

Memo No. **14****Memo**Issue Date **September 16, 2016**Meeting Date(s) **PCC Meeting September 30, 2016**

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Project	Liabilities & Equity—Targeted Improvements		
Project Stage	Initial Deliberations		
Issue(s)	Potential Private Company Alternative for Accounting for Financial Instruments with Down Round Features		

Purpose of This Memo

1. The purpose of this memo is to analyze a potential private company alternative for accounting for financial instruments with down round features as requested by the Private Company Council (PCC) at its July 19, 2016 meeting. PCC members recommended that the FASB staff perform research on a private company alternative as one of the alternatives the Board considers within this project. PCC members also requested that the staff provide the PCC with an update on the research associated with the alternative before the Board has any more discussion on this topic. This memo includes the staff's analysis on that suggested alternative as well as analysis of other options for moving the project forward.
2. This memo includes the following sections:
 - (a) Accounting Issues Associated with Financial Instruments with Down Round Features
 - (b) Project Overview

- (c) Background—Current GAAP Related to Financial Instruments with Down Round Features
 - (d) Private Company Alternative
 - (e) Other Potential Paths Forward
 - (f) Questions for Discussion.
3. The following Appendixes are included with this memo:
- (a) Appendix A—Summary of Tentative Decisions Reached in This Project
 - (b) Appendix B—Flowcharts Illustrating Current GAAP for Equity Contracts, Stock and Convertible Shares, and Convertible Debt (Including Notes to Illustrate the Effect of the Board’s Tentative Decisions Reached and the PCC Alternative)
 - (c) Appendix C—Staff Summary of GAAP for Convertible Instruments
 - (d) Appendix D—Chart Comparing Outcomes Under the Board’s Tentative Decisions and Private Company Alternatives for Specific Instrument Types.

Accounting Issues Associated with Financial Instruments with Down Round Features

4. A down round feature is a provision in an equity-linked financial instrument, such as a warrant or a convertible instrument that provides for a downward adjustment of the exercise price specified in the contract in certain circumstances. It is commonly referred to as a round of financing in which investors purchase stock from a company at a lower valuation than the valuation placed upon the company’s stock by earlier investors. A down round feature is a form of protection provided to one investor, or a group of investors, but generally not to all investors. This differs from a standard anti-dilution provision, which is provided equally to all investors. As defined in the *FASB Accounting Standards Codification*® Master Glossary, standard anti-dilution provisions are those that result in adjustments of the conversion ratio in the event of an equity restructuring transaction that are designed to maintain the value of the conversion option.

5. Based on the staff's research and outreach, currently, down round features are most common in private company issuances of warrants and convertible preferred shares. Public companies may also issue warrants or convertible debt instruments with down round features. Typically, these are development-stage or start-up entities seeking venture capital financing or private companies that recently went through an initial public offering.
6. Based on stakeholders' feedback, practice issues arise with the accounting for down round features included in warrants and convertible instruments because of the application of derivatives guidance in Topic 815, Derivatives and Hedging. Under current GAAP, a down round feature generally would trigger fair value measurement for warrants and embedded conversion options that are deemed to have a debt host (assuming the underlying shares are readily convertible to cash or the contract provides for net settlement). As a result, stakeholders indicate that current accounting guidance creates issues of cost and complexity when fair value measurement of the entire instrument or conversion option is required on an ongoing basis because of the presence of a down round feature. Current GAAP for financial instruments with down round features is discussed later in this memo.
7. The following issues have been identified by stakeholders:
 - (a) The financial reporting results under current GAAP do not reflect the economics of the down round feature, which exists only to protect investors from declines in an issuer's share price. That is, current accounting guidance in Topic 815 on derivatives requires changes in fair value of an instrument with a down round feature to be recognized in earnings for both increases and decreases in share price, even though an increase in share price will not cause a down round feature to be triggered.
 - (b) Current accounting guidance in Topic 815 on derivatives that requires freestanding and embedded instruments with down round features to be classified as liabilities that are subject to fair value measurement on an ongoing basis creates a significant reporting burden and unnecessary income statement volatility associated with changes in value of an entity's own share price.

Project Overview

8. In November 2014, the Board decided to add the Liabilities and Equity Targeted Improvements project to its technical agenda, with the intent of addressing targeted issues that have created pervasive practice issues in this area. As a result of the feedback from stakeholders regarding the cost and complexity of applying current GAAP for financial instruments with down round features and based on its research and outreach, the Board decided to include the issue of accounting for financial instruments with those features within the scope of the project. The Board determined that the objective in addressing the accounting for financial instruments with down round features is to develop an accounting approach that would reduce the cost and complexity of current accounting guidance and improve the usefulness of the financial reporting result by resolving the issues (in paragraph 7) that have been identified by stakeholders.
9. While the Board has acknowledged the issues with the current accounting guidance, an advantage of the current accounting for financial instruments with down round features is that it provides financial statement users with some information about the value that is being provided to one but not all shareholders. That is, the fair value measurement and derivatives disclosure provides important information to the other investors who do not have a down round feature included in their instrument and provides information about potential dilution of their ownership interest.
10. At the September 16, 2015 Board meeting, the Board deliberated several accounting alternatives for financial instruments with down round features and selected an approach from among those alternatives. The Board considered alternatives that would result in no accounting recognition for the down round (for example, equity classification with no additional accounting requirements for the down round) as well as alternatives that would provide for some accounting recognition. The Board tentatively decided to pursue an approach that would require recognition of the value of the down round feature when it is triggered. The Board rejected alternatives that would have resulted in no recognition of the effect of the down round feature based on its view that the holder of the instrument that includes a down round feature is receiving value above and beyond the other investors and that value transfer should be reported in the financial statements. At that meeting, the

Board directed the staff to draft a proposed Accounting Standards Update for vote by written ballot based on the tentative decisions reached. Three Board members expressed a preference for a holistic approach to addressing accounting issues with distinguishing liabilities from equity in lieu of a targeted improvements approach and indicated that they would provide their Alternative Views in the proposed Update.

11. At a Board meeting in February 2016, the Board discussed potential projects for its future agenda and topics to be included in its Invitation to Comment. At that meeting, the Board voted four to three to continue with the current phase of the Liabilities and Equity: Targeted Improvements project. (The current phase includes addressing financial instrument with down round features and replacing the indefinite deferral in Topic 480, Distinguishing Liabilities from Equity, for mandatorily redeemable financial instruments of certain nonpublic entities and certain mandatorily redeemable noncontrolling interests with a scope exception to improve the readability of the Codification.) The Board also decided to remove from its technical agenda the remaining issues that would have been addressed in future phases of the project because of a broader liabilities and equity research project was added its agenda.
12. A summary of tentative decisions reached in this project is included in Appendix A. An external review draft of the proposed Update based on the Board's tentative decisions reached was issued on February 25, 2016. The significant issues arising from that review were discussed at the July 19, 2016 PCC meeting. At that meeting, the PCC requested that the staff perform research on a potential private company alternative.

Background—Current GAAP Related to Financial Instruments with Down Round Features

13. Current GAAP contains significant guidance for financial instruments with characteristics of liabilities and equity. Both freestanding financial instruments (such as warrants) and convertible instruments comprising a host debt or equity contract and an embedded conversion option can contain down round features. The analysis of those financial instruments under current GAAP follows a particular navigation to determine the appropriate accounting.

Navigation for Financial Instruments with Down Round Features

14. Appendix B contains three flowcharts that illustrate the navigation through current GAAP for equity contracts, stock and convertible shares, and convertible debt and how that navigation would be modified based on the Board's tentative decisions and the PCC's suggested private company alternative for financial instruments with down round features.
15. As illustrated in the flowcharts in Appendix B related to equity contracts and convertible stock, the first step in the analysis for warrants and convertible preferred shares would be to determine whether the equity-form instrument would be required to be classified as a liability under Topic 480, Distinguishing Liabilities from Equity (originally issued as FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*). As discussed in paragraph 480-10-55-33, warrants on redeemable shares (that is, puttable or mandatorily redeemable shares) are liabilities under Topic 480 because the issuer has a conditional obligation to repurchase its shares for cash (or other assets). In addition, that guidance indicates that the warrants are liabilities even if the share repurchase feature is conditional on a defined contingency.
16. Accordingly, the classification of the underlying shares issued upon exercise should not be considered to determine the classification of the warrant itself. While the guidance in Topic 480 currently includes an indefinite deferral for mandatorily redeemable financial instruments of certain nonpublic entities, that indefinite deferral is not applicable to warrants on a mandatorily redeemable instrument. For warrants for which the underlying is mandatorily redeemable preferred stock, liability classification for the warrants would be required regardless of whether the warrant included a down round feature. That is, the liability classification is driven by the classification guidance in Topic 480 (essentially, the shares are puttable, which allows the holder to compel the reporting entity to redeem the shares) and not by the analysis of whether the feature is "indexed to an entity's own stock" under Subtopic 815-40, Derivatives and Hedging—Contracts in Entity's Own Equity.

18. The analysis described below relates to financial instruments with down round features that are not required to be liability classified based on the guidance in Topic 480.

Application of Guidance in Topic 815 on Derivatives to Financial Instruments with Down Round Features

19. All freestanding financial instruments and hybrid financial instruments with unique features that alter the characteristics of an otherwise standard instrument are required to be assessed under the guidance in Topic 815, Derivatives and Hedging. The evaluation starts with an assessment of whether the instrument is a freestanding derivative under Topic 815 or contains an embedded feature (for example, a conversion option) that must be accounted for as a derivative. In Appendix B, the flowcharts for equity contracts and convertible stock show this as the second step in the analysis (after the analysis of the application of Topic 480), while the flowchart for convertible debt instruments shows this as the first step in the analysis. As illustrated in these flowcharts, there are multiple steps to this analysis, which are explained in the paragraphs below.
20. If an equity-linked financial instrument (or an embedded feature) meets the definition of a derivative in Topic 815, then the contract must be analyzed to determine if it qualifies for a scope exception from derivative accounting. The scope exception relevant to these instruments is in paragraph 815-10-15-74, which specifies that a contract that would otherwise meet the definition of a derivative that is both (a) indexed to its own stock and (b) classified in stockholder's equity in its statement of financial position should not be considered a derivative financial instrument.
21. Subtopic 815-40, Derivatives and Hedging—Contracts in Entity's Own Equity, provides guidance to assess whether this scope exception is met. There are two components to this guidance. Subtopic 815-40 provides guidance to determine whether an instrument is considered "indexed to an entity's own stock" from legacy guidance in EITF Issue No. 07-5, "Determining Whether an Instrument (or Embedded Feature) Is Indexed to an Entity's Own Stock." Subtopic 815-40 also contains guidance on the classification, recognition, and measurement of equity-linked financial instruments that are considered indexed to an entity's own stock depending on the form of settlement of the instrument

from legacy guidance in ETIF Issue No. 00-19, “Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company’s Own Stock.”

22. Under this guidance, if an instrument that meets the definition of a derivative is considered (a) indexed to an entity’s own stock and (b) is classified in a stockholder’s equity in its statement of financial position, the instrument satisfies the scope exception in Topic 815 and is classified as equity. At each reporting date, the entity must assess whether the instrument continues to meet both parts of the scope exception in Topic 815 by reassessing it under the guidance in Subtopic 815-40 (originally issued as Issue 07-5 and Issue 00-19) to qualify for equity classification. If the entire financial instrument meets the definition of a derivative and does not qualify for the scope exception, then it is required to be measured at fair value with changes in value recognized in earnings. Likewise, if the embedded feature meets the definition of a derivative and does not qualify for the scope exception, it must be bifurcated and measured at fair value with changes in value recognized in earnings.
23. The guidance in Subtopic 815-40 still applies if a freestanding equity-linked financial instrument does not meet the definition of a derivative under Topic 815. The contract must be evaluated under that guidance to determine whether it is indexed to the entity’s own shares. If not, the contract is required to be accounted for as a liability and initially measured at fair value under paragraph 815-40-15-8A.

Guidance in Subtopic 815-40 Related to Whether the Instrument Is “Indexed to an Entity’s Own Stock” (Originally Issued as Issue 07-5)

24. The guidance related to whether the instrument is indexed to an entity’s own stock originated in Issue 07-5. It requires a two-step evaluation of exercise contingencies and settlement adjustments based on the terms of the contract. Step 1 is to evaluate the instrument’s contingent exercise provisions, if any, and Step 2 is to evaluate the instrument’s settlement provisions.

Step 1: Evaluate the Instrument's Contingent Exercise Provisions, if Any

25. An exercise contingency does not preclude an instrument (or embedded feature) from being considered indexed to an entity's own stock provided that it is not based on either of the following:
- (a) An observable market, other than the market for the issuer's stock (if applicable)
 - (b) An observable index, other than an index calculated or measured solely by reference to the issuer's own operations (for example, sales revenue of the issuer; earnings before interest, taxes, depreciation, and amortization of the issuer; net income of the issuer, or total equity of the issuer).
26. The analysis would proceed to Step 2 if the evaluation of Step 1 does not preclude an instrument from being considered indexed to the entity's own stock.
27. The exercise contingency would be evaluated under Step 1 if an instrument's strike price or the number of shares used to calculate the settlement amount would be adjusted upon the occurrence of an exercise contingency and the potential adjustment to the instrument's settlement amount would be evaluated under Step 2.

Step 2: Evaluate the Instrument's Settlement Provisions

28. As required by paragraph 815-40-15-7C:

An instrument (or embedded feature) shall be considered indexed to an entity's own stock if its settlement amount will equal the difference between the following:

- a. The fair value of a fixed number of the entity's equity shares
- b. A fixed monetary amount or a fixed amount of a debt instrument issued by the entity.

For example, an issued share option that gives the counterparty a right to buy a fixed number of the entity's shares for a fixed price or for a fixed stated principal amount of a bond issued by the entity shall be considered indexed to the entity's own stock.

29. An instrument's strike price or the number of shares used to calculate the settlement amount are not fixed if its terms provide for any potential adjustment, regardless of the probability of such adjustment(s) or whether such adjustments are in the entity's control. If the instrument's strike price or the number of shares used to calculate the settlement amount are

not fixed, the instrument (or embedded feature) would still be considered indexed to an entity's own stock if the only variables that could affect the settlement amount would be inputs to the fair value of a fixed-for-fixed forward or option on equity shares.

30. A fixed-for-fixed forward or option on equity shares has a settlement amount that is equal to the difference between the price of a fixed number of equity shares and a fixed strike price. The fair value inputs of a fixed-for-fixed forward or option on equity shares may include the entity's stock price and additional variables, including all of the following:
 - (a) Strike price of the instrument
 - (b) Term of the instrument
 - (c) Expected dividends or other dilutive activities
 - (d) Stock borrow cost
 - (e) Interest rates
 - (f) Stock price volatility
 - (g) The entity's credit spread
 - (h) The ability to maintain a standard hedge position in the underlying shares.
31. The guidance indicates that determinations and adjustments related to the settlement amount (including the determination of the ability to maintain a standard hedge position) must be commercially reasonable.
32. An instrument (or embedded feature) cannot be considered indexed to the entity's own 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. An instrument (or embedded feature) is not considered indexed to the entity's own stock if either:
 - (a) The instrument's settlement calculation incorporates variables other than those used to determine the fair value of a fixed-for-fixed forward or option on equity shares

- (b) The instrument contains a feature (such as a leverage factor) that increases exposure to the additional variables listed in the preceding paragraph in a manner that is inconsistent with a fixed-for-fixed forward or option on equity shares.

33. Paragraph 815-40-15-7G states:

Standard pricing models for equity-linked financial instruments contain certain implicit assumptions. One such assumption is that the stock price exposure inherent in those instruments can be hedged by entering into an offsetting position in the underlying equity shares. For example, the Black-Scholes-Merton option-pricing model assumes that the underlying shares can be sold short without transaction costs and that stock price changes will be continuous. Accordingly, for purposes of applying Step 2, fair value inputs include adjustments to neutralize the effects of events that can cause stock price discontinuities. For example, a merger announcement may cause an immediate change in the price of shares underlying an equity-linked option contract. A holder of that instrument would not be able to continuously adjust its hedge position in the underlying shares due to the discontinuous stock price change. As a result, changes in the fair value of an equity-linked instrument and changes in the fair value of an offsetting hedge position in the underlying shares will differ, creating a gain or loss for the instrument holder as a result of the merger announcement. Therefore, the inclusion of provisions that adjust the terms of the instrument to offset the net gain or loss resulting from a merger announcement or similar event does not preclude an equity-linked instrument (or embedded feature) from being considered indexed to an entity's own stock.

Application to Instruments with Down Round Features

34. Step 2 in this analysis may result in the instrument being required to be classified as a liability due to the existence of a down round feature. Paragraphs 815-40-55-33 through 55-34 (originally issued as Issue 07-5, Example 8) illustrate a warrant issued with a down round feature:

> > Example 9: Variability Involving Future Equity Offerings and Issuance of Equity-Linked Financial Instruments

815-40-55-33 This Example illustrates the application of the guidance beginning in paragraph 815-40-15-5. Entity A issues warrants that permit the holder to buy 100 shares of its common stock for \$10 per share. The warrants have 10-year terms and are exercisable at any time. However, the terms of the warrants specify both of the following:

- a. If the entity sells shares of its common stock for an amount less than \$10 per share, the strike price of the warrants is reduced to equal the issuance price of those shares.

- b. If the entity issues an equity-linked financial instrument with a strike price below \$10 per share, the strike price of the warrants is reduced to equal the strike price of the newly issued equity-linked financial instrument.

815-40-55-34 The warrants are not considered indexed to Entity A's own stock based on the following evaluation:

- a. Step 1. The instruments do not contain an exercise contingency. Proceed to Step 2.
- b. Step 2. The settlement amount would not equal the difference between the fair value of a fixed number of the entity's equity shares and a fixed strike price. The strike price would be adjusted if Entity A sells shares of its common stock for an amount less than \$10 per share or if Entity A issues an equity-linked financial instrument with a strike price below \$10 per share. Consequently, the settlement amount of the warrants can be affected by future equity offerings undertaken by Entity A at the then-current market price of the related shares or by the contractual terms of other equity-linked financial instruments issued in a subsequent period. *The occurrence of a sale of common stock by the entity at market is not an input to the fair value of a fixed-for-fixed option on equity shares. Similarly, the occurrence of a sale of an equity-linked financial instrument is not an input to the fair value of a fixed-for-fixed option on equity shares, if the transaction was priced at market.* [Emphasis added.]

- 35. In this example, the down round feature precludes the warrant from being considered indexed to the entity's own stock. As a result, the warrant is required to be classified as a derivative liability and measured at fair value with changes in value recognized in net income if the warrant meets the definition of a derivative and does not qualify for the scope exception in Topic 815 for contracts in the entity's own equity. While the example focuses on a freestanding warrant, the same issue arises in a convertible debt instrument; the existence of the down round feature would result in the embedded option requiring bifurcation and fair value measurement if a convertible debt instrument contains an embedded conversion option (that meets the definition of a derivative) with a down round feature.
- 36. The staff understands that the basis for the guidance in Issue 07-5 requiring liability classification for financial instruments with down round features was that the price protection affects only the holder of the option rather than all common shareholders, which is not a characteristics of equity. In contrast, Issue 07-5 does not require liability

classification for instruments containing standard anti-dilution features, because an anti-dilution feature is designed to adjust the terms of the contract such that the holder is not worse off because of a dilutive effect of a particular event (for example, a stock split). In this case, the adjustment protects the holder against the effect of the dilutive event, but does not put it in an economically better position than before the event. A down round feature, however, enables the holder to obtain equity shares at a more advantageous price than before the event and benefits them relative to existing shareholders.

Guidance in Subtopic 815-40 Related to Classification in Stockholders' Equity (Originally Issued as Issue 00-19)

37. Paragraph 815-10-15-74 specifies that a contract that otherwise would meet the definition of a derivative that is both (a) indexed to its own stock and (b) classified in stockholder's equity in its statement of financial position should not be considered a derivative financial instrument. The issue and alternatives discussed in this memo deal with the first part of the scope exception (indexed to its own stock), but will not change the second part of the scope exception (classified in stockholder's equity).
38. The second part of the scope exception relates to the form of settlement of the contract and is assessed under the guidance from the legacy standard Issue 00-19. That guidance explains that the initial balance sheet classification of such contracts is based on the concept that contracts that require net cash settlement are assets or liabilities, while contracts that require settlement in shares are equity instruments. In addition, net cash settlement is assumed if the contract provides the counterparty with a choice of net cash settlement or settlement in shares. settlement in shares is assumed if the contract provides the entity with a choice of net cash settlement or settlement in shares. The guidance also applies to any freestanding financial instrument that potentially is settled in an entity's own stock, regardless of whether the instrument has all the characteristics of a derivative instrument under Topic 815.
39. In addition to its application to freestanding instruments, an entity also is required to consider this guidance when the entity evaluates evaluating whether an embedded derivative qualifies for the scope exception related to contracts in its own shares.

Bifurcation of the embedded derivative and measurement at fair value is not required if it meets the scope exception.

40. Paragraphs 815-40-25-7 through 25-8 provide the general concepts that contracts that include any provision that could require net cash settlement cannot be accounted for as equity of the entity (except in those limited circumstances in which holders of the underlying shares also would receive cash) and that, generally, if an event that is not within the entity's control could require net cash settlement, the contract must be classified as an asset or a liability. Because any contract provision that could require net cash settlement precludes accounting as equity of the entity, the guidance also includes additional specific criteria that evaluate the feasibility of settlement in shares in order to allow the entity to conclude that equity classification is permitted.
41. Accordingly, paragraph 815-40-25-10 provides the following list of conditions that must be met for a contract to be classified as equity:
 - a. Settlement permitted in unregistered shares; the contract permits the entity to settle in unregistered shares.
 - b. Entity has sufficient authorized and unissued shares. The entity has sufficient authorized and unissued shares available to settle the contract after considering all other commitments that may require the issuance of stock during the maximum period the derivative instrument could remain outstanding.
 - c. Contract contains an explicit share limit. The contract contains an explicit limit on the number of shares to be delivered in a share settlement.
 - d. No required cash payment if entity fails to file in a timely manner. There are no required cash payments to the counterparty in the event the entity fails to make timely filings with the U.S. Securities and Exchange Commission (SEC).
 - e. No cash-settled **top-off** or **make-whole provisions**. There are no cash settled top-off or make-whole provisions.
 - f. 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.
 - g. No collateral required. There is no requirement in the contract to post collateral at any point or for any reason.
42. The guidance does not allow for an evaluation of the likelihood that an event would trigger cash settlement (whether net cash or physical), except that if the payment of cash is

required only upon the final liquidation of the entity, then that potential outcome need not be considered when applying the guidance.

43. In terms of sequencing, this assessment typically comes after the indexed to an entity's own stock analysis in the derivatives guidance. If an instrument is not indexed to an entity's own stock, thus resulting in liability classification with fair value measurement, there is no need to determine if the instrument also would fail other tests for equity classification.

Specialized Guidance for Convertible Instruments under Current GAAP

44. Convertible instruments are evaluated under derivatives guidance in Topic 815 as a first step to determine if the embedded conversion feature requires bifurcation and fair value measurement. If a convertible instrument with a down round feature does not require bifurcation under Topic 815 because it meets the scope exception related to instruments indexed to an entity's own shares and classified in shareholder's equity, the issuer must determine whether the convertible instrument has other features that require separation under specialized GAAP (for example, cash conversion feature or beneficial conversion feature (BCF)). If any of those specialized models require separation, the issuer must separate the instrument into two components and the issuer would measure the components in accordance with appropriate guidance. Appendix B illustrates this step in the navigation for convertible stock and convertible debt below the evaluation under Topic 815. Appendix C details the guidance and separation models applicable to convertible instruments.

Private Company Alternative

45. At the July 19, 2016 PCC meeting, PCC members recommended that the staff perform research on a private company alternative for accounting for financial instruments with down round features. That alternative would require equity classification for certain financial instruments with down round features and no accounting recognition for the down round (that is, no recognition due to the existence or the trigger of the down round). Based

on the PCC's discussion at the July 19, 2016 meeting, the instruments captured under that alternative would have all of the following characteristics:

- (a) The instrument is in equity form (for example, warrants, convertible preferred shares).
- (b) The instrument is required to be share settled or net share settled (for example, share-settled warrants).
- (c) The instrument includes a down round feature, as defined based on the Board's tentative decisions in this project:

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 current strike price of the issued financial instrument or issues an equity-linked financial instrument with a strike price below the current strike price of the issued financial instrument. A **standard anti-dilution provision** is not considered a down round feature.

- (d) The instrument does not contain features other than the down round feature or other contractual terms that would result in liability classification or that would require derivative accounting for the instrument in its entirety or bifurcation of an embedded derivative (for example, the instrument is not subject to the guidance in Topic 480 or Topic 815 and meets the additional criteria for equity classification in Subtopic 815-40).
46. For those instruments, there would be no recognition and measurement of the effect of the down round feature at any time (not at inception of the instrument or upon trigger of the down round feature). An entity would disclose the existence of the down round feature if it was triggered. In contrast to the Board's tentative decisions, under this alternative an entity would not be required to assign any value to the effect of the down round. Instead, in the disclosure the entity would describe the down round feature, state the strike price before and after the trigger of the down round feature, and state the number of shares subject to the down round feature.
47. The following guidance would need to be drafted to implement the private company alternative:

- (a) Establish a scope of financial instruments that would be subject to the private company alternative (as discussed above).
 - (b) Establish a scope exception for private companies from Topic 815 for instruments with the characteristics described in (a).
 - (c) Establish a scope exception applicable to private companies from the guidance in Subtopic 470-20 related to convertible preferred shares with contingent BCF that would meet the definition of a down round feature as defined in this project.
48. As a result of the scoping above, the private company alternative would not apply to the following (list may not be all-inclusive):
- (a) Instruments with down round features that are in debt form. For example, the alternative would not include convertible debt instruments with down round features. (Those instruments would continue to be subject to Topic 815 or specialized models for convertible instruments.)
 - (b) Freestanding, equity-form instruments (for example, warrants) with down round features on redeemable shares (that is, puttable or mandatorily redeemable shares). (Those instruments would continue to be classified as liabilities under the guidance in Topic 480 (originally issued as Statement 150)).
 - (c) Freestanding, equity-form instruments with down round features that are required to be cash settled or net cash settled (for example, net-cash-settled warrants) or where the investor has the option to settle in cash. (Those instruments would continue to be classified as liabilities and measured at fair value under the guidance in Subtopic 815-40 (originally issued as Issue 00-19)).

- (d) Equity-form, share-settled instruments that have features or contractual terms¹ other than a down round feature requiring liability classification that cause it to be a derivative in its entirety or a bifurcatable derivative or that cause it to be separated. (Those instruments would continue to be subject to the guidance in Topic 480, Topic 815, or Subtopic 470-20.)
 - (e) Convertible preferred shares with down round features that do not meet the definition in paragraph 45(c) above. For example, convertible preferred shares with a down round feature that is triggered based on reduction of the strike price of an issued financial instrument due to any event *other than* the issuer (i) selling shares of its stock for an amount less than the current strike price of the issued financial instrument or (ii) issuing an equity-linked financial instrument with a strike price below the current strike price of the issued financial instrument would not be subject to the private company alternative. (Those instruments would continue to be subject to Topic 815 or the current contingent BCF model.)
49. This alternative would change the navigation under current GAAP as follows, as illustrated through the notes to the flowcharts in Appendix B:
- (a) The suggested private company alternative would alter the navigation for warrants that meet the definition of a derivative by bypassing the analysis under the scope exception in Topic 815 regarding whether the down round feature causes the instrument not to be indexed to an entity's own stock. However, the guidance would still require an analysis of whether the second part of the scope exception is met (that is, that the instrument would be classified in stockholder's equity) under Subtopic 815-40 (originally issued as Issue 00-19). If both parts of the scope exception are met, the warrant would be classified as equity with no subsequent measurement requirement.
 - (b) For convertible preferred shares, the private company alternative would alter the analysis in the same way as for warrants and also would bypass the guidance in

¹ For example, terms that would cause an instrument to be evaluated under the guidance in Subtopic 815-40 to determine whether share settlement is feasible, as discussed in paragraph 41.

Subtopic 470-20 related to BCFs for down round features within the scope of the alternative.

- (c) Even though the private company alternative would exclude debt-form instruments from its scope, some convertible preferred instruments within the scope of the private company alternative could fall under the guidance for convertible debt (if the instrument has a host contract that is more akin to debt under Topic 815 or is required to be classified as a liability under Topic 480). In that case, the issuer would apply either embedded derivatives guidance in Topic 815 or a specialized model for convertible instruments, as appropriate). Those models are explained in detail in Appendix C. This outcome occurs because the private company alternative does not provide for equity classification for instruments that contain features other than down round features that require liability classification or separation.

Outreach (Public Company Pervasiveness)

Pre-Agenda Research

- 50. As part of the pre-agenda research, the staff performed outreach with Big 4 auditors, reviewed restatement studies (of public companies), and reviewed prior project files (that is, EITF files) related to this topic. The staff also performed outreach with members of the PCC and two members of the AICPA Private Companies Practice Section (PCPS) Technical Issues Committee (TIC) who had provided some feedback at the September 16, 2014 TIC meeting on the complexity of applying the guidance in Issue 07-5.
- 51. Stakeholders asserted that the accounting for freestanding and embedded instruments with down round features as liabilities creates undue complexity. Some have indicated that fair value measurement on an ongoing basis creates a significant reporting burden and unnecessary income statement volatility associated with changes in value of an entity's own share price. Stakeholders also stated that this accounting does not reflect the economics of the down round feature, which exists only to protect investors from declines in the issuer's share price. That is, current accounting guidance requires changes in fair value of an

instrument with a down round feature to be recognized in earnings for both increases and decreases in share price, even though an increase in share price will not cause a down round feature to be triggered.

52. One TIC member shared an example of a research and development start-up company that had no revenue, but reflected millions of dollars in profit for several quarters because of the accounting requirements for a convertible debt instrument with a down round feature. In this case, the conversion option met the definition of a derivative under Topic 815 and did not meet the derivatives scope exception because of the existence of the down round feature. When the conversion option was bifurcated, it initially was recorded at fair value. The fair value of the option exceeded the proceeds received and, therefore, the entire par amount was allocated to the option with no amount allocated to the debt. In subsequent periods, the option was marked to fair value with gains and losses recognized in the income statement. The resulting marks were large relative to the overall earnings of the entity due to the volatility in its stock price. This TIC member's view was that the end result did not reflect the economics of the transaction and added complexity in trying to understand the financial results of the company.
53. The staff spoke with a second TIC member who also raised issues with accounting for down rounds. This TIC member noted that the complexity in the application of the guidance is in determining the fair value of the feature. Many companies (private companies especially) need to hire third-party valuation experts to determine the fair value, which results in added costs.
54. The staff did not solicit any direct user feedback given the very narrow nature of this issue, with input provided to the staff by members of the PCC. From a public company perspective, the FASB Investor Liaison indicated the belief that disclosure about the terms of the instrument likely would be most relevant to a user of financial statements.

The Convertible Instruments Market—2014 Research

55. In connection with the Board's review of the accounting for convertible instruments as part of the Liabilities and Equity Targeted Improvements project, the staff performed research and conducted outreach with convertible instrument dealers and accounting policy directors

from two large international banks to gain an understanding of the current market for convertible instruments. The representatives from each of the banks primarily provided the staff with insight on the convertible market from a public company perspective due to a lack of available data and experience working with private clients. While the staff was unable to gather as much information regarding private company activity in the convertible debt market, the staff was able to identify some key differences between public and private companies in this area.

Public Companies

56. According to the dealers, the public convertibles market contains three types of instruments: convertible debt, mandatorily convertible instruments, and convertible preferred stock. Convertible debt is the most common instrument issued and accounts for approximately 80 percent of the total market, while mandatorily convertible debt and convertible preferred stock make up the remaining 20 percent of the market.
57. The market for convertible debt reached a ten year high in 2007, with annual issuances totalling over \$95 billion. The global financial crisis caused the convertible debt market to deteriorate between 2008 and 2012 because equity markets were in decline, and there was low demand from investors for instruments with equity upside. However, over the past two years the convertible debt market has experienced significant increases in volume due to the improving equity markets and a rebounding global economy. Annual volume for publicly issued convertible debt increased from \$21.6 billion in 2012 to \$42.6 billion in 2013. Currently, 2014 year-to-date issuances of convertible debt are approximately \$36 billion, and analysts expect volumes to rise to more than \$47 billion by year end.² As of September 30, 2013, the U.S. convertibles market had a market capitalization of \$216 billion with approximately 500 issues, representing nearly \$2 trillion of underlying common equity.³
58. The convertible debt market spans across a wide range of industries. Recently, there has been an increase in the number of technology companies issuing convertible debt because they can demand very low coupon rates (from 0 percent to 2 percent) and high conversion spreads

² Source: Thomson Financial and Bloomberg.

³ Source: Barclays Convertible Market Watch September 2013.

(60% percent and up) due to their high equity upside.⁴ Also, many technology companies choose to issue convertible debt because they do not have sustainable long term cash flow to get debt financing at an investment grade rate. Approximately 70 percent of convertible bond issuers have a below-investment-grade credit rating.⁵ Furthermore, although companies of all sizes issue convertible debt, the majority of issuers are small-capitalization companies with less than \$5 billion in market capitalization.

59. Investors in public company convertible debt are institutional asset managers such as mutual funds and hedge funds. According to the convertible instrument dealers, investors are agnostic toward whether they receive cash or shares upon settlement of a convertible. However, according to the dealers, approximately 75 percent of the convertible debt instruments issued currently contain a cash conversion feature, which provides desired flexibility to the issuer. Investors demand that convertible debt instruments contain certain anti-dilution provisions and change control/takeover protection tables. The most frequent anti-dilution provisions included in instruments are for stock splits and stock dividends, changes in dividend amounts paid, noncash distributions and spin-offs, and above market tender offers. Each of these provisions does not preclude the instrument from receiving equity treatment under Issue 07-5.

Private Companies

60. While the convertibles market for public companies is dominated by convertible debt, one firm indicated its belief that private companies primarily issue convertible preferred stock with stock price protection features. The convertible debt market for private companies is very small. One possible reason for this may be that many privately owned companies do not issue convertible debt because it presents a risk of dilution of ownership. One of the key differences between convertible instruments issued by public versus private companies is that down round provisions are more frequent for private issuers. Another key difference is that instruments with BCFs are issued by private companies, but are almost never issued by public companies. There is a belief that sometimes private companies issue a convertible instrument with a BCF unintentionally because they also are issued with detachable

⁴ Source: Bloomberg and SEC filings.

⁵ Source: Dinsmore Capital Management, LLC – A Review of the Convertible Securities Market, October 2011.

warrants, and the accounting mechanics give rise to a BCF. In addition, because private companies are not as sensitive to earnings per share (EPS) as public companies, they may be more inclined to issue an instrument with that feature, which would have less preferential EPS treatment than some cash-convertible debt instruments. Lastly, both private and public companies issue instruments with standard anti-dilution features, but only public companies typically issue instruments containing control/takeover protection tables.

Additional Outreach Performed in 2016

61. After the July 2016 PCC meeting, the staff performed additional outreach with two accounting firms to understand whether instruments with down round features are issued by public companies and, if so, the prevalence of those features. One of the firms provided the staff with results of research performed using the firm's consultation and filings databases showing that in 2014, there were more than 40 filings with instruments with down round features that were audited by Big 4 accounting firms. When expanded to mid-sized and smaller tier accounting firms, the number of filings is more than 150. The firm acknowledged that the majority of those filings were warrants with down round features.
62. The staff performed similar research for 2015. The staff found 136 companies (out of a population of 6,867 registrants) that disclosed in their filings with the SEC that they had financial instruments with down round features. The staff expects that the population of financial instruments with down rounds issued by registrants is larger than the results of our search because it only captured situations in which the existence of the down round was explicitly disclosed in the filing. Of these filings, 79 percent were warrants with down round features. Life sciences, technology, and energy were the most common industries in which down round features were disclosed but the staff notes it is not limited to those industries.
63. Based on the staff's outreach, our understanding is that the following are the most common situations in which public companies issue instruments with a down round feature.
 - (a) Initial public offering (IPO): Private companies that have just gone public
 - (b) Financial Difficulty: Public companies that are having financial difficulty and, therefore, do not have much flexibility in their financing. Historically there has been an uptick in down round features when there is an economic downturn.

- (c) **Private Equity:** A private investment in public equity, often called a PIPE deal, involves the selling of publicly traded common shares or some form of preferred stock or convertible security to private investors. It is an allocation of shares in a public company not through a public offering in a stock exchange. These types of investments generally occur when a public company's shares are trading at a low price.
64. The feedback during this latest outreach generally is consistent with the outreach the staff performed earlier in the project. That is, while the existence of down rounds in financial instruments is more prevalent for private companies than public companies, the features do exist in instruments issued by public companies.

Private Company Decision Making Framework (PCDMF) Analysis

65. Because the PCC has asked the staff to research a potential private company alternative for equity instruments that include down round features, the staff analyzed the Private Company Decision-Making Framework (PCDMF) to understand whether the framework would support an alternative in this area. The framework guide explains:

The primary purpose of this Guide is to assist the Board and the PCC in determining whether and in what circumstances to provide alternative recognition, measurement, disclosure, display, effective date, and transition guidance for private companies reporting under U.S. GAAP. The assessment of significant differential factors between private companies and public companies is considered to be an important source of input in developing this Guide. [paragraph 7]

66. A key tenet of the PCDMF is user relevance with cost being a secondary concern. Paragraphs 1.2 and 1.4 of the PCDF state:

. . .the Board and the PCC first should determine whether the recognition or measurement guidance being evaluated provides relevant information to users of private company financial statements at a reasonable cost. That analysis should focus on (a) the relevance of the information in meeting the objective of financial reporting for typical users of private company financial statements, (b) the characteristics that differentiate users of private company financial statements from users of public company financial statements, and (c) the cost and complexity of applying the guidance.

If the Board and the PCC determine that either (a) the information provided by the guidance is not relevant or (b) the information provided by the guidance is relevant but is overly costly or complex to provide and no practical expedient is available, they should proceed to analyzing the benefits and costs of potential alternative recognition or measurement methods for private companies.

67. The Board added this targeted improvements project to its agenda for the following reasons as discussed in paragraph 7:
- (a) Current accounting does not reflect the economics of the down round feature, which exists only to protect investors from declines in the issuer's share price. That is, current accounting guidance requires changes in fair value of an instrument with a down round feature to be recognized in earnings for both increases and decreases in share price, even though an increase in share price will not cause a down round feature to be triggered.
 - (b) There is significant cost and complexity of ongoing fair value measurements (and P&L volatility) as well as cost of furnishing derivatives disclosures on these instruments/features.
68. These reasons relate to both private and public companies. Therefore, if a private company alternative was created to address these instruments, the issues would still exist for public companies. Accordingly, while this issue is more pervasive for private companies, this issue is relevant for both private and public companies and, therefore, does not meet the threshold for creating a private company alternative.
69. Outreach and research conducted both during the pre-agenda phase and in connection with the exploration of the private company alternative supports this view. In terms of recent findings, based on a search of public company filings for 2015 conducted by the staff, 136 public entities across a variety of industries disclosed information about instruments with down round features. The vast majority of companies reporting these instruments were not high market capitalization companies. This validates the pre-agenda research and outreach conducted with convertible instrument dealers that public companies may issue instruments with down round features, and those issuers likely would be start-up companies in need of financing. As a result, because these instruments with identical economics can be issued by

both private and public companies, there should be consistency between private company reporting and public company reporting of the effects of the instruments.

70. Some PCC members noted at the July 19, 2016 meeting that a private company alternative might make sense for this issue because the transactions in question are not settled in cash. Question 1.6(a) of the PCDMF guidance in determining user relevance is “Does the transaction, event, or balance affect reported cash balances, cash flows, or adjusted EBITDA?” The PCDMF also includes the following on cash transactions:

. . .private company financial statements may have a greater focus on cash that can be realized from their investments, including dividends, interest, repayment of principal, possible buyouts, business combinations, or, less frequently, initial public offerings, as the sources for their investment return. [paragraph DF6]

Lenders and other creditors are concerned most about financial statement amounts and notes that affect reported amounts of cash, liquidity, and cash flow from operations available to service debt. [paragraph DF7]

Most private company investors in nonfinancial institutions indicate that they are less interested in accounting guidance that does not affect reported cash amounts or probable future cash flows. They also are less interested in accounting guidance that produces or results in volatility in reported earnings and asset and liability values resulting from underlying changes in fair value that are expected to reverse contractually in the future if the company has the intent and ability to hold the related instrument to maturity or term. [paragraph DF7]

71. Although the PCDMF notes that a focus on the cash impact of transaction may affect user relevance, in this case, that may not be synonymous with saying that there is a difference in user relevance between public and private companies. That is, although the relevance of the information is diminished for private companies because there is a lack of an effect on cash in these transactions, the fact that the current accounting does not appropriately reflect the economics of the transaction is true for both public and private companies and, therefore, there is not a difference in user relevance in this case.
72. Even though the PCDMF would not support a private company alternative, the staff considered whether the alternative suggested by the PCC could be expanded to include both public and private companies. The following factors that suggest that extension of the PCC alternative likely would not be supportable:

- (a) The PCC's approach would require circumventing several existing accounting models (for example, derivatives and BCFs) resulting in inconsistent accounting for economically identical or similar instruments. For example, this alternative would result in different accounting for convertible preferred shares with a down round feature that is triggered based on a reduction of the share price due to issuance of shares at a lower price and convertible preferred shares with a down round feature that is triggered based on a reduction of the share price based on the occurrence of an IPO (or some other event). In reaching its tentative decisions, the Board believed it could not support this outcome and, therefore, determined under its tentative decisions that all convertible instruments with down round features would remain subject to the current BCF model.
- (b) The scoping of the private company alternative and the economic similarity of instruments with down round features leads to several other questions that may need to be considered:
 - (i) Whether all convertible preferred shares with down round features (regardless of the nature of the trigger) should be recognized as a single equity instrument with no recognition of the effect of the feature under the contingent BCF model
 - (ii) Whether convertible debt instruments with down round features should be recognized as a single liability with no recognition of the down round feature under the contingent BCF model
 - (iii) If a *contingent* BCF in a convertible instrument no longer is separately recognized upon being triggered, whether BCFs that exist at inception also no longer should be recognized given that separate recognition in both cases is based on the existence of intrinsic value.
- (c) The alternative also would add to potential confusion in navigating the guidance due to the need to create several new scope exceptions to execute the changes.
- (d) In deliberations on this project, the Board rejected any proposals that resulted in no accounting recognition of the effect of the down round features.

Other Potential Paths Forward

73. This section discusses potential paths forward for this project, which would be applicable to both public and private companies:
- (a) Alternative A: If pricing adjusts, there should be an accounting entry (FASB Tentative Decisions)
 - (b) Alternative B: Remove project from the agenda in lieu of broader liabilities and equity research project.
74. Appendix D is a flowchart comparing outcomes under current GAAP, the Board's tentative decisions, and the private company alternative for specific instrument types.

Alternative A: If Pricing Adjusts, There Should Be an Accounting Entry (FASB Tentative Decisions)

75. In summary, the Board decided that for financial instruments with down round features (as defined in this project), an entity would not consider the down round feature when assessing whether the instrument is indexed to its own stock (when determining if an instrument or feature may be equity classified). Consequently, the existence of a down round feature would not affect the initial classification of a free-standing financial instrument or be determinative of the existence of an embedded derivative. However, the effect of the feature would be recognized and measured at fair value when the feature is triggered.
76. The presentation of the effect of the down round feature being triggered would be based on the classification of the instrument. For a financial instrument classified as equity, the fair value of the effect of the down round feature, when triggered, would be recognized in equity as a deemed dividend. For a financial instrument classified as a liability, the fair value of the effect of the down round feature, when triggered, would be recognized through a charge to net income. For liability-classified instruments, including liability-classified instruments that are in-form equity such as certain warrants, the Board's tentative decisions would require that upon a down round feature being triggered, a charge to an expense would be recognized with an offsetting adjustment to the basis of the

liability. Subsequently, the basis adjustment would be amortized through earnings using the interest method or recognized as part of extinguishment gain or loss. (In external review, questions were raised regarding whether the offsetting entry should be to additional paid in capital consistent with equity-classified instruments.)

77. Disregarding the down round feature for purposes of the derivative assessment, as part of this approach, has two main effects. With respect to warrants, this approach results in classification of the warrants as equity rather than a liability (assuming there is no other feature in the instrument that would require liability classification). Similarly, for convertible debt, this approach avoids separation and fair value measurement of the conversion option as a bifurcated derivative. In each instance, this is viewed as a simplification relative to existing GAAP because the issuer no longer has to remeasure the instrument at fair value each reporting period (in the case of warrants) or separately account for a bifurcated derivative (in the case of convertible debt) when the only reason for this outcome is the existence of a down round.
78. Under the Board's tentative decisions, a down round feature no longer would preclude an instrument from meeting the Topic 815 derivatives scope exception. For freestanding instruments with down round features, the Board's tentative decisions would require measurement of the effect of the down round feature upon trigger. The measurement would be based on fair value or an alternative (simplified) measurement method. The fair value measurement would be performed by comparing the fair value of a contract with a down round provision that has been triggered (and could be triggered again) to the fair value of an instrument without it (with terms adjusted to reflect the absence of the down round feature) to isolate the value of the down round feature (referred to as a "with and without" method). An alternative measurement method would be based on the difference between two hypothetical financial instruments (without down round features)—one instrument having a strike price corresponding to the initial strike price of the instrument issued and one instrument having a strike price corresponding to the reduced strike price upon the down round feature being triggered.

80. Convertible instruments with down round features that are currently accounted for as having bifurcated embedded conversion options under Topic 815 no longer would require bifurcation and fair value measurement each period. However, those instruments would be required to filter through current GAAP on convertible instruments. In the case of instruments with down round features, if the down round feature results in a contingent adjustment of a conversion price or ratio that would result in the instrument becoming beneficial upon occurrence of the triggering event, then such instruments would contain a contingent BCF. Most (if not all) down round features also are contingent BCFs and, therefore, would fall under that model if not captured by the cash convertibles model.
81. The guidance related to contingent BCFs applies to instruments with conversion features that are not beneficial at the commitment date but that become beneficial upon the occurrence of a future event. Once the contingent event occurs the issuer is required to compute the number of shares that would be received pursuant to the new conversion price, which is then compared with the number that would have been received before the occurrence of the contingent event. The excess number of shares multiplied by the commitment date stock price equals the incremental intrinsic value that results from the resolution of the contingency and the corresponding adjustment to the conversion price. That incremental amount shall be recognized when the triggering event occurs. Paragraph 470-20-55-23 illustrates the requirements for instruments with contingent BCFs:

Assume Entity A issues for \$1 million a convertible debt instrument that is convertible into 100,000 shares of Entity A common stock (\$10 conversion price) when the fair value of the stock is \$10. This instrument provides that if Entity A subsequently issues common stock at a price less than \$10, the conversion price adjusts to 90 percent of that subsequent issue price. If Entity A subsequently issues common stock at a price of \$8 per share, the holder's conversion price adjusts to \$7.20 ($\$8 \times 90\%$) and the holder now would receive 138,888 shares ($\$1 \text{ million} \div \7.20) upon conversion, an increase of 38,888 shares from the 100,000 shares that would have been received before the occurrence of the contingent event. The incremental intrinsic value that results from triggering the contingent option is \$388,888—calculated as 38,888 shares \times \$10 stock price at the commitment date or, alternatively, ($\$1 \text{ million} \div \7.20) \times ($\$10 - \7.20)—and would be recognized upon the subsequent issuance of common stock at the \$8 per share price. The accretion of this discount would be required from the date the common stock was subsequently issued at \$8 per share in accordance with this Subtopic.

82. The Board's tentative decisions would retain the contingent BCF model for these instruments rather than integrating that model with the down round models. Accordingly, under the Board's tentative decisions reached, convertible instruments with down round features would be required to follow the contingent BCF model and the effect of the feature would be required to be recognized when the triggering event occurs. The Board believes this to be a practical approach that is consistent with the approach taken when guidance for convertible debt with cash conversion features was issued. Based on that guidance, the cash conversion guidance would apply and the BCF would not be recognized if a convertible debt instrument included both a cash conversion feature and a BCF. In addition, the Board noted that the value transferred by the down round feature would still be recognized under the BCF model at the trigger date, albeit based on a different measurement (intrinsic value). External reviewers were unable to predict the volume of convertible instruments that would newly fall under the convertible models if the Board's tentative decisions reached were finalized.
83. Because of its scope, which would include all financial instruments with down round features, the tentative decisions add incremental accounting requirements for certain instruments relative to current GAAP. An example would be a private company warrant that contains a down round feature but that does not meet the definition of a derivative because it is gross share settled. (Such instruments are not subject to the guidance in Subtopic 815-40 (Issue 07-5) because they do not need to evaluate the derivatives scope exception for instruments indexed to an entity's own stock.) Because this model would apply to all instruments with down round features (that is, not only to down round features in instruments that already are accounted for as derivatives under existing GAAP), more instruments would need to be continuously monitored for the down round feature being triggered.
84. This alternative would change the navigation under current GAAP as follows, as illustrated through the notes to the flowcharts in Appendix B:
- (a) The Board's tentative decisions reached would alter the navigation for warrants that meet the definition of a derivative by bypassing the analysis under the scope exception in Topic 815 regarding whether the down round feature causes the

instrument not to be indexed to an entity's own stock. However, the guidance would still require an analysis of whether the second part of the scope exception is met (that is, that the instrument would be classified in stockholder's equity) under Subtopic 815-40 (Issue 00-19). If both parts of the scope exception are met, the warrant would be classified as equity with no subsequent measurement requirement. (This is the same as the private company alternative.)

(b) For convertible preferred shares, the Board's tentative decisions regarding the application of Topic 815 would alter the analysis in the same way as for warrants. However, the Board's tentative decisions would not bypass the application of the BCF model; bypassing the derivatives guidance moves these instruments "down the chain" to the BCF model. Because a down round feature is, in substance, the same as a contingent BCF, these instruments would get swept into that model. (The application of the BCF model rather than bypassing it is different from the private company alternative.)

(c) For convertible debt instruments, the Board's tentative decisions regarding the application of Topic 815 would apply in the same way as for convertible preferred shares. The Board's tentative decisions would not bypass the application of the specialized models for convertible instruments. Therefore, if the convertible instrument has both a down round feature and a cash conversion feature, the cash conversion model under Subtopic 470-20 would apply. If not, the contingent BCF model would apply. (The application of the Board's tentative decisions to debt-form instruments is different from the private company alternative, which would exclude debt-form instruments from the suggested PCC alternative.)

85. The Board's tentative decisions are based on the concept that when the down round is triggered, the issuer transfers value to the holder at its option by adjusting the share price, and that the value transfer should be recognized in the financial statements. For equity-classified financial instruments, this alternative views the triggering of the down round feature effectively as the "declaration" of a dividend because it is generally within the issuer's control to issue more shares and the down round feature creates an obligation of the issuer. Under this approach for equity-classified financial instruments, the fair value

of the effect of the down round would be recognized as a debit to retained earnings and would reduce the numerator for EPS purposes. The offset would be equity (additional paid in capital). This would be consistent with approach for recognizing the effects of pro rata dividends to shareholders and the approach for recognizing stock dividends in Subtopic 505-20, Equity—Stock Dividends and Stock Splits. Paragraph 505-20-30-3 requires the fair value of the stock issued as a share dividend to be transferred from retained earnings. For liability-classified instruments, the Board’s decision that an expense should be recognized when the down round feature is triggered would be similar in concept to the accounting for repricing of stock options, in that there is an accounting entry for the value transferred to the holder. Guidance in Topic 718, Stock Compensation, requires that stock option repricing be accounted for as a modification, which results in the recognition of additional compensation expense.

86. This alternative is loosely based on the guidance for registration payment arrangements in Subtopic 825-20, Financial Instruments—Registration Payment Arrangements (originally issued as FASB Staff Position No. EITF 00-19-2, *Accounting for Registration Payment Arrangements*). However, this alternative is not identical to the guidance for registration payment arrangements because that guidance would require recognition of a liability when it is probable that a payment is required to be made under the registration rights agreement. This alternative would result in an effect to equity or earnings when the down round feature is triggered, rather than recording a liability when it is probable that it will be triggered. The reason for this is that, from a practical standpoint, the timing of these features being probable of being triggered is likely to be very close to the actual trigger date. Therefore, including a probability threshold in this alternative likely would not result in a material timing difference in terms of recognizing the effects of the down round feature, but would increase the complexity of applying the alternative.
87. One benefit of that approach cited by the Board when issuing the guidance in FSP EITF 00-19-2 was that it results in consistent accounting for the registration rights agreement regardless of whether it is issued in conjunction with a derivative (for example, a warrant), a hybrid instrument (for example, convertible debt), or a nonderivative financial instrument (for example, straight debt). In all cases, the registration rights agreement would be accounted for separately, thereby eliminating the need for it to be assessed for

separation from a nonderivative host. Furthermore, regardless of the outcome of the registration rights provisions (that is, whether or not a payment is made), the outcome of the financial instrument is not affected. For example, if a registration rights agreement is issued in conjunction with a warrant settleable in shares, the warrant will be settled in shares regardless of whether a payment is made under the registration rights agreement. Similarly, under this alternative, the down round feature would not drive liability classification and fair value measurement of the entire freestanding or embedded instrument containing the feature.

88. The primary benefit of the Board's tentative decisions is the relief it would provide for accounting for freestanding warrants. Warrants that currently are classified as liabilities because of the guidance in Subtopic 815-40 (originally issued as Issue 07-5) on down round features no longer would be classified as liabilities. The accounting for these instruments would be simplified because they no longer would be measured at fair value each period. Instead, under the Board's decisions, the classification of the instrument would not be affected by the down round feature and the effect of the down round feature would be recognized only when it is triggered. No incremental accounting required if the down round is never triggered .
89. There also would be relief, relative to current GAAP, for convertible instruments that had an embedded conversion option required under current GAAP to be bifurcated and marked to market each period because of the existence of the down round feature. Under the Board's tentative decisions, the embedded conversion option no longer would be bifurcated under Topic 815. However, other guidance for convertible instruments would apply. Because down round features are, in substance, contingent BCFs, that model would apply and the effects of the feature when triggered would be measured at intrinsic value with the remainder of the proceeds recognized as a separate liability or equity component.
90. Based on outreach and research performed, the staff understands that the majority of instruments issued with down round features by both public and private companies are warrants. The staff's search of 2015 public company filings revealed that of those public companies that disclosed information about a financial instrument with a down round feature, 79 percent of these instruments were warrants. Convertible debt instruments with

down round features are much less common in the current marketplace. The staff understands they are essentially nonexistent in the current marketplace for private companies but are occasionally issued by public, development-stage companies. Therefore, based on this information, keeping the contingent BCF model in effect for those instruments under this alternative may not affect a significant number of instruments and, therefore, may be acceptable from a cost-benefit perspective.

91. While this alternative would require a measurement of the effect of the down round feature, and, therefore, does not fully alleviate the measurement issue, that measurement of the effect of the down round feature is limited to situations in which the feature is triggered. Some practitioners have noted that unlike a fair value measurement, the alternative measurement method does not consider the value of future down round protection. Also, some note that the potential for a partial double counting of the fair value of down round feature exists because the fair value of the down round feature is initially captured as part of the recorded basis of the financial instrument. If the down round is then triggered shortly after issuance and is measured on a standalone basis at fair value (or based on an approach that estimates the fair value of the effect of the down round feature), the accounting for the down round feature after the trigger results in a partial double counting effect in the financial statements for the down round feature. The staff notes that these issues, while valid, are the result of the creation of a model to generate practical simplifications for the accounting for financial instruments with down round features. The objective of that alternative measurement was to provide a proxy for fair value measurement that would be practicable (in other words, it would not require the direct measurement of an instrument with a down round feature and without a down round feature to derive the fair value of the down round feature itself, which is significantly more complex than the alternative approach).

Alternative B: Remove Project from the Agenda in Lieu of Broader Liabilities and Equity Research Project

92. On August 4, 2016, the FASB issued its Invitation to Comment, Agenda Consultation (ITC). The ITC includes a chapter on Distinguishing Liabilities from Equity. The ITC considers a holistic examination of the accounting requirements for distinguishing between liabilities and equity. The examination would include simple instruments (for example, shares, options, and forwards) and complex instruments (for example,

convertible debt and convertible preferred shares). The initial research aims to answer the question of whether a present obligation to transfer shares of the reporting entity meets the definition of a liability. The ITC presents two potential paths the project might take.

- (a) Alternative A: Equity classification—no obligations to transfer assets or shares (for example, perpetual instruments) (indexation and settlement are irrelevant)
- (b) Alternative B: Equity classification—distinguishes between obligations to transfer assets versus shares (indexation and settlement matter).

93. It is impossible to know what direction this research project may take as it progresses because it is in an early stage. Although the ITC includes some alternatives, the Board could consider other alternatives once the project is added to the technical agenda (for example, if stakeholders respond to ITC with other ideas). The staff thinks that under any holistic approach, it is likely that instruments with down round features within the scope of this project would be liability-classified in the broader project. It could be possible that under an Alternative B path, down rounds might be equity classified if the Board decided to carry forward the exceptions discussed in this current project to that future project. However, there is some risk of a potential double accounting change for these entities. That is, entities would need to adopt the changes made in this targeted improvements project and then may need to change their accounting again after the broader project is completed, depending on the outcome of that project.
94. Even if there is a double change, the period of time that companies would benefit from the simplified accounting for down round is continually diminishing. It has been two and a half years since this targeted improvements project was added to the Board's research agenda (January 2014). The staff thinks that it would take six months (if the Board continues with its current path) to one year (if Board changes course to a different alternative) to finalize the amendments. Therefore, the period of potential benefit decreases the longer this targeted improvements project takes to complete while progress is being made on the broader research project.

Overarching issues

95. Other than a holistic approach described in Alternative B, there are challenges that are common to any path forward that would amend current GAAP for financial instruments that include down round features. Creating a specific model (or scope exceptions from specific models) for one type of feature adds to the already complex framework in GAAP that exists for financial instruments with characteristics of liabilities and equity. Adding a new dimension to this framework by creating a specialized model for a specific feature within a specific subset of instruments adds to that complexity. Furthermore, it creates a risk that entities applying this guidance will incorrectly navigate the guidance, especially when economically similar instruments have different accounting. For example, under the private company alternative, convertible preferred instruments with some types of down round features would be classified as single equity instruments with no recognition upon the feature being triggered, while others would be accounted for as having two equity components under the contingent BCF model upon the down round feature being triggered.
96. In addition, different accounting treatment for one type of feature within a particular type of instrument calls into question the accounting for economically identical or similar features across instruments. For example, each separation model for convertible instruments was created to address a particular type of feature that transfers value to the investor, and the consequence of unwinding one separation model likely would call into question the validity of all models. Appendix C on convertible instruments discusses the underlying rationale for development of each of the separation models under GAAP.
97. A related point is that there is no conceptual basis for limiting the exception to one particular feature. Creating a private company alternative or a specialized model for one particular feature based on cost and complexity for some issuers may lead other entities to seek relief from the accounting for other features on the same basis. The Board focused this project on instruments with down round features because of feedback from the PCC. However, the staff notes there other features where stakeholders may perceive similar issues with the financial reporting. For instance, guidance in Subtopic 815-40 includes

the following example on when liability classification and ongoing fair value measurement are required.

- (a) Company A issues warrants that permit the holder to buy 100 shares of its common stock for an initial price of \$10 per share. The warrants have 10-year terms and are exercisable at any time. However, the terms of the warrants specify that the strike price is reduced by \$0.50 after any year in which Company A does not achieve revenues of at least \$100 million.
98. This example is similar to the down rounds scenario because the strike price adjustment provides the investor with downside protection (when the company does not achieve its revenue target). Even if the company is over performing (that it its revenue far exceeds \$100 million), and, therefore, the strike price adjustment will not be triggered, the entity is still recording the instrument as a liability and marking to market the fair value each period. Economically, this instance seems similar to the down round feature but results in different financial reporting under any of the alternatives.
99. Finally, both the private company alternative and the Board’s tentative decisions would result in equity classification of certain instruments that are currently classified in whole or part as liabilities. From a conceptual standpoint, some believe that equity classification of instruments with down round features contradicts the underlying rationale for the guidance in Issue 07-5 that the feature is not considered a characteristic of equity ownership.

Questions for Discussion

Discussion Questions

1.Paragraphs 45—49 of the memo describe the suggested private company alternative. Please provide any feedback on the alternative and any suggested modifications to the alternative.

2. Paragraph 48 of the memo describes certain instruments that would not be subject to the suggested private company alternative. For example, the alternative would apply to convertible preferred stock with a contingent BCF that also is a down round feature, but the alternative would not apply to convertible debt with a comparable feature. Do you have any concerns that two economically similar instruments would

receive different accounting? Are there any concerns that this creates an opportunity for structuring?

3. What are your thoughts on the volume of companies that might apply a private company alternative, given that companies that issue instruments with down round features often aspire to go public? How does that affect your thoughts on the benefits (and costs) of a potential private company alternative?

4. In light of the research related to public company pervasiveness of instruments with down round features and the staff's analysis of the PCDMF, would you recommend we continue to pursue a solution for all companies or is a private company alternative justified? If you support a private company alternative, what are your thoughts on the effect of the alternative on comparability of financial statements (that is, comparing private companies electing the alternative to public companies and comparing private companies electing the alternative with those not electing the alternative)?

5. Do you have any concerns about the timing of this targeted improvements project considering that the liabilities and equity research project is underway? That is, from a cost-benefit perspective do you have any concerns about the timing of a potential double change?

6. What are PCC members' recommendations on next steps for this project?