrease in principal) for the new debt.

The debt modification analysis differs for loan participations and loan syndications. In a loan participation, a single lead creditor makes a loan to the debtor and then transfers participation interests in the loan to other creditors. A debtor company need only perform a single cash flow analysis for a loan participation because from the company's perspective there is only one creditor. In a loan syndication, the debtor has a credit relationship with each member of the syndicate. As a result, the debtor would need to perform a cash flow analysis for each creditor in the loan syndicate in a debt modification analysis.

The steps to analyze a change in debt follow:

1. Determine the terms of the original debt (old debt) and the restructured debt (new debt).
2. Calculate the effective interest rate of the old debt, including interest payments at the stated rate of the debt, debt issuance costs, and origination fees paid to (or received from) the lender.
3. Determine the present value of the remaining cash flows of the old debt and the present value of the cash flows of the restructured terms of the new debt using the effective interest rate of the old debt for both calculations.
4. Calculate the percentage difference of the present values of the remaining cash flows of the old debt and the cash flows of the restructured terms of the new debt.
5. Conclude on whether the change in the debt is an extinguishment or a modification. If it is a modification, calculate the effective rate of the new debt.
6. Account for the fees associated with the new debt.

   If the change in debt is an extinguishment,

   a. The fees paid to or received from the creditor are included in determining the gain or loss.
   b. The fees paid to third parties including lawyers and accountants are amortized over the term of the new debt using the effective interest method.

   If the change in debt is a modification,

   a. The fees paid to or received from the creditor are amortized as an adjustment of interest expense over the remaining term of the restructured debt along with any existing unamortized premium or discount using the effective interest method.
   b. The fees paid to third parties are expensed as incurred.

ANALYZE A DEBT MODIFICATION

Facts

DeepPockets LLP lends $750,000 to R Company on January 1, 2005. The debt is due on December 31, 2009 - it is issued at par, the coupon rate is 8%, the origination fee paid to the lender is 4% of the face amount of the debt or $30,000. Other debt issuance costs for lawyers and accountants amounted to $30,000.

Dr Cash	$750,000
Dr Debt discount	$30,000
Dr Debt issue costs	$30,000
Cr Debt	$750,000
Cr Cash	$30,000
Cr Cash	$30,000

On January 1, 2008, R Company borrowed an additional $375,000 from DeepPockets as it needed greater liquidity to finish developing and begin marketing a new product. DeepPockets agreed to extend the due date of the original and new debt by three years to December 31, 2012, and maintain the interest rate. In return, R Company provided warrants to DeepPockets for 20,000 shares of its common stock (with a fair value of $45,790) that expire on December 31, 2017.

Dr Cash	$375,000
Dr Debt discount	$45,790
Cr Debt	$375,000
Cr Warrant liability	$45,790

Analysis

Is R Company's change in debt a modification or extinguishment?

Step 1: R Company analyzes the terms of the original (the old) and the restructured (the new) debt.

Principal	Origination Date	Due Date	Interest	Origination Fee	Other Debt Issuance Costs
Original					
$750,000	1/1/05	12/31/09	8%	$30,000 4%	$30,000
As Modified					
$1,125,000	1/1/08	12/31/12	8%	$45,790	
(+375,000)		(+3 years)		10 year warrant for 20,000 shares	

Step 2: The Company calculates the effective yield on the old debt based on the cash flows associated with the terms of the original debt.

1/1/05	12/31/05	12/31/06	12/31/07	12/31/08	12/31/09
(690,000)*	60,000	60,000	60,000	60,000	810,000
*Original Debt Principal – Origination Fees – Other Debt Issuance Costs = 1/1/05 amount **** 750,000 - 30,000 - 30,000 = 690,000***					
Effective Yield = 10.12%					

Step 3: R Company calculates the present value of the remaining cash flows of the old debt and the present value of the cash flows of the new debt using the effective interest rate of the original debt.

Present Value at 10.12%	**1/1/08**	**12/31/08**	**12/31/09**	**12/31/10**	**12/31/11**	**12/31/12**
Original Terms						
722,449		$60,000	$810,000			
Restructured Terms						
705,656	$(329,210)*	$90,000	$90,000	$90,000	$90,000	$1,215,000
*Incremental debt – fees to lender = amount of new debt at the date it was restructured * 375,000 – 45,790 = 329,210						

Step 4: R Company calculates the percentage difference of the present values of the remaining cash flows of the old debt and the cash flows of the restructured terms of the new debt.

722,449
Divided by = 102%
705,656

Step 5: R Company concludes that the new debt represents a modification rather than an extinguishment as the difference is less than 10% (i.e., it is between 110% and 90%).

The new debt represents a modification.

Step 6: R Company calculates the effective yield of the modified debt.

1/1/08	12/31/08	12/31/09	12/31/10	12/31/11	12/31/12
What is the effective yield?					
$1,051,778*	$90,000	$90,000	$90,000	$90,000	$1,215,000
*Original Debt Principal – Unamortized Fees + New Borrowing – Fees on New Borrowings *750,000 – 27,432 + 375,000 – 45,790 = 1,051,778					
Effective Yield = 9.70%					

Step 7: R Company accounts for the fee paid to the creditor at the time of restructuring of the debt as a modification. Consequently, R Company amortizes the $45,790 together with the existing unamortized discount of $27,432 as an adjustment of interest expense over the remaining term of the new debt using the effective interest method. R Company's annual amortization of the unamortized and new fees is summarized in the table below.

	1/1/08	12/31/08	12/31/09	12/31/10	12/31/11	12/31/12	Total
Unamortized fees from old debt	$27,432						
Fees from new debt	$45,790						
Total	$73,222						
Annual amortization		$12,022	$13,188	$14,468	$15,872	$17,672	$73,222

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