FASB EXPOSURE DRAFT

Proposed Accounting Standards Update

Issued: December 7, 2016
Comments Due: February 6, 2017

Distinguishing Liabilities from Equity (Topic 480)

I. Accounting for Certain Financial Instruments with Down Round Features
II. Replacement of the Indefinite Deferral for Mandatorily Redeemable Financial Instruments of Certain Nonpublic Entities and Certain Mandatorily Redeemable Noncontrolling Interests with a Scope Exception

The Board issued this Exposure Draft to solicit public comment on proposed changes to Topic 480 of the *FASB Accounting Standards Codification*®. Individuals can submit comments in one of three ways: using the electronic feedback form on the FASB website, emailing comments to director@fasb.org, or sending a letter to "Technical Director, File Reference No. 2016-370, FASB, 401 Merritt 7, PO Box 5116, Norwalk, CT 06856-5116."

Financial Accounting Standards Board

Notice to Recipients of This Exposure Draft of a Proposed Accounting Standards Update

The Board invites comments on all matters in this Exposure Draft until February 6, 2017. Interested parties may submit comments in one of three ways:

- Using the electronic feedback form available on the FASB website at Exposure Documents Open for Comment
- Emailing comments to director@fasb.org, File Reference No. 2016-370
- Sending a letter to "Technical Director, File Reference No. 2016-370, FASB, 401 Merritt 7, PO Box 5116, Norwalk, CT 06856-5116."

All comments received are part of the FASB's public file and are available at www.fasb.org.

The *FASB Accounting Standards Codification*® is the source of authoritative generally accepted accounting principles (GAAP) recognized by the FASB to be applied by nongovernmental entities. An Accounting Standards Update is not authoritative; rather, it is a document that communicates how the Accounting Standards Codification is being amended. It also provides other information to help a user of GAAP understand how and why GAAP is changing and when the changes will be effective. A copy of this Exposure Draft is available at www.fasb.org.

FASB FINANCIAL ACCOUNTING STANDARDS BOARD

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I. Accounting for Certain Financial Instruments with Down Round Features

II. Replacement of the Indefinite Deferral for Mandatorily Redeemable Financial Instruments of Certain Nonpublic Entities and Certain Mandatorily Redeemable Noncontrolling Interests with a Scope Exception

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Summary and Questions for Respondents

Why Is the FASB Issuing This Proposed Accounting Standards Update (Update)?

The Board decided to undertake this project to address issues identified as a result of the complexity associated with applying generally accepted accounting principles (GAAP) for certain financial instruments with characteristics of liabilities and equity.

Part I of this proposed Update addresses the complexity of accounting for certain financial instruments with down round features. Down round features are features of certain equity-linked instruments (or embedded features) that result in the strike price being reduced on the basis of the pricing of future equity offerings. Current accounting guidance creates cost and complexity for entities that issue financial instruments (such as warrants and convertible instruments) with down round features that require fair value measurement of the entire instrument or conversion option.

Stakeholders have asserted that accounting for freestanding and embedded instruments with down round features as liabilities 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. Stakeholders also suggest that this accounting does not reflect the economics of the down round feature, which exists to protect certain 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 and a decrease will only cause an adjustment when an entity engages in a subsequent equity offering.

Part II of this proposed Update addresses the difficulty of navigating Subtopic 480-10, Distinguishing Liabilities from Equity—Overall, because of the existence of extensive pending content in the *FASB Accounting Standards Codification*®. This pending content is the result of the indefinite deferral of accounting requirements about mandatorily redeemable financial instruments of certain nonpublic entities and certain mandatorily redeemable noncontrolling interests.

Who Would Be Affected by the Amendments in This Proposed Update?

The amendments in Part I of this proposed Update would affect all entities that issue equity-linked instruments (or embedded features) that include down round features. The amendments in Part II of this proposed Update will not have an accounting effect.

What Are the Main Provisions?

The amendments in Part I of this proposed Update would change the accounting for certain equity-linked financial instruments (or embedded features) with down round features. The proposed amendments would require that when determining whether certain financial instruments should be classified as liabilities or equity instruments, an entity would not consider the down round feature when assessing whether the instrument is indexed to its own stock. However, an entity would recognize the effect of the feature when triggered (that is, when the exercise price of the related equity-linked financial instrument is adjusted downward because of the down round feature) as follows:

1. For a financial instrument classified as equity, an entity would recognize the value of the effect of the down round feature in equity as a dividend.
2. For a financial instrument classified as a liability, an entity would recognize the value of the effect of the down round feature through a charge to net income.

For financial instruments with down round features that have been triggered during the reporting period, an entity would disclose that the feature has been triggered, the value of the effect of the down round feature being triggered, and the financial statement line item in which that effect is recorded.

The amendments in Part II of this proposed Update are a recharacterization of the indefinite deferral of certain provisions of Subtopic 480-10, that are currently presented as pending content in the Codification, to a scope exception. These amendments will not have an accounting effect.

How Would the Main Provisions Differ from Current Generally Accepted Accounting Principles (GAAP) and Why Would They Be an Improvement?

The amendments in Part I of this proposed Update create a model that would apply to certain financial instruments (either freestanding or embedded) with down round features. Under current GAAP, an equity-linked financial instrument with a down round feature that is not otherwise required to be classified as a liability under

Subtopic 480-10 is evaluated under the guidance in Topic 815, Derivatives and Hedging, to determine whether it meets the definition of a derivative. If it does meet that definition, the instrument (or embedded feature) is evaluated to determine whether it is indexed to an entity's own stock as part of the analysis of whether it qualifies for a scope exception from derivative accounting. Generally, for warrants and conversion options embedded in financial instruments that are deemed to have a debt host (assuming the underlying shares are readily convertible to cash or the contract provides for net settlement such that the embedded conversion option meets the definition of a derivative), a down round feature results in an instrument not being considered indexed to an entity's own stock. This results in a requirement that the freestanding financial instrument or the bifurcated conversion option be classified as a liability, which the reporting entity must measure at fair value initially and at each subsequent reporting date.

The proposed amendments would eliminate the requirement to evaluate the down round feature in financial instruments (or embedded features) in determining whether those instruments are indexed to an entity's own stock under the guidance in Subtopic 815-40, Derivatives and Hedging—Contracts in Entity's Own Equity, for purposes of determining whether it qualifies for a scope exception from derivative accounting. An entity would still be required to determine whether instruments would be classified in equity under the guidance in Subtopic 815-40 in determining whether they qualify for that scope exception. If they do qualify, those instruments would not be classified as liabilities and instead would be subject to the guidance in this proposed Update.

The proposed model for financial instruments with down round features would apply to instruments with down round features that currently meet the definition of a derivative and are subject to the guidance in Subtopic 815-40 as well as those for which the down round feature does not currently affect classification and measurement under current GAAP, thus eliminating an inconsistency in the accounting for those instruments that exists under current GAAP. For convertible instruments, the proposed model for financial instruments with down round features would apply only if an entity is not required to apply existing specialized accounting guidance for convertible instruments in Subtopic 470-20, Debt—Debt with Conversion and Other Options.

Not considering the down round feature for purposes of assessing whether an instrument is indexed to an entity's own stock under Topic 815 is a simplification relative to current GAAP. This is because, assuming the required criteria for equity classification in Subtopic 815-40 are met, an entity that issued such an instrument would no longer measure the instrument at fair value at each reporting period (in the case of warrants) or separately account for a bifurcated derivative (in the case of convertible instruments) on the basis of the existence of a down round feature. The effect of the down round feature would be measured only when the feature is triggered, which reflects the occurrence of an economic transfer of value to the holder of the instrument, while alleviating the complexity and income statement volatility associated with fair value measurement on an ongoing basis (when value is not transferred). Similarly, for convertible instruments with down round features, applying specialized guidance such as the model for contingent beneficial conversion features rather than bifurcating an embedded derivative also would be a simplification because the issuer would recognize the intrinsic value of the feature only when the feature is triggered.

The proposed amendments in Part II of this proposed Update would replace the indefinite deferral of certain guidance in Subtopic 480-10 with a scope exception. This will have the benefit of improving the readability of the Codification and reducing the cost and complexity associated with navigation of the guidance in Subtopic 480-10.

When Would the Amendments Be Effective?

The Board will determine the effective date of Part I of this proposed Update after considering stakeholders' feedback on this proposed Update.

The proposed amendments in Part II of this proposed Update would not require any transition guidance because those amendments do not have an accounting effect.

Questions for Respondents

The Board invites individuals and organizations to comment on all matters in this proposed Update, particularly on the issues and questions below on Part I of this proposed Update. Comments are requested from those who agree with the proposed guidance as well as from those who do not agree. Comments are most helpful if they identify and clearly explain the issue or question to which they relate. Those who disagree with the proposed guidance are asked to describe their suggested alternatives, supported by specific reasoning.

Question 1: Do you agree that when classifying certain financial instruments with down round features, the down round feature should be excluded from the assessment of whether an instrument is indexed to an entity's own stock (in accordance with the guidance in Subtopic 815-40)? If not, please explain why and suggest alternatives.

Question 2: Do you agree that for certain financial instruments with down round features, the effect of the down round feature should be recognized when it is triggered and that the approach for recognition should follow the classification (liability or equity) of the instrument? If not, please explain why and suggest alternatives.

Question 3: The proposed amendments in paragraphs 480-20-30-1 through 30-2 describe how to measure the effect of the down round trigger. Do you agree with that approach? If not, please explain why and suggest alternatives.

Question 4: Do you agree that for certain financial instruments with down round features that have been triggered during the reporting period, an entity should disclose the fact that the feature has been triggered, the value of the effect of the down round being triggered, and the financial statement line item in which that effect has been recorded? If not, please explain why and suggest alternatives.

Question 5: Do you agree that entities should apply the proposed guidance to outstanding instruments as of the effective date of the change, with no adjustments to prior periods presented, with the cumulative effect of the change recognized as an adjustment of the opening balance of retained earnings in the fiscal year or interim period of adoption? If not, please explain why and suggest alternatives.

Question 6: How much time would be necessary to adopt the amendments in this proposed Update? Should early adoption be permitted? Would the amount of time needed to apply the proposed amendments by entities other than public business entities be different from the amount of time needed by public business entities?

Amendments to the *FASB Accounting Standards Codification*®

Summary of Proposed Amendments to the Accounting Standards Codification

1. The following table provides a summary of the proposed amendments to the Accounting Standards Codification. The amendments in this proposed Update are separated into two parts. Part I relates to proposed amendments to the accounting for certain financial instruments with down round features. Part II relates to proposed amendments to the indefinite deferral in Subtopic 480-10 related to mandatorily redeemable financial instruments of certain nonpublic entities and certain mandatorily redeemable noncontrolling interests.

Codification Topic	**Description of Changes**
Part I: Accounting for Certain Financial Instruments with Down Round Features	
480—Distinguishing Liabilities from Equity	Add Subtopic 480-20, Distinguishing Liabilities from Equity—Certain Financial Instruments with Down Round Features, to create a separate accounting model for certain financial instruments with down round features. Change all instances of references to "Topic 480" to "Subtopic 480-10."
470—Debt	Amend Subtopic 470-20 to clarify how the convertible instruments guidance interacts with guidance on financial instruments with down round features in Subtopic 480-20.
505—Equity	Amend Topic 505 to clarify how the equity instruments guidance interacts with guidance on financial instruments with down round features.
815—Derivatives and Hedging	Amend Topic 815 to clarify how the derivatives guidance interacts with guidance on financial instruments with down round features.

Codification Topic	Description of Changes
Part II: Replacement of the Indefinite Deferral for Mandatorily Redeemable Financial Instruments of Certain Nonpublic Entities and Certain Mandatorily Redeemable Noncontrolling Interests with a Scope Exception	
480—Distinguishing Liabilities from Equity	Amend Subtopic 480-10 to change transition guidance to a scope exception.

Introduction

2. The Accounting Standards Codification is amended as described in paragraphs 3–13. In some cases, to put the change in context, not only are the amended paragraphs shown but also the preceding and following paragraphs. Terms from the Master Glossary are in **bold** type. Added text is <u>underlined</u>, and deleted text is ~~struck out~~.

Part I

Accounting for Certain Financial Instruments with Down Round Features

3. Amend each of the following paragraphs and related pending content to change all instances of “Topic 480” to “Subtopic 480-10” and “Topics 480 and XXX” to “Subtopic 480-10 and Topic XXX,” with a link to transition paragraph 480-20-65-1, as follows:

Subtopic	Paragraph Amended
260-10, Earnings Per Share—Overall	260-10-55-36A
405-10, Liabilities—Overall	405-10-05-2(h)
460-10, Guarantees—Overall	460-10-25-1(d) 460-10-55-20
470-20, Debt—Debt with Conversion and Other Options	470-20-35-9
505-10, Equity—Overall	505-10-05-3 505-10-60-3A

Subtopic	Paragraph Amended
718-10, Compensation—Stock Compensation—Overall	718-10-25-7 718-10-25-8 718-10-25-9 718-10-25-12 718-10-35-12 718-10-35-14 718-10-55-131
810-10, Consolidation—Overall	810-10-40-1 810-10-45-17
815-10, Derivatives and Hedging—Overall	815-10-25-10
815-15, Derivatives and Hedging—Embedded Derivatives	815-15-25-14 815-15-55-110
815-40, Derivatives and Hedging—Contracts in Entity's Own Equity	815-40-15-3(e) 815-40-15-5C 815-40-15-8 815-40-15-12 815-40-55-8 815-40-55-12 815-40-55-18

Amendments to Master Glossary

4. Add the new Master Glossary term *Down Round Feature,* with a link to transition paragraph 480-20-65-1, as follows:

<u>Down Round Feature</u>

<u>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 antidilution provision** is not considered a down round feature.</u>

Addition of Subtopic 480-20

5. Add Subtopic 480-20, Distinguishing Liabilities from Equity—Certain Financial Instruments with Down Round Features, with a link to transition paragraph 480-20-65-1, as follows:

[For ease of readability, the new Subtopic is not underlined.]

Distinguishing Liabilities from Equity—Certain Financial Instruments with Down Round Features

Overview and Background

General

480-20-05-1 An entity may issue a **financial instrument** (for example, a warrant or a convertible instrument) with a **down round feature**. This Subtopic provides guidance on such instruments.

Scope and Scope Exceptions

General

> Entities

480-20-15-1 The guidance in this Subtopic applies to all entities.

> Instruments

480-20-15-2 The guidance in this Subtopic applies to **financial instruments** with a **down round feature**.

480-20-15-3 The guidance in this Subtopic does not apply to any of the following:

a. Share-based payment awards within the scope of Topic 718 on stock compensation.
b. Share-based payment transactions within the scope of Subtopic 505-50 on equity-based payments to non-employees.
c. Financial instruments required to be classified as assets or liabilities under Subtopic 480-10.
d. Freestanding financial instruments and embedded equity-linked features that are measured at fair value on a recurring basis, including (but not limited to) the following:
    1. Freestanding financial instruments and embedded equity-linked features requiring separate accounting that meet the definition of a derivative in Subtopic 815-10 on derivatives and hedging and do not qualify for the scope exception on contracts in an entity's own shares in paragraph 815-10-15-74 due to contractual terms or features other than a down round feature

    2. Freestanding contracts that are indexed to and potentially settled in the entity's stock and classified as assets or liabilities under Section 815-40-25
    3. Financial instruments that are measured at fair value under the fair value option elections in Subtopic 825-10 on financial instruments and Subtopic 815-15 on embedded derivatives.
b. Convertible instruments that are required to be separated under the following guidance:
    1. Convertible debt with a cash conversion feature within the scope of the Cash Conversion Subsections of Subtopic 470-20 on debt with conversion and other options
    2. Convertible instruments with a **beneficial conversion feature** or a contingent beneficial conversion feature within the scope of Subtopic 470-20
    3. Convertible debt issued at a substantial premium required to be recognized as paid-in capital in accordance with paragraph 470-20-25-13.

Glossary

Beneficial Conversion Feature

A nondetachable conversion feature that is in the money at the commitment date.

Down Round Feature

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 antidilution provision** is not considered a down round feature.

Equity Restructuring

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.

Financial Instrument

Cash, evidence of an ownership interest in an entity, or a contract that both:

a. Imposes on one entity a contractual obligation either:

1. To deliver cash or another financial instrument to a second entity
2. To exchange other financial instruments on potentially unfavorable terms with the second entity.

b. Conveys to that second entity a contractual right either:
1. To receive cash or another financial instrument from the first entity
2. To exchange other financial instruments on potentially favorable terms with the first entity.

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

Contractual rights and contractual obligations encompass both those that are conditioned on the occurrence of a specified event and those that are not. All contractual rights (contractual obligations) that are financial instruments meet the definition of asset (liability) set forth in FASB Concepts Statement No. 6, Elements of Financial Statements, although some may not be recognized as assets (liabilities) in financial statements—that is, they may be off-balance-sheet—because they fail to meet some other criterion for recognition.

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

Standard Antidilution Provisions

Standard antidilution provisions are those that result in adjustments to the conversion ratio in the event of an **equity restructuring** transaction that are designed to maintain the value of the conversion option.

Recognition

General

480-20-25-1 An entity shall classify a **financial instrument** with a **down round feature** as a liability or equity in accordance with applicable generally accepted accounting principles (GAAP) without consideration of the existence of the down round feature for purposes of determining whether an instrument is indexed to an entity's own stock under Subtopic 815-40 on derivatives and hedging—contracts in an entity's own equity.

480-20-25-2 An entity shall recognize the value of the effect of a down round feature when that feature has been triggered (that is, the strike price of the related equity-linked financial instrument has been reduced).

480-20-25-3 When a down round feature is triggered, an entity shall recognize the value of the effect of the feature on the basis of the balance sheet classification of the financial instrument that includes the feature, as follows:

a. If the entity classifies the financial instrument that includes the down round feature as equity, the entity shall recognize the value of the effect of the down round feature, when triggered, as a reduction of retained earnings and an increase of additional paid-in capital.
b. If the entity classifies the financial instrument that includes the down round feature as a liability, the entity shall recognize the value of the effect of the down round feature, when triggered, as a reduction of earnings and an increase of the carrying amount of the liability-classified instrument that includes the feature.

Initial Measurement

General

480-20-30-1 As of the date that a **down round feature** is triggered (that is, the date that the strike price of the related equity-linked **financial instrument** has been reduced), an entity shall measure the value of the effect of the feature as the difference between the following amounts determined immediately after the down round feature is triggered:

a. The fair value of the financial instrument (without the down round feature) with a strike price corresponding to the current strike price of the instrument issued (that is, before the strike price reduction)
b. The fair value of the financial instrument (without the down round feature) with a strike price corresponding to the reduced strike price upon the down round feature being triggered.

480-20-30-2 The fair values of the financial instruments referenced in paragraph 480-20-30-1 shall be measured in accordance with the guidance in Topic 820 on fair value measurement.

Subsequent Measurement

General

480-20-35-1 An entity shall recognize the incremental value of the effect of the **down round feature** each time it is triggered but shall not otherwise subsequently remeasure the value of a down round feature that it has recognized and measured in accordance with paragraphs 480-20-25-3 and 480-20-30-1 through 30-2.

480-20-35-2 For a **financial instrument** with a down round feature classified as equity for which the value of the effect of the down round feature has been recognized upon trigger in accordance with paragraph 480-20-25-3, an entity shall not subsequently amortize the amount in additional paid-in capital arising from recognition of the value of the effect of the down round feature.

480-20-35-3 For a financial instrument with a down round feature classified as a liability for which the value of the effect of the down round feature has been recognized upon trigger in accordance with paragraph 480-20-25-3, an entity shall subsequently amortize the adjustment of the carrying amount of the liability-classified instrument arising from recognition of the value of the effect of the down round feature using the effective interest method in accordance with Topic 835 on interest.

Derecognition

General

480-20-40-1 For a **financial instrument** with a **down round feature** classified as equity for which the value of the effect of the down round feature has been recognized upon trigger in accordance with paragraph 480-20-25-3, an entity shall not derecognize the amount in additional paid-in capital arising from recognition of the value of the effect of the down round feature when the related equity-classified instrument is settled.

480-20-40-2 When a financial instrument classified as a liability with a down round feature for which the value of the effect of the down round feature has been recognized upon trigger (in accordance with paragraph 480-20-25-3) is extinguished, an entity shall recognize the remaining amount of the basis adjustment that has not been amortized as part of the gain or loss upon extinguishment. Paragraph 470-50-40-2 requires that the difference between the reacquisition price of debt and the net carrying amount of the extinguished debt be recognized currently in income in the period of extinguishment as losses or gains.

480-20-40-3 When a convertible financial instrument classified as a liability with a down round feature for which the value of the effect of the down round feature has been recognized upon trigger (in accordance with paragraph 480-20-25-3) is converted, an entity shall reclassify to equity any amount of the basis adjustment that the entity has not amortized in accordance with paragraph 470-20-40-4. If the convertible instrument is extinguished, the entity shall recognize the remaining amount of the basis adjustment as part of the gain or loss recognized upon extinguishment as the difference between the cash reacquisition price and the carrying amount of the convertible instrument, as required by paragraph 470-50-40-4.

Disclosure

General

480-20-50-1 For a **financial instrument** with a **down round feature** that has been triggered during the reporting period, an entity shall disclose the following:

a. The fact that the feature has been triggered
b. The value of the effect of the down round feature being triggered
c. The financial statement line item in which that effect is recorded.

480-20-50-2 An entity shall disclose information required by paragraph 505-10-50-3 about pertinent rights and privileges of its outstanding securities that include down round features.

Implementation Guidance and Illustrations

General

> Illustrations

> > Example 1: Warrant with a Down Round Feature

480-20-55-1 Assume Entity A issues warrants that permit the holder to buy 100 shares of its common stock for $10 per share. The warrants have a 10-year term, are exercisable at any time, and contain a **down round feature**. The warrants are classified as equity by Entity A in accordance with the guidance in this Subtopic. The terms of the down round feature specify that if Entity A issues additional shares of its common stock for an amount less than $10 per share or issues an equity-linked **financial instrument** with a strike price below $10 per share, the strike price of the warrants would be reduced to the most recent issuance price or strike price, but the terms of the down round are such that the strike price cannot be reduced below $8 per share. After the issuance of the warrants, Entity A issues shares of its common stock at $7 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 $8 per share.

480-20-55-2 At the date at which the strike price is reduced because of the equity issuance, Entity A should recognize the value of the effect of the down round feature in the warrants in accordance with the guidance in paragraphs 480-20-25-3 and 480-20-30-1 through 30-2. Entity A determines the value on the basis of the guidance in paragraphs 480-20-30-1 through 30-2. Entity A determines that the fair value of the warrants (without the down round feature) with a strike price of $10 per share immediately after the down round feature is triggered is $1,000 and that the fair value of the warrants (without the down round feature) with a strike price of $8 per share immediately after the down round feature is triggered is $1,500. The increase in the value of $500 is the value of the effect of the down round feature to be recognized in equity as follows.

Retained earnings	$500	
Additional paid-in capital		$500

Transition and Open Effective Date Information

General

> Transition Related to Accounting Standards Update No. 201X-XX, *Distinguishing Liabilities from Equity (Topic 480): Part I, Accounting for Certain Financial Instruments with Down Round Features*

480-20-65-1 The following represents the transition and effective date information related to Accounting Standards Update No. 201X-XX, *Distinguishing Liabilities from Equity (Topic 480): Part I, Accounting for Certain Financial Instruments with Down Round Features*:

a. The pending content that links to this paragraph shall be effective for the first fiscal year and interim period beginning after [date to be inserted after exposure].
b. The pending content that links to this paragraph shall be applied to outstanding **financial instruments** with a **down round feature** at the effective date by means of a cumulative-effect adjustment to the statement of financial position as of the beginning of the first fiscal year and interim period(s) in which the pending content that links to this paragraph is effective. The cumulative effect of the change shall be recognized as an adjustment of the opening balance of retained earnings in the fiscal year and interim period of adoption.
c. An entity shall provide the following disclosures consistent with Section 250-10-50 in the period of adoption:
    1. The nature of the change in accounting principle
    2. The cumulative effect of the change on retained earnings in the statement of financial position as of the beginning of the earliest period presented in which the pending content that links to this paragraph is effective.
d. An entity that issues interim financial statements shall provide the disclosures in item (c) in the financial statements of both the interim period of the change and the fiscal year of the change.

Amendments to Subtopic 470-20

6. Add paragraph 470-20-25-14, with a link to transition paragraph 480-20-65-1, as follows:

Debt—Debt with Conversion and Other Options

Recognition

> Conversion Features That Are Not Beneficial

470-20-25-14 For instruments within the scope of Subtopic 480-20 on distinguishing liabilities from equity—certain financial instruments with down round features, an entity shall recognize the effect of a **down round feature** when it has been triggered (that is, the exercise price of the related equity-linked **financial instrument** has been reduced). An entity shall recognize a convertible debt instrument with a conversion feature that is not beneficial that contains a down round feature in accordance with paragraph 470-20-25-12 and shall apply the guidance in Subtopic 480-20 when the down round feature is triggered. ~~Paragraph not used.~~

Amendments to Subtopic 505-10

7. Add paragraphs 505-10-25-4 and 505-10-50-10B, with a link to transition paragraph 480-20-65-1, as follows:

Equity—Overall

Recognition

505-10-25-4 For instruments within the scope of Subtopic 480-20 on distinguishing liabilities from equity—certain financial instruments with down round features, an entity shall recognize the effect of a **down round feature** when it has been triggered (that is, the exercise price of the related equity-linked **financial instrument** has been reduced). An entity that issues an equity instrument that contains a down round feature and is within the scope of the guidance in that Subtopic shall apply the guidance in Subtopic 480-20 when the down round feature is triggered.

Disclosure

> Contingently Convertible Securities

<u>**505-10-50-10B** For an incremental disclosure requirement for a **financial instrument** with a **down round feature**, see paragraph 480-20-50-1.</u>

Amendments to Subtopic 815-10

8. Add paragraph 815-10-15-75A, with a link to transition paragraph 480-20-65-1, as follows:

Derivatives and Hedging—Overall

Scope and Scope Exceptions

> Instruments

> > Instruments Not within Scope

> > > Certain Contracts Involving an Entity's Own Equity

815-10-15-74 Notwithstanding the conditions of paragraphs 815-10-15-13 through 15-139, the reporting entity shall not consider the following contracts to be derivative instruments for purposes of this Subtopic:

a. Contracts issued or held by that reporting entity that are both:
   1. Indexed to its own stock
   2. Classified in stockholders' equity in its statement of financial position.
b. Contracts issued by the entity that are subject to Topic 718 or Subtopic 505-50. If any such contract ceases to be subject to Topic 718 or Subtopic 505-50 in accordance with paragraphs 718-10-35-9 through 35-14, the terms of that contract shall then be analyzed to determine whether the contract is subject to this Subtopic. An award that ceases to be subject to Topic 718 or Subtopic 505-50 in accordance with those paragraphs shall be analyzed to determine whether it is subject to this Subtopic.
c. Any of the following contracts:
   1. A contract between an acquirer and a seller to enter into a business combination
   2. A contract to enter into an **acquisition by a not-for-profit entity**
   3. A contract between one or more NFPs to enter into a **merger of not-for-profit entities**.
d. Forward contracts that require settlement by the reporting entity's delivery of cash in exchange for the acquisition of a fixed number of its equity shares (forward purchase contracts for the reporting entity's shares that require physical settlement) that are accounted for under paragraphs 480-10-30-3 through 30-5, 480-10-35-3, and 480-10-45-3.

815-10-15-75 The scope exceptions in the preceding paragraph do not apply to either of the following:

a. The counterparty in those contracts. For example, the scope exception in (b) in the preceding paragraph related to stock-based compensation arrangements does not apply to equity instruments (including stock options) received by nonemployees as compensation for goods and services.
b. A contract that an entity either can or must settle by issuing its own equity instruments but that is indexed in part or in full to something other than its own stock. That contract can be a derivative instrument for the issuer under paragraphs 815-10-15-13 through 15-139, in which case it would be accounted for as a liability or an asset in accordance with the requirements of this Subtopic. For example, a forward contract that is indexed to both an entity's own stock and currency exchange rates does not qualify for the exception in (a) in the preceding paragraph with respect to that entity's accounting because the forward contract is indexed in part to something other than that entity's own stock (namely, currency exchange rates).

815-10-15-75A For purposes of evaluating whether a financial instrument meets the scope exception in paragraph 815-10-15-74(a)(1), a **down round feature** shall be excluded from the consideration of whether the instrument is indexed to the entity's own stock.

Amendments to Subtopic 815-40

9. Add paragraph 815-40-15-3A and amend paragraph 815-40-15-4, with a link to transition paragraph 480-20-65-1, as follows:

Derivatives and Hedging—Contracts in Entity's Own Equity

Scope and Scope Exceptions

> Instruments

815-40-15-2 The guidance in this Subtopic applies to freestanding contracts that are indexed to, and potentially settled in, an entity's own stock. Paragraph 815-40-55-1 provides related implementation guidance.

815-40-15-3 The guidance in this Subtopic does not apply to any of the following:

a. Either the **derivative instrument** component or the **financial instrument** if the derivative instrument component is embedded in and not detachable from the financial instrument

b. Contracts that are issued to compensate employees
c. Contracts that are issued to acquire goods or services from nonemployees when performance has not yet occurred
d. A written put option and a purchased call option embedded in the shares of a noncontrolling interest of a consolidated subsidiary if the arrangement is accounted for as a financing under the guidance beginning in paragraph 480-10-55-53
e. Financial instruments that are within the scope of Topic 480 (see paragraph 815-40-15-12).

815-40-15-3A When classifying a financial instrument with a **down round feature**, the feature is excluded from the consideration of whether the instrument is indexed to the entity's own stock for the purposes of applying paragraphs 815-40-15-7C through 15-7I (Step 2).

815-40-15-4 Item (a) in ~~the preceding~~ paragraph 815-40-15-3 does not negate the applicability of this Subtopic (as further discussed in paragraphs 815-40-25-39 through 25-40) in analyzing the embedded feature under paragraphs 815-15-25-1(c) and 815-15-25-14 as though it were a freestanding instrument.

10. Supersede paragraphs 815-40-55-33 through 55-34 and their related heading, with a link to transition paragraph 480-20-65-1, as follows:

Implementation Guidance and Illustrations

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

815-40-55-33 Paragraph superseded by Accounting Standards Update No. 201X-XX. ~~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 Paragraph superseded by Accounting Standards Update No. 201X-XX. ~~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.~~

Part II

Replacement of the Indefinite Deferral for Mandatorily Redeemable Financial Instruments of Certain Nonpublic Entities and Certain Mandatorily Redeemable Noncontrolling Interests with a Scope Exception

Amendments to Subtopic 480-10

11. Supersede paragraph 480-10-15-7, add paragraphs 480-10-15-7A through 15-7F and 480-10-15-8A and their related headings, and amend the heading preceding paragraph 480-10-15-8, with no link to a transition paragraph, as follows:

Distinguishing Liabilities from Equity—Overall

Scope and Scope Exceptions

> Overall Guidance

480-10-15-1 The Scope Section of the Overall Subtopic establishes the pervasive scope for the Distinguishing Liabilities from Equity Topic.

> Entities

480-10-15-2 The guidance in the Distinguishing Liabilities from Equity Topic applies to all entities.

> Instruments

480-10-15-3 The guidance in the Distinguishing Liabilities from Equity Topic applies to any **freestanding financial instrument**, including one that has any of the following attributes:

a. Comprises more than one option or forward contract
b. Has characteristics of both a liability and equity and, in some circumstances, also has characteristics of an asset (for example, a forward contract to purchase the **issuer's equity shares** that is to be net cash settled). Accordingly, this Topic does not address an instrument that has only characteristics of an asset.

480-10-15-4 For example, an instrument that consists of a written put option for an issuer's equity shares and a purchased call option and nothing else is a freestanding financial instrument (paragraphs 480-10-55-18 through 55-20 provide examples of such instruments). That freestanding financial instrument embodies an **obligation** to repurchase the issuer's equity shares and is subject to the requirements of this Topic.

480-10-15-5 Because paragraph 480-10-15-3 limits the scope of this Topic to freestanding instruments, this Topic does not apply to a feature embedded in a **financial instrument** that is not a derivative instrument in its entirety.

480-10-15-6 Paragraphs 480-10-55-53 through 55-58 apply to the specific circumstances described by those paragraphs in which a majority owner enters into a transaction in the **shares** of a consolidated subsidiary and a derivative instrument indexed to the **noncontrolling interest** in that subsidiary.

480-10-15-7 <u>Paragraph superseded by Accounting Standards Update No. 201X-XX.</u> ~~The guidance in this Topic does not apply to the following instruments:~~

~~a. Registration payment arrangements within the scope of Subtopic 825-20.~~ **[Content moved to paragraph 480-10-15-8A]**

<u>**> Instruments Not within Scope of Certain Classification, Measurement, and Disclosure Provisions of This Subtopic**</u>

> > Certain Mandatorily Redeemable Financial Instruments of Nonpublic Entities

480-10-15-7A ~~1. The effective date of~~The classification, measurement, and disclosure guidance in this Subtopic does not apply to **mandatorily redeemable financial instruments** that meet both of the following: ~~is deferred for **mandatorily redeemable financial instruments**~~

a. They are issued by nonpublic entities that are not **Securities and Exchange Commission (SEC) registrants**~~, as follows:~~

~~i.~~b. ~~For instruments that~~ They are mandatorily redeemable, but not on fixed dates or not for amounts that either are fixed or are determined by reference to an interest rate index, currency index, or another external index~~, the classification, measurement, and disclosure provisions of this Subtopic were effective for fiscal periods beginning after December 15, 2004~~.

~~ii. For all other **financial instruments** that are mandatorily redeemable, the classification, measurement, and disclosure provisions of this Subtopic are deferred indefinitely pending further Financial Accounting Standards Board (FASB) action. During that indefinite deferral, the FASB plans to reconsider implementation issues and, perhaps, classification or measurement guidance for those instruments in conjunction with the FASB's ongoing project on liabilities and equity.~~ **[Content amended as shown and moved from paragraph 480-10-65-1(a)(1)]**

480-10-15-7B ~~2.~~ Mandatorily redeemable financial instruments issued by an SEC registrant ~~SEC registrants~~ are not eligible for the scope exception in paragraph 480-10-15-7A ~~either of the deferrals in item (a)~~, even if the entity meets the definition of a nonpublic entity in this Subtopic. ~~Those entities shall follow the effective dates required by this Subtopic and related guidance, including the deferral for certain mandatorily redeemable noncontrolling interests that follows, as appropriate.~~ **[Content amended as shown and moved from paragraph 480-10-65-1(a)(2)]**

480-10-15-7C ~~3.~~ Some entities have issued shares that are required to be redeemed under related agreements. If the shares are issued with ~~the~~a redemption agreement and the required redemption relates to those specific underlying shares, the shares are mandatorily redeemable. If an entity with such shares and redemption agreement is a nonpublic entity that is not an SEC registrant, ~~the effective date for~~ those mandatorily redeemable shares ~~is deferred as stated~~ meet the scope exception in paragraph 480-10-15-7A if they meet the conditions specified in that paragraph ~~480-10-65-1(a)~~. **[Content amended as shown and moved from paragraph 480-10-65-1(a)(3)]**

480-10-15-7D ~~4.~~ Although the disclosure requirements of this Subtopic do not apply for those mandatorily redeemable instruments of certain nonpublic companies that meet the scope exception in paragraph 480-10-15-7A ~~while application of this Subtopic to those instruments is deferred~~, the requirements of Subtopic 505-10 still apply. In particular, paragraph 505-10-50-3 requires information about the pertinent rights and privileges of the various securities outstanding, which includes mandatory redemption requirements. Paragraph 505-10-50-11 also requires disclosure of the amount of redemption requirements for all issues of stock that are redeemable at fixed or determinable prices on fixed or determinable dates in each of the next five years. **[Content amended as shown and moved from paragraph 480-10-65-1(a)(4)]**

> > Certain Mandatorily Redeemable Noncontrolling Interests

480-10-15-7E ~~b. Certain mandatorily redeemable noncontrolling interests.~~

~~1. The effective date of~~The guidance in this Subtopic does not apply to ~~is deferred for certain~~ mandatorily redeemable noncontrolling interests (of all entities, public and nonpublic), as follows:

- ~~i.~~a. ~~For~~The classification and measurement provisions of this Subtopic do not apply to mandatorily redeemable noncontrolling interests that would not have to be classified as liabilities by the subsidiary, under the only upon liquidation exception in paragraphs 480-10-25-4 and 480-10-25-6, but would be classified as liabilities by the parent in consolidated financial statements~~, the classification and measurement provisions of this Subtopic are deferred indefinitely pending further FASB action~~.
- ~~ii.~~b. ~~For other mandatorily redeemable noncontrolling interests that were issued before November 5, 2003, the~~The measurement provisions of this Subtopic do not apply to other mandatorily redeemable noncontrolling interests that were issued before November 5, 2003 ~~are deferred indefinitely~~, both for the parent in consolidated financial statements and for the subsidiary that issued the instruments that result in the mandatorily redeemable noncontrolling interest~~, pending further FASB action~~. For those instruments, the measurement guidance for redeemable shares and noncontrolling interests in other predecessor literature (for example, in paragraph 480-10-S99-3A~~EITF Abstracts Topic No. D-98, "Classification and Measurement of Redeemable Securities"~~) continues to apply~~ during the deferral period. However, the classification provisions of this Subtopic are not deferred~~. **[Content amended as shown and moved from paragraph 480-10-65-1(b)(1)]**

480-10-15-7F ~~3. During the deferral period for certain mandatorily redeemable noncontrolling interests, all~~All public entities as well as nonpublic entities that are SEC registrants with mandatorily redeemable noncontrolling interests subject to the classification and measurement scope exception in paragraph 480-10-15-7E are required to follow the disclosure requirements in paragraphs 480-10-50-1 through 50-3 as well as disclosures required by other applicable guidance. **[Content amended as shown and moved from paragraph 480-10-65-1(b)(3)]**

> ~~Other Considerations~~<u>Topics and Subtopics Not within Scope</u>

> > Share-Based Compensation

480-10-15-8 The guidance in the Distinguishing Liabilities from Equity Topic does not apply to an obligation under share-based compensation arrangements if that obligation is accounted for under Topic 718 or Subtopic 505-50. For example, **employee stock ownership plan** shares or freestanding agreements to repurchase those shares are not within the scope of this Topic because those shares are accounted for under Subtopic 718-40 through the point of redemption. However, this Topic does apply to a freestanding financial instrument that was issued under a share-based compensation arrangement but is no longer subject to Topic 718 or Subtopic 505-50. For example, this Topic applies to a mandatorily redeemable share issued upon an employee's exercise of an employee share option. (Topic 718 and Subtopic 505-50 provide accounting guidance for dividends on allocated shares, redemption of shares, recognition of expense, and computing earnings per share [EPS].) However, employee stock ownership plan shares that are mandatorily redeemable or freestanding agreements to repurchase those shares continue to be subject to other applicable guidance related to Subtopic 718-40.

<u>> > Registration Payment Arrangements</u>

<u>480-10-15-8A</u> The guidance in this Topic does not apply to the following instruments:

a. Registration payment arrangements within the scope of Subtopic 825-20. **[Content moved from paragraph 480-10-15-7]**

12. Supersede paragraphs 480-10-55-8 through 55-9, with no link to a transition paragraph, as follows:

Implementation Guidance and Illustrations

> Implementation Guidance

480-10-55-8 <u>Paragraph superseded by Accounting Standards Update No. 201X-XX.</u> ~~In the preceding example, because the trust-preferred securities are~~

~~mandatorily redeemable and represent obligations to transfer assets to redeem the shares:~~

- ~~a. Those instruments are classified as liabilities in the consolidated financial statements of the financial institution.~~
- ~~b. Payments or accruals of dividends and other amounts to be paid to holders are reported as interest cost.~~

480-10-55-9 <u>Paragraph superseded by Accounting Standards Update No. 201X-XX.</u> ~~If redemption is required only upon liquidation or termination of the trust, this Subtopic does not require the securities to be reported as liabilities in the trust's standalone financial statements. However, this Subtopic does require the obligation to be reported as a liability in the consolidated financial statements of the financial institution because redemption is required to occur before the liquidation or termination of the reporting entity, that is, of the financial institution.~~

13. Supersede paragraph 480-10-65-1 and its related heading as follows:

[Note: As a result of this change, the pending content that links to paragraph 480-10-65-1 will become current content.]

~~**> Transition Related to FASB Staff Position FAS 150-3, *Effective Date, Disclosures, and Transition for Mandatorily Redeemable Financial Instruments of Certain Nonpublic Entities and Certain Mandatorily Redeemable Noncontrolling Interests Under FASB Statement No. 150***~~

480-10-65-1 <u>Paragraph superseded on (date) by Accounting Standards Update No. 201X-XX.</u> ~~The effective date of the pending content that links to this paragraph is as follows for mandatorily redeemable financial instruments of certain nonpublic entities and for certain mandatorily redeemable noncontrolling interests:~~

- ~~a. Mandatorily redeemable financial instruments of certain nonpublic entities.~~
  - ~~1. The effective date of this Subtopic is deferred for **mandatorily redeemable financial instruments** issued by nonpublic entities that are not **Securities and Exchange Commission (SEC) registrants**, as follows:~~
    - ~~i. For instruments that are mandatorily redeemable on fixed dates for amounts that either are fixed or are determined by reference to an interest rate index, currency index, or another external index, the classification, measurement, and disclosure provisions of this Subtopic were effective for fiscal periods beginning after December 15, 2004.~~
    - ~~ii. For all other **financial instruments** that are mandatorily redeemable, the classification, measurement, and disclosure~~

~~provisions of this Subtopic are deferred indefinitely pending further Financial Accounting Standards Board (FASB) action. During that indefinite deferral, the FASB plans to reconsider implementation issues and, perhaps, classification or measurement guidance for those instruments in conjunction with the FASB's ongoing project on liabilities and equity.~~ **[Content amended and moved to paragraph 480-10-15-7A]**

2. ~~Mandatorily redeemable financial instruments issued by SEC registrants are not eligible for either of the deferrals in item (a), even if the entity meets the definition of a nonpublic entity in this Subtopic. Those entities shall follow the effective dates required by this Subtopic and related guidance, including the deferral for certain mandatorily redeemable noncontrolling interests that follows, as appropriate.~~ **[Content amended and moved to paragraph 480-10-15-7B]**
3. ~~Some entities have issued shares that are required to be redeemed under related agreements. If the shares are issued with the redemption agreement and the required redemption relates to those specific underlying shares, the shares are mandatorily redeemable. If an entity with such shares and redemption agreement is a nonpublic entity that is not an SEC registrant, the effective date for those mandatorily redeemable shares is deferred as stated in paragraph 480-10-65-1(a).~~ **[Content amended and moved to paragraph 480-10-15-7C]**
4. ~~Although the disclosure requirements of this Subtopic do not apply for those mandatorily redeemable instruments of certain nonpublic companies while application of this Subtopic to those instruments is deferred, the requirements of Subtopic 505-10 still apply. In particular, paragraph 505-10-50-3 requires information about the pertinent rights and privileges of the various securities outstanding, which includes mandatory redemption requirements. Paragraph 505-10-50-11 also requires disclosure of the amount of redemption requirements for all issues of stock that are redeemable at fixed or determinable prices on fixed or determinable dates in each of the next five years.~~ **[Content amended and moved to paragraph 480-10-15-7D]**

b. ~~Certain mandatorily redeemable noncontrolling interests.~~
   1. ~~The effective date of this Subtopic is deferred for certain mandatorily redeemable noncontrolling interests (of all entities, public and nonpublic) as follows:~~
      i. ~~For mandatorily redeemable noncontrolling interests that would not have to be classified as liabilities by the subsidiary, under the only upon liquidation exception in paragraphs 480-10-25-4 and 480-10-25-6, but would be classified as liabilities by the parent in consolidated financial statements, the classification and measurement provisions of this Subtopic are deferred~~

~~indefinitely pending further FASB action.~~ **[Content amended and moved to paragraph 480-10-15-7E(a)]**

~~ii. For other mandatorily redeemable noncontrolling interests that were issued before November 5, 2003, the measurement provisions of this Subtopic are deferred indefinitely, both for the parent in consolidated financial statements and for the subsidiary that issued the instruments that result in the mandatorily redeemable noncontrolling interest, pending further FASB action. For those instruments, the measurement guidance for redeemable shares and noncontrolling interests in other predecessor literature (for example, in EITF Abstracts Topic No. D-98, "Classification and Measurement of Redeemable Securities") continues to apply during the deferral period. However, the classification provisions of this Subtopic are not deferred.~~ **[Content amended and moved to paragraph 480-10-15-7E(b)]**

~~2. The FASB plans to reconsider implementation issues and, perhaps, classification or measurement guidance for those noncontrolling interests during the deferral period, in conjunction with the FASB's ongoing projects.~~

~~3. During the deferral period for certain mandatorily redeemable noncontrolling interests, all public entities as well as nonpublic entities that are SEC registrants are required to follow the disclosure requirements in paragraphs 480-10-50-1 through 50-3 as well as disclosures required by other applicable guidance.~~ **[Content amended and moved to paragraph 480-10-15-7F]**

The amendments in this proposed Update were approved for publication by four members of the Financial Accounting Standards Board. Messrs. Schroeder and Siegel voted against publication of the amendments. Their alternative views are set out at the end of the basis for conclusions. Ms. Botosan abstained.

Members of the Financial Accounting Standards Board:

Russell G. Golden, *Chairman*
James L. Kroeker, *Vice Chairman*
Christine A. Botosan
Daryl E. Buck
R. Harold Schroeder
Marc A. Siegel
Lawrence W. Smith

Background Information, Basis for Conclusions, and Alternative Views

Introduction

BC1. The following summarizes the Board's considerations in reaching the conclusions in this proposed Update. It includes reasons for accepting certain approaches and rejecting others. Individual Board members gave greater weight to some factors than to others.

BC2. The proposed amendments in this Update would simplify the accounting guidance on financial instruments with characteristics of liabilities and equity, particularly as it relates to the area of equity-linked financial instruments (or embedded features) with down round features.

Background Information—Part I

BC3. A down round feature is a provision in an equity-linked financial instrument (or embedded feature), such as a warrant or a conversion option that provides a downward adjustment of the current exercise price on the basis of the price of future equity offerings. Down round features are most common in warrants, convertible preferred shares, and convertible debt instruments issued by private companies and development-stage public companies. A standard anti-dilution provision is not considered a down round feature for the purposes of the definition of this term and the scope of this proposed Update.

BC4. Current GAAP contains extensive guidance for financial instruments with characteristics of liabilities and equity. Both freestanding financial instruments (such as warrants) and convertible instruments, comprising a 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.

BC5. The first step in the analysis for warrants and convertible preferred shares is to determine whether the equity-form instrument would be required to be classified as a liability under Subtopic 480-10. For freestanding financial instruments with down round features that are not required to be classified as liabilities based on the guidance in Subtopic 480-10 and for hybrid financial instruments containing embedded conversion options with down round features, an analysis under other Topics or Subtopics is required to determine the appropriate accounting for the entire freestanding instrument or embedded conversion option.

BC6. Subtopic 815-40, Derivatives and Hedging—Contracts in Entity's Own Equity, provides guidance to determine whether an equity-linked financial instrument (or an embedded feature) should be classified as an asset, liability, or as an equity instrument of the issuer. 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. 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. Under this guidance, if an instrument is considered indexed to an entity's own stock (and can be settled in shares), the instrument is classified as equity. However, if the instrument does not meet the criteria to be considered indexed to an entity's own stock, it must be classified as a liability or an asset.

BC7. Subtopic 815-40 provides guidance to evaluate whether an equity-indexed instrument can be considered indexed to an entity's own stock in two instances:

a. To evaluate whether a freestanding equity-linked financial instrument or embedded feature that meets the definition of a derivative in Topic 815 is indexed to, and potentially settled in, an entity's own shares for the purposes of determining whether the instrument or embedded feature qualifies for a scope exception from derivative accounting. (For an embedded feature, this only needs to be considered if both of the other criteria for bifurcation are met—that the embedded feature is not clearly and closely related to the host contract and that the hybrid instrument is not measured at fair value in its entirety.)
b. To evaluate whether a freestanding equity-linked financial instrument that is potentially settled in an entity's own stock and that does not meet the definition of a derivative instrument in Topic 815 is considered indexed to its own stock.

BC8. Regarding (a) above, if a freestanding equity-linked financial instrument (or an embedded feature) meets the definition of a derivative in Topic 815, the contract must be analyzed to determine if it qualifies for a scope exception from derivative accounting. Paragraph 815-10-15-74 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 stockholders' equity in an entity's statement of financial position shall not be considered a derivative financial instrument. Subtopic 815-40 provides guidance on evaluating whether the contract is indexed to the entity's own stock. If the entire financial instrument meets the definition of a derivative and does not qualify for the scope exception, it must be measured at fair value with changes in fair 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 fair value recognized in earnings.

BC9. Regarding (b) above, if a freestanding equity-linked financial instrument does not meet the definition of a derivative under Topic 815, the guidance in Subtopic 815-40 still applies. The contract must be evaluated under that guidance to determine whether it is indexed to the entity's own shares. If it is not indexed to the entity's own shares, the contract must be accounted for as a liability and initially measured at fair value under paragraph 815-40-15-8A.

BC10. The guidance in Subtopic 815-40 on whether the instrument is indexed to an entity's own stock requires a two-step evaluation of exercise contingencies and settlement adjustments on the basis of the terms of the contract. Step 1 is to evaluate the instrument's contingent exercise provisions, if any. If the evaluation does not preclude an instrument from being considered indexed to the entity's own stock, an entity would proceed to Step 2, which is to evaluate the instrument's settlement provisions. According to paragraph 815-40-15-7C, an instrument (or embedded feature) is 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.

However, a contract is considered indexed to the entity's own stock even if the strike price or number of shares used to calculate the settlement amount is not fixed provided 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.

BC11. Under current GAAP, Step 2 in this analysis may result in the instrument being required to be classified as a liability because of the existence of a down round feature. This is because the settlement of a financial instrument with a down round feature can be affected by future equity offerings undertaken by the issuer 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. When analyzed under Step 2, the occurrence of a sale of common stock by the issuer 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.

BC12. Under the amendments in this proposed Update, a financial instrument with a down round feature would no longer be classified as a liability solely because of the guidance in Subtopic 815-40 on down round features. However, the instrument may still be required to be classified as a liability if it contains terms or features other than the down round feature that would cause liability classification on the basis of the guidance in Subtopic 480-10 or Subtopic 815-40 (such as features that cause the instrument not to meet the additional criteria for equity classification in Subtopic 815-40 or other features that would cause the instrument not to be considered indexed to the entity's stock).

BC13. Although convertible instruments with embedded options that have down round features would no longer be required to be classified as a liability as a result of the guidance in Subtopic 815-40, an entity would need to consider whether the instrument is subject to other specialized accounting models (such as the guidance in Subtopic 470-20, Debt—Debt with Conversion and Other Options) on the basis of the navigation followed under current GAAP before applying the new down round model. The Board decided that the proposed amendments would not override other existing accounting models for convertible instruments.

BC14. Accordingly, the amendments in the proposed Update would change the navigation under current GAAP for specific types of financial instruments with down round features as follows:

a. The proposed amendments would alter the navigation under GAAP for warrants that meet the definition of a derivative by not considering a down round feature in the analysis under the scope exception in Topic 815 about whether the instrument is indexed to the entity's own stock. The proposed amendments would continue to require an analysis of whether the second part of the scope exception is met (that is, whether the instrument would be classified in stockholder's equity) under Subtopic 815-40. If the second part of the scope exception is met, the warrant would be classified as equity and would be subject to the proposed model for financial instruments with down round features.
b. The proposed amendments would alter the navigation under GAAP for convertible preferred shares with a debt host by not considering a down round feature in the analysis under the scope exception in Topic 815 about whether the embedded conversion option is indexed to the entity's own stock. The proposed amendments would continue to require an analysis of whether the second part of the scope exception is met (that is, whether the embedded conversion option would be classified in stockholder's equity) under Subtopic 815-40. If the second part of the scope exception is met, the conversion option would not require bifurcation under Topic 815. In this case, the entity must determine whether a specialized accounting model for convertible instruments applies. If the convertible preferred share has a down round feature, the current accounting guidance for contingent beneficial conversion features in Subtopic 470-20 would generally apply. The proposed model for financial instruments with down round features would apply only if an entity was not required to apply any existing specialized accounting guidance for separation of convertible instruments in Subtopic 470-20.
c. The proposed amendments would alter the navigation for convertible debt instruments under GAAP by not considering a down round feature in the analysis under the scope exception in Topic 815 about whether the embedded conversion option is indexed to the entity's own stock. The proposed amendments would continue to require an analysis of whether the second part of the scope exception is met (that is, whether the

embedded conversion option would be classified in stockholder's equity) under Subtopic 815-40. If the second part of the scope exception is met, the conversion option would not require bifurcation under Topic 815. In this case, the entity must determine whether a specialized accounting model for convertible instruments applies. 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 would apply. If not, the specialized guidance for contingent beneficial conversion features in Subtopic 470-20 would generally apply. The proposed model for financial instruments with down round features would apply only if an entity was not required to apply any existing specialized accounting guidance for convertible instruments.

Basis for Conclusions—Part I

Benefits and Costs

BC15. The amendments in a proposed Update should provide information that is useful in making business and economic decisions, and the benefits should justify the costs. Providing useful information means producing economically "neutral" information that permits users to make their own decisions on the basis of the financial information. Neutral information faithfully reports the economics of a transaction, regardless of any perceived positive or negative effect of reporting that information.

BC16. Paragraph OB2 of FASB Concepts Statement No. 8, *Conceptual Framework for Financial Reporting, Chapter 1*, The Objective of General Purpose Financial Reporting, *and Chapter 3*, Qualitative Characteristics of Useful Financial Information, state the following:

> The objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders, and other creditors in making decisions about providing resources to the entity. Those decisions involve buying, selling, or holding equity and debt instruments and providing or settling loans and other forms of credit. [Footnote reference omitted.]

BC17. Considering the objective of general purpose financial reporting, the Board determined the objective of Part I of this proposed Update was to reduce cost and complexity associated with the accounting for certain financial instruments with down round features. Much of the cost and complexity associated with determining and applying the accounting requirements to such instruments is a result of the complexity of the underlying arrangement. Nonetheless, cost and complexity do arise from the requirement to measure those instruments at fair value at each reporting date based on the requirement to account for instruments (or embedded options) containing those features as derivatives. The issue on accounting for down round features in financial instruments was raised by members of the Private Company Council (PCC) and the AICPA Private Companies Practice Section Technical Issues Committee (TIC). In accordance with the FASB's process of reassessing existing accounting standards when stakeholders raise concerns or practice issues arise, the Board undertook research and outreach to obtain information about the nature of instruments for which the accounting is asserted to be overly complex and potential alternatives for improving the decision usefulness of financial reporting for those instruments. The Board solicited input from two large international banks that are dealers in convertible instruments to obtain an understanding of the nature of equity-indexed financial instruments prevalent in the marketplace. In addition, the Board conducted outreach with public and private company auditors, preparers, and a regulator.

BC18. Stakeholders asserted that the requirement under current GAAP to account for certain freestanding and embedded instruments with down round features as liabilities creates undue complexity. They indicated that measuring the fair value of those instruments 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 that they view to be inconsistent with the economics of the transaction in a variety of cases. That is, stakeholders also asserted that the current accounting model for certain financial instruments with down round features does not reflect the economics of the down round feature, which exists only to protect investors from declines in the issuer's share price. This is because current accounting guidance requires that changes in fair value of an instrument with a down round feature 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. The Board determined that the complexity associated with the current accounting model for financial instruments with down round features should be addressed.

BC19. Present and potential investors, creditors, and other users of financial information benefit from improvements in financial reporting, while the costs to implement new guidance are borne primarily by the entity and, by extension, present investors. The Board's assessment of the costs and benefits likely to result from issuing a new standard is unavoidably more qualitative than quantitative because there is not an identified method to objectively quantify the costs to implement the new guidance or to quantify the value of expected, improved information on financial statements.

BC20. On the basis of due process and input received from stakeholders, the Board concluded that the proposed amendments will increase the decision usefulness of information provided about financial instruments with down round features and provide users with more relevant information about those instruments in a more cost-efficient manner for preparers. The proposed amendments would result in the following benefits:

a. Elimination of the requirement to measure financial instruments or embedded features with down round features at fair value initially and subsequently under derivatives guidance, resulting in a reduction of cost and complexity associated with determining the fair value of the instrument or embedded feature at each reporting date
b. Better reflection in the financial statements of the nature of the financial instrument with a down round feature given that the existence of the down round feature would no longer drive the classification of the entire financial instrument
c. Closer alignment of the financial reporting for financial instruments with down round features and their economics by recognizing the effect of the down round feature only when it is triggered, thereby reflecting the protective nature of a down round feature
d. Reporting of incremental information about additional equity value that has been transferred to holders of financial instruments with down round features.

BC21. The Board understands that certain reporting entities will incur additional costs because of the amendments in this proposed Update. The expected costs of the proposed amendments could include the following:

a. Initial costs to educate employees about how to apply the amendments as well as how to explain the effects of the changes on the entity's financial statements to users of financial statements
b. Incremental costs to apply the proposed amendments to some financial instruments with down round features that are not measured at fair value under current GAAP (because the instrument currently does not meet the definition of a derivative and is not required to be measured at fair value or bifurcated under Topic 815)
c. Incremental costs to provide the additional required disclosure about financial instruments with down round features that have been triggered.

BC22. The Board considered the potential effects of the proposed amendments on complexity in financial reporting. The Board acknowledges that integrating a separate model for financial instruments with down round features with existing guidance on equity-linked financial instruments potentially increases complexity in navigating and applying GAAP in this area. However, the Board noted that disregarding the down round feature for purposes of the derivative assessment under Topic 815 is a simplification relative to current GAAP because the issuer no longer has to remeasure the instrument at each reporting period (in the case of warrants) or separately account for a bifurcated derivative (in the case of convertible instruments) when the only reason for this outcome is the existence of a down round feature. The Board decided that the expected reduction in cost and complexity as a result of eliminating the requirement to measure financial instruments with down round features at fair value on an ongoing basis sufficiently mitigated the potential concern about creating a separate model for certain of these instruments.

BC23. Overall, the Board believes that entities will not incur significant incremental costs as a result of the amendments in the proposed Update because the amendments simplify the application of current GAAP. Although cost and complexity may be reduced for some entities and increased for others, the Board believes that the expected benefits of the proposed amendments justify the perceived costs.

Scope

BC24. The Board decided to create a separate model for certain financial instruments with down round features. The Board decided to define the term *down round feature* and base the scope of the proposed Update on that definition, with certain explicit exceptions.

BC25. Current GAAP includes an example of a warrant with a down round feature in paragraph 815-40-55-33. In this example, a company issues warrants that permit the holder to buy a fixed number of shares for a specified price, and the terms of the warrants specify that the price would be reduced to reflect the current issuance price of the company's shares if the company either (a) sells shares of its common stock for an amount less than the specified price in the contract or (b) issues an equity-linked financial instrument with a strike price below the specified share price in the contract.

BC26. The scope that the Board proposes would not be 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, for instruments within the scope of the proposed Update, the proposed amendments would apply to down round features that result in any reduction of the current strike price. For example, a down round feature may reduce the strike price of a warrant or option to the current issuance price, with the amount of the reduction limited by a floor, or the down round feature may reduce the strike price of a warrant or option on the basis of a formula that considers a ratio of shares outstanding before and after an issuance, resulting in a price that is at a discount to the original exercise price but above the new issuance price of the shares.

BC27. Under current GAAP, some instruments with down round features are not required to be measured at fair value because those instruments do not meet the definition of a derivative (for example, a private-company warrant that is gross share settled). As a result, down round features in certain financial instruments that had no accounting effect previously would be required to be recognized and measured when the down round feature is triggered under the proposed model. The Board decided that this outcome would be acceptable to improve the accounting for financial instruments with down round features and that it would be needed to promote greater consistency in the accounting for instruments that include down round features.

Interaction with GAAP for Convertible Instruments Required to Be Separated into Liability and Equity Components

BC28. The Board considered how to integrate the guidance in the proposed Update with current GAAP for convertible instruments that are required to be separated into liability and equity components and that also have down round features. Specifically, the Board considered whether (and if so how) to apply the guidance in the proposed Update to convertible instruments that have a down round feature and that were either issued at a substantial premium or have another feature, such as a beneficial conversion feature (or a contingent beneficial conversion feature) or a cash conversion feature, that requires recognition of both a liability and an equity component or two equity components.

BC29. The Board decided that the proposed amendments for financial instruments with down round features would not apply to convertible instruments that are captured by the specialized models in Subtopic 470-20. That is, the proposed model would not apply to convertible instruments that either were issued at a substantial premium or have a beneficial conversion feature (or a contingent beneficial conversion feature) or a cash conversion feature that would be required to be separated into two components under other Topics or Subtopics. In reaching this decision, the Board concluded that it would not override the objectives of the current separation models that were established under prior accounting standards and that it would not amend those models as part of this project. The Board noted that each of those models was developed to achieve a specific objective for the particular type of convertible instrument and that those objectives remain valid and are unrelated to the Board's purpose for issuing this proposed Update.

BC30. For convertible instruments that are required to be separated under current GAAP, the Board considered as a practical matter how to apply the guidance in this proposed Update incrementally to those separation models. For convertible instruments that may have a cash conversion feature, a beneficial conversion feature, or a substantial premium requiring separation, those features would be recognized separately at initial recognition under the relevant model. If the guidance in this proposed Update was to be applied incrementally, it would be applied at a point after inception when the down round feature was triggered. In those cases, the Board would have had to determine whether the effect of the down round feature (when triggered) should then be recognized as retained earnings (because it relates to the equity component) or in earnings (because it relates to the liability component). The Board determined that applying the guidance in this proposed Update to convertible instruments currently required to be separated into two components would have added complexity to GAAP by either overriding existing models in certain circumstances or adding incremental requirements.

BC31. In addition, the Board identified an interaction between the guidance in this proposed Update for financial instruments with down round features and current guidance for contingent beneficial conversion features. Under current GAAP, a reduction of the strike price on a convertible instrument triggered by the issuance of another round of financing with a lower share price that would be beneficial when it occurs is accounted for as a beneficial conversion feature. The Board noted that this would overlap with the guidance in this proposed Update. In either case, a value would be assigned to the impact of down round adjustment when it is triggered, but the value would be different depending upon which model applied. In addition, in the specific case of a convertible debt instrument that has two contingent beneficial conversion features that coexist (one that is a down round feature as defined by this proposed Update and one that is an adjustment that does not meet that definition, for example, because the strike price may be reduced on the basis of an initial public offering occurring), the Board observed that applying different models would create inconsistent accounting outcomes for similar features. If different models were to be applied, the accounting for the down round feature in the scope of this proposed Update would depend on which feature gets triggered first. That is, if the down round feature within the scope of this proposed Update was triggered first, the effect would be to earnings if the overall instrument is classified as a liability. However, if the contingent beneficial conversion feature that is not a down round feature as defined in this proposed Update was triggered first, the current intrinsic value model would apply. In that case, the convertible instrument would be separated into liability and equity components and the Board would have had to determine how to apply the guidance in this proposed Update to the separated instrument. The Board observed that allowing the current beneficial conversion model to prevail avoids these complexities. Therefore, as a practical matter, the Board believes that convertible instruments with down round features generally will be subject to the guidance for contingent beneficial conversion features and not the proposed model for financial instruments with down round features.

BC32. The Board concluded that applying the down round model incrementally to the existing separation models would create unwarranted complexity and additional costs that are not justified by the benefit. The Board understands that, generally, the value of a down round feature compared to the overall value of a conversion option is often relatively small and that instruments that have both down round features and other features captured by specific convertible instrument models are rare or nonexistent in the current marketplace. Ultimately, in developing the model for financial instruments with down round features, the Board decided to maintain the objectives of the specialized accounting guidance for convertible instruments and views of the prior Boards.

Separate Model for Financial Instruments with Down Round Features

BC33. For financial instruments within the scope of this proposed Update, the Board decided that when determining whether a financial instrument is indexed to an entity's own stock, for purposes of determining liability or equity classification, an entity should not consider whether an instrument contains a down round feature. However, the entity would recognize the value of the effect of the down round feature when the feature is triggered (that is, when the exercise price of the related equity-linked financial instrument is adjusted downward because the entity issues stock at a price lower than the original exercise price of the equity-linked financial instrument). The Board decided that the effect of the down round feature should be recognized on the basis of the classification of the financial instrument that includes that feature, as follows:

a. For a financial instrument classified as equity, the entity would recognize the value of the effect of the down round feature in equity as a reduction of retained earnings with an increase of additional paid-in capital.
b. For a financial instrument classified as a liability, the entity would recognize the value of the effect of the down round feature as a reduction of earnings and an increase of the carrying value of the liability-classified instrument that includes that feature.

BC34. The Board observed that the proposed accounting upon the trigger of the down round feature for an equity-classified instrument is consistent with 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. For an instrument that would be classified as a liability without consideration of the down round feature, the Board believes that the effect of the down round feature upon trigger should be recognized as a charge to net income with a corresponding increase to the basis of the liability-classified instrument. The adjustment to the basis of the liability-classified instrument would be amortized over time using the interest method consistent with the general practice for such instruments under GAAP. This is consistent with the guidance in Subtopic 835-30, Interest—Imputation of Interest, which requires that the exchange of unstated rights or privileges that accompany a note issuance be recognized by establishing a premium or discount that is amortized as interest income or expense over the life of the instrument using the interest method. The Board also observed that this accounting is similar to the current accounting for liability-classified preferred stock, for which payments to holders are reported as interest cost and accrued but not yet paid payments are part of the liability for the shares.

BC35. In determining the appropriate method to establish the value to be recognized when a down round feature is triggered, the Board considered a method that would capture the rights existing in the down round feature without introducing significant measurement complexity. The Board decided to require a method that would measure this adjustment on the basis of the difference between the fair values of two instruments that have terms consistent with the actual instrument but that do not have a down round feature, where one instrument has a strike price that corresponds to the initial strike price of the actual instrument and the second instrument has a strike price that corresponds to the strike price of the instrument after the trigger date. Each of those fair value measurements would be required to comply with the guidance in Topic 820, Fair Value Measurement. The

Board decided that this would be a practical way to assign a value to the down round feature that meets the objective of capturing the effect of the down round feature once it is triggered.

BC36. The Board observed that it would not be appropriate to analogize to the measurement method in this proposed Update to instruments with features other than down round features within the scope of this proposed Update.

BC37. The Board concluded that the amendments in this proposed Update would simplify the accounting for financial instruments that include down round features. While the proposed approach would require measurement of the value of the effect of the down round feature, that measurement is limited to situations in which the feature is triggered. Thus, the Board concluded this would alleviate some of the measurement complexity and income statement volatility associated with fair value measurement on an ongoing basis, as is currently required. The Board also expects that the proposed amendments would reduce the cost burden that exists under current GAAP because many companies may engage third-party valuation experts to determine the fair value of these instruments.

BC38. Additionally, the Board concluded that the amendments in this proposed Update better reflect the economics of the transaction when a down round feature is triggered. While current GAAP requires that changes in fair value of an instrument with a down round feature be recognized in earnings for both increases and decreases in share price, under the proposed amendments, the down round feature would not affect the accounting for the instrument unless the down round feature is triggered when the share price decreases. The Board decided that measuring the entire instrument or embedded conversion option at fair value as a result of the existence of a down round feature, regardless of whether it had been triggered, does not provide useful financial reporting information.

BC39. The Board also considered the following alternatives:

a. Create an exception in Subtopic 815-40 for financial instruments with down round features (that is, classify financial instruments with down round features as equity [or do not require bifurcation]), with no recognition of the effect of the down round feature when it is triggered
b. Classify financial instruments with down round features as liabilities and require initial fair value measurement only.

BC40. The Board decided not to pursue those alternatives because neither alternative accounts for the economic event that occurs when the down round feature is triggered. The Board concluded that the exercise of a down round feature results in an entity giving up value to one (or some), but not all, investors. The Board decided that this value transfer should be reflected in an entity’s financial statements to provide transparency to an entity’s stakeholders. Furthermore, alternative (b) would result in a difference between settlement value of the financial instrument and its carrying amount at the settlement date, regardless of whether the down round is actually triggered. The accounting for this difference would result in a charge to either equity or earnings at the settlement date and would not necessarily indicate if and when the down round feature is triggered.

BC41. The issues related to accounting for equity-linked financial instruments with down round features were initially raised to the Board by members of the PCC. During the Board's deliberations, PCC members expressed support for the Board's efforts to address those issues and agreed that the proposed amendments would provide relief from the cost and complexity of recurring fair value measurement of those instruments. In addition, the PCC discussed with the Board a potential disclosure-only alternative for private companies that issue equity-form financial instruments with down round features to provide relief that is incremental to the Board's proposal. However, a majority of PCC members did not want the Board to pursue that alternative because the Private Company Decision-Making Framework does not support a private company alternative and PCC members were concerned about creating a difference between public company accounting and private company accounting for those instruments. As such, a majority of the PCC members supported the Board's decisions, as included in this proposed Update.

Disclosures

BC42. The Board considered whether any additional disclosure requirements should accompany the new guidance on financial instruments with down round features. Current GAAP contains guidance that is broadly applicable to issued debt and equity instruments. Subtopic 505-10, Equity—Overall, requires disclosure of information about a company's capital structure. Companies must provide information about securities, specifically a summary explanation in their financial statements of the pertinent rights and privileges of their outstanding securities.

BC43. Paragraph 815-40-50-5 indicates that the disclosures required by Subtopic 505-10 apply to all contracts within the scope of Subtopic 815-40. The Board observed that this guidance currently requires entities to disclose information about down round features and clarified the requirement in paragraph 480-20-50-2.

BC44. In addition to the current GAAP disclosures, the Board decided that for financial instruments with down round features within the scope of this proposed Update that have been triggered during the reporting period, an entity would disclose the fact that the feature has been triggered, the value of the effect of the down round feature being triggered, and the financial statement line item in which that effect is recorded. The Board concluded that the financial statements should provide users with the information that indicates that additional equity value has been transferred to holders of certain equity-linked financial instruments (or embedded features) and the effect of that value transfer. The Board observed that the disclosure requirements in Topic 820 would not apply to the down round feature because the value of the effect of that feature is determined on the basis of the fair values of other instruments.

Effective Date and Transition

BC45. The Board will determine the effective date after considering stakeholders' feedback on this proposed Update.

BC46. The Board decided to require that entities apply the proposed guidance to certain outstanding instruments with down round features as of the effective date of the change with no adjustments to prior periods presented (a cumulative-effect approach). The cumulative effect of the change would be recognized as an adjustment of the opening balance of retained earnings in the fiscal year or interim period of adoption.

BC47. For a freestanding financial instrument with a down round feature that had been classified as a liability and measured at fair value under previous accounting guidance, but that would be classified as an equity instrument under the amendments in this proposed Update, the proposed amendments would require the difference in retained earnings that would have been reported as if this proposed Update was in effect at the issuance and throughout the term of the financial instrument to be recognized as a cumulative-effect adjustment of the opening balance of retained earnings upon adoption. In addition, the freestanding financial instrument would be reclassified from a liability to equity on the basis of the proceeds received at issuance.

BC48. A convertible instrument with a down round feature that had been bifurcated into a host contract and an embedded conversion option measured initially and subsequently at fair value with changes in fair value recognized in earnings under derivative accounting guidance but that would not have been bifurcated if this proposed Update was in effect at issuance of the convertible instrument would be recombined at the date of adoption. The difference in retained earnings that would have been reported as if this proposed Update was in effect at issuance of the convertible instrument would be recognized as a cumulative-effect adjustment of the opening balance of retained earnings at adoption and as an adjustment of the recombined instrument, which would be classified as a liability or equity instrument in its entirety as provided by this proposed Update. If the convertible instrument had a cash conversion feature or a contingent beneficial conversion feature that had been triggered before the effective date, upon initial application, the convertible instrument would be separated into two components on the basis of the appropriate model as if that model had been applied upon issuance or upon trigger, as appropriate, with any resulting difference in retained earnings recognized as a cumulative-effect adjustment of the opening balance of retained earnings. Under the transition approach, when recombining the host contract and bifurcated conversion option, an entity would not establish that value as the carrying value as of the date of adoption without any reversal of prior gains and losses on the derivative component.

Basis for Conclusions—Part II

BC49. In 2003, an FASB Staff Position was issued to defer the effective date of applying the provisions of FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*, for mandatorily redeemable financial instruments of certain nonpublic entities and certain mandatorily redeemable noncontrolling interests. The transition guidance in paragraph 480-10-65-1 explains the deferral. However, stakeholders have indicated that the existence of the deferral creates pending content in Subtopic 480-10 that makes the Codification difficult to read and to navigate. For this reason, the Board decided to replace the indefinite deferral in Subtopic 480-10 with a scope exception to improve the readability of the Codification.

BC50. The Board concluded that the amendments in Part II of this proposed Update would have the benefit of improving the readability of the Codification and reducing the cost and complexity associated with navigation of the guidance in Subtopic 480-10. The Board noted that these proposed amendments will not result in any differences compared with existing practice because these amendments only move (but do not change) the guidance.

BC51. In addition, the Board observed that the decision to replace the indefinite deferral in the transition Section of Subtopic 480-10 with a scope exception is solely being proposed to improve the content in the Codification and is not the result of a reconsideration of the accounting for the instruments within the scope of Subtopic 480-10. Therefore, these proposed amendments should not be interpreted (implicitly or explicitly) as an expression of a view by the Board that the affected instruments conceptually should be considered equity instruments or that the Board has resolved the underlying issue that led to the indefinite deferral.

Alternative Views

Part I—Accounting for Certain Financial Instruments with Down Round Features

BC52. Messrs. Schroeder and Siegel do not support the issuance of Part I of this proposed Update because it fails to meet the primary objective set forth at the beginning of the project. That objective is to make targeted improvements that simplify the accounting guidance for financial instruments with characteristics of liabilities and equity. The proposed amendments in this Update pertain only to certain financial instruments with down round features. Therefore, Messrs. Schroeder and Siegel believe that the proposed amendments would fail to simplify and would, instead, add to the complexity of accounting guidance for financial instruments with characteristics of liabilities and equity. Messrs. Schroeder and Siegel do not believe that financial reporting would be improved by accounting for down round features differently depending on the type of financial instrument that contains the feature. As a result, they believe that the proposed amendments would perpetuate further the path-dependent, rules-based nature of current accounting guidance for financial instruments with characteristics of liabilities and equity. Additionally, they are concerned that the amendments may be introducing additional inconsistencies that would hinder the decision usefulness of reported results.

BC53. As noted in paragraph BC30, "the Board determined that applying the guidance in this proposed Update to convertible instruments currently required to be separated into two components would have added complexity to GAAP by either overriding existing models . . . or adding incremental requirements." Messrs. Schroeder and Siegel believe that the issues that prevented the Board from proposing that the amendments in this proposed Update should be applied to all financial instruments with down round features highlight that making targeted improvements is not a viable solution to simplifying and improving the complicated guidance for financial instruments with characteristics of liabilities and equity. An approach that focuses on targeted improvements might seem appealing because many of the issues raised by stakeholders focus on discrete accounting outcomes relating to specific instruments or features; therefore, targeting those specific issues might appear to provide an effective and more timely response to stakeholder concerns. However, because the guidance on classifying financial instruments with characteristics of liabilities and equity is significantly interconnected, Messrs. Schroeder and Siegel believe that it is nearly impossible to amend one area of the guidance without introducing unintended effects and further complications elsewhere. Consequently, further attempts at targeted improvements likely would lead to inevitable compromises similar to ones made by the Board in this proposed Update, increasing inconsistency and complexity, often necessitating the development of additional "rules."

BC54. Messrs. Schroeder and Siegel believe that it is unsustainable to attempt to address the existing issues by developing accounting outcomes that "make sense" for individual instruments in isolation. Instead, they believe that the only way to simplify the accounting guidance for classifying financial instruments with characteristics of liabilities and equity is to take a holistic approach that begins with the development of a revised liabilities definition in the conceptual framework. Messrs. Schroeder and Siegel believe that without first establishing an agreed-upon definition of a liability at the conceptual level, the development of standards in this area will continue to be a patchwork effort driven by desired outcomes. Furthermore, they view a holistic approach based on a conceptual foundation to be critical because it would provide a consistent basis for determining the accounting for all instruments with characteristics of liabilities and equity. Consistent classification of financial instruments with similar characteristics as either liabilities or equity is important because it also affects how the instruments would be measured, which ultimately determines an entity's comprehensive income.

BC55. Messrs. Schroeder and Siegel believe that a holistic approach would obviate the need for the myriad set of narrow, inconsistent, and complex rules that currently prescribe the classification and measurement of financial instruments with characteristics of liabilities and equity. They believe that only by eliminating the patchwork of current guidance and holistically replacing it with new guidance based on a revised liabilities definition will the Board be able to address most, if not all, of the problems most commonly cited by stakeholders with this area of accounting, namely (a) inconsistent reporting outcomes for instruments that are economically similar, which hinders the decision usefulness of reported information, (b) difficulties in applying and interpreting overly complex accounting guidance that often leads to unintentional misapplications and accounting restatements, and (c) additional costs to audit and regulate such information.

Part II—Replacement of the Indefinite Deferral for Mandatorily Redeemable Financial Instruments of Certain Nonpublic Entities and Certain Mandatorily Redeemable Noncontrolling Interests with a Scope Exception

BC56. Messrs. Schroeder and Siegel disagree with the issuance of Part II of this proposed Update because it implies that we have resolved the underlying issues that predicated its publication. On the contrary, in August 2016, the Board issued an Invitation to Comment on Agenda Consultation that includes discussion of a broader project on distinguishing between liabilities and equity. This broader project potentially would include efforts to resolve the issues that previously were brought to the Board’s attention and necessitated the indefinite deferral. Messrs. Schroeder and Siegel do not believe that it is in the best interest of stakeholders to provide a permanent scope exception for those instruments while concurrently considering a project to make broad changes to guidance that could affect accounting for those same instruments. While they understand the majority view that this proposal has an objective to improve the readability of the Codification, they are concerned that a scope exception runs the risk of creating confusion among stakeholders because it implies that deliberations for those particular instruments are complete notwithstanding the explanation provided in paragraph BC51. The indefinite deferral has existed in the Codification for many years and serves as means to communicate to stakeholders that the Board is contemplating a solution to the accounting for the instruments within its scope, and Messrs. Schroeder and Siegel believe that, in fact, is the Board’s current intent. As such, they would prefer to leave the deferral in place until the Board decides how to proceed with the broader, more holistic project on liabilities and equity.

Amendments to the XBRL Taxonomy

The provisions of this Exposure Draft, if finalized as proposed, would require changes to the U.S. GAAP Financial Reporting Taxonomy (Taxonomy). We welcome comments on these proposed changes to the Taxonomy through ASU Taxonomy Changes provided at www.fasb.org. After the FASB has completed its deliberations and issued a final Accounting Standards Update, proposed amendments to the Taxonomy will be made available for public comment at www.fasb.org and finalized as part of the annual release process.