A Roadmap to Accounting for Contracts on an Entity’s Own Equity

2019
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Acknowledgments

This Roadmap reflects the thoughts, contributions, and accumulated experience of members of the financial instruments team in Deloitte’s National Office. We are grateful for the contributions of Magnus Orrell, who led the preparation of the Roadmap, as well as Ashley Carpenter and Jonathan Howard, who provided advice and direction. In addition, we acknowledge the contributions of Lynne Campbell, Amy Davidson, and David Frangione in our Production group.
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Preface

August 2019

To our clients, colleagues, and other friends:

We are pleased to present the 2019 edition of *A Roadmap to Accounting for Contracts on an Entity’s Own Equity*, which provides an overview of the guidance in ASC 815-40 as well as insights into and interpretations of how to apply it in practice. For ease of reference, we have accompanied our discussion with the related authoritative text. The 2019 edition includes several new and revised examples as well as some modifications to previously expressed views to reflect our latest thinking and input from standard setters and regulators. Appendix F highlights all new content as well as any substantive revisions to previous content.

We frequently receive questions related to the accounting for warrants, options, forwards, conversion features, and other contracts on an entity’s equity shares. Contracts on own equity are often lengthy and complex, and the related accounting guidance contains many detailed rules and exceptions. A contract’s particular wording can have significant accounting ramifications, such as whether the contract qualifies as equity or is an asset or a liability and the associated earnings effect. As a result, the SEC staff often asks registrants about their accounting for contracts on own equity and their supporting accounting analyses.

This Roadmap is intended to help you navigate the accounting guidance, overcome the complexity, and arrive at appropriate accounting conclusions.

Subscribers to the Deloitte Accounting Research Tool (DART) may access any interim updates to this publication by selecting the document from the “Roadmaps” tab on DART’s home page. If a “Summary of Changes Since Issuance” displays, subscribers can view those changes by clicking the related links or by opening the “active” version of the Roadmap.

We hope you will find this Roadmap to be a useful resource in determining the appropriate accounting for contracts on an entity’s own equity, and we welcome your suggestions for future improvements to it. If you need assistance applying the guidance or have other questions about this topic, we encourage you to consider consulting our technical specialists and other professional advisers.

Sincerely,

Deloitte & Touche LLP
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Chapter 1 — Overview

ASC 815-40

For a number of business reasons, an entity may enter into contracts that are indexed to, and sometimes settled in, its own stock. This Subtopic provides guidance on accounting for such contracts. Examples of these contracts include put and call options (both written and purchased) and forward contracts (for both sales and purchases). These contracts may be settled using a variety of settlement methods, or the issuing entity or counterparty may have a choice of settlement methods. The contracts may be either freestanding or embedded in another financial instrument.

ASC 815-40 provides guidance on the accounting for contracts that are indexed to, and potentially settled in, an entity’s own equity (also known as contracts on own equity or equity-linked financial instruments). Examples of contracts and transactions that may require evaluation under ASC 815-40 include:

- Call options on own stock (both written and purchased).
- Warrants on own stock.
- Forward contracts to sell own stock.
- Purchased put options on own stock.
- Accelerated share repurchase programs.
- Contingent consideration arrangements in business combinations.
- Convertible bond hedges.
- Equity line facilities that permit an entity to sell own stock.
- Hybrid equity units.
- Prepaid forward purchases of own stock.
- Prepaid written put options on own stock.

While the accounting requirements in ASC 815-40 focus on freestanding contracts, some of the guidance also applies to features embedded in other contracts. In particular, the indexation guidance and other conditions for equity classification in ASC 815-40 apply to both freestanding and embedded derivative instruments in the evaluation of whether they are exempt from derivative accounting under ASC 815-10 (see Section 2.2). Examples of embedded derivative features that would be assessed under the indexation and equity classification guidance in ASC 815-40 include:

- Equity conversion features embedded in debt or equity securities or lines of credit that are debt hosts.

1 For a list of abbreviations used in this publication, see Appendix E. For the full titles of standards, topics, and regulations used in this publication, see Appendix D.
• Written put options embedded in the entity's equity securities (i.e., stock redeemable by the holder).
• Redemption requirements in equity securities that are not certain to be redeemed (e.g., mandatorily redeemable convertible preferred stock).

ASC 815-40 provides guidance on whether a contract on own equity should be classified as equity or as an asset or a liability. In making this determination, an entity considers the following questions:

<table>
<thead>
<tr>
<th>Question</th>
<th>Roadmap Discussion</th>
</tr>
</thead>
<tbody>
<tr>
<td>Is the contract within the scope of ASC 815-40?</td>
<td>Chapter 2</td>
</tr>
<tr>
<td>What are the terms of the contract?</td>
<td>Chapter 3</td>
</tr>
<tr>
<td>Does the contract meet the criteria to be considered indexed to the entity's own stock?</td>
<td>Chapter 4</td>
</tr>
<tr>
<td>Does the contract meet other conditions for equity classification?</td>
<td>Chapter 5</td>
</tr>
</tbody>
</table>

Only a contract that is both indexed to the entity's own stock and meets all other conditions for equity classification can be classified as equity. If a contract either (1) is not considered indexed to the entity's own stock (e.g., because it is indexed to an extraneous variable such as the price of gold) or (2) does not meet other conditions for equity classification (e.g., because the entity could be forced to net cash settle the contract), the contract is classified as an asset or a liability.
ASC 815-40 also provides guidance (other than for embedded features) on the following aspects of the accounting for freestanding equity-linked financial instruments (Chapter 6):

- Initial measurement (i.e., fair value).
- Subsequent measurement (which depends on the contract’s classification as equity or an asset or a liability).
- Reclassification between (1) equity and (2) liabilities or assets (the classification of a contract is subject to continual reassessment).
- Settlements.

Further, ASC 815-40 includes disclosure requirements for contracts on an entity’s own equity (Chapter 7).

Some entities are affected by both U.S. GAAP and IFRS® Standards. There are significant differences between the guidance in ASC 815-40 and the equivalent guidance under IFRS Standards (Chapter 8).

The appendixes of this Roadmap include a tabular overview of the FASB’s examples in ASC 815-40 (Appendix A), checklists for determining whether a contract or a feature qualifies as equity under ASC 815-40 (Appendix B), and glossary terms from ASC 815-40-20 along with selected terms from the ASC master glossary (Appendix C).

Although practitioners still sometimes refer to the guidance that was in effect before the FASB’s codification in 2009 of U.S. GAAP (the “Codification”) and is now contained in ASC 815-40, they have begun to do so less frequently. Such guidance was principally contained in EITF Issues 07-5 and 00-19 (see table below) and has not changed significantly since being codified. However, the text of those EITF Issues is no longer recognized as a source of authoritative GAAP.

<table>
<thead>
<tr>
<th>EITF Issue</th>
<th>Pre-Codification Guidance</th>
<th>Codification Reference</th>
</tr>
</thead>
<tbody>
<tr>
<td>Determining Whether an Instrument (or Embedded Feature) Is Indexed to an Entity’s Own Stock</td>
<td>EITF Issue 07-5</td>
<td>ASC 815-40-15-7 through 15-8A and ASC 815-40-55-26 through 55-48</td>
</tr>
<tr>
<td>Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company’s Own Stock</td>
<td>EITF Issue 00-19</td>
<td>ASC 815-40</td>
</tr>
</tbody>
</table>

The following ASUs have amended the guidance in ASC 815-40:

- **ASU 2012-04** (issued in October 2012) eliminated certain unintended differences between (1) the Codification and (2) the pre-Codification guidance in EITF Issue 07-5. For example, the ASU added ASC 815-40-15-8A (see Section 6.3) and amended Example 16 in ASC 815-40-55 (see Section 4.3.5.1).

- **ASU 2016-19** (issued in December 2016) added guidance on registration payment arrangements (see Section 3.2.4).

- **ASU 2017-11** (issued in July 2017) makes limited changes to an issuer’s evaluation of whether a contract that contains a down-round feature qualifies as equity under ASC 815-40 (see Section 4.3.7.2). The ASU also adds recognition and measurement requirements for freestanding equity-classified contracts (e.g., warrants) that contain down-round features (see Section 6.1.5).

- **ASU 2018-07** (issued in June 2018) amends the ASC 815-40 scope exception for obligations under share-based payment arrangements (see Section 2.4).
For public business entities, ASUs 2017-11 and 2018-07 are effective for annual reporting periods beginning after December 15, 2018, including interim periods within those annual reporting periods. For all other entities, the ASUs are effective for annual reporting periods beginning after December 15, 2019, and interim periods within annual reporting periods beginning after December 15, 2020. Early adoption is permitted in any interim or annual period for which financial statements have not yet been issued (for public business entities) or have not been made available for issuance (for all other entities), except that an entity may not adopt ASU 2018-07 before it adopts ASC 606.

**Connecting the Dots**

When analyzing equity-linked contracts and embedded features, entities typically must consider multiple Codification subtopics in addition to ASC 815-40, including:

- ASC 260-10 (see Deloitte's *A Roadmap to the Presentation and Disclosure of Earnings per Share*).
- ASC 470-20 (see Deloitte's *A Roadmap to the Issuer's Accounting for Convertible Debt*).
- ASC 480-10 (see Deloitte's *A Roadmap to Distinguishing Liabilities From Equity*).
- ASC 815-10 and ASC 815-15 (on derivatives and embedded derivatives).

The FASB has an active project on its agenda to improve the understandability, and reduce the complexity, of the guidance on distinguishing liabilities from equity, including convertible debt. On July 31, 2019, the FASB issued a proposed ASU that would relax the equity classification conditions in ASC 815-40 by:

- Adding a “likelihood threshold” to ASC 815-40. Potential adjustments and contingent events that have only a remote likelihood of occurring would be disregarded in the accounting analysis under ASC 815-40-15 (see Chapter 4) and ASC 815-40-25 (see Section 5.2.2).
- Removing the following equity classification conditions from ASC 815-40-25:
  - “Settlement permitted in unregistered shares” (see Section 5.3.2).
  - “No counterparty rights rank higher than shareholder rights” (see Section 5.3.7).
  - “No collateral required” (see Section 5.3.8).
- Clarifying that penalty payments would not be included in the condition that no cash payments are required if the entity fails to file with the SEC in a timely manner (see Section 5.3.5).
- Requiring reassessment only upon the occurrence of a reassessment event, such as an adjustment to the instrument’s strike price or the number of shares used to calculate the settlement amount (see Section 5.4).

Comments on the proposed ASU are due by October 14, 2019.
Chapter 2 — Scope

Before an entity applies ASC 815-40 to a contract, it should evaluate whether the contract is of a type that would be within the scope of the guidance and whether any scope exception applies. In addition to freestanding contracts indexed to, and potentially settled in, the entity’s own stock, ASC 815-40 applies to contracts on the stock of substantive subsidiaries as well as to the evaluation of whether embedded features qualify for a scope exception from the guidance on derivative accounting. Contracts exempt from the scope include obligations to repurchase shares by transferring assets, certain obligations to issue a variable number of shares, many share-based payment transactions, and lock-up options.

In this chapter, we discuss the applicability of ASC 815-40 to the following types of contracts:

• Freestanding contracts indexed to, and potentially settled in, the entity’s own equity (see Section 2.1).
  ◦ Derivative instruments, including embedded derivative features (see Section 2.2).
• Contracts to repurchase shares by transferring assets (see Section 2.3.1).
• Certain contracts to issue a variable number of shares (see Section 2.3.2).
• Contracts issued as compensation for employee service (see Section 2.4.1).
• Contracts to acquire goods or services from nonemployees (see Section 2.4.2).
• Employee stock option appreciation securities (see Section 2.4.3).
• Contingent consideration in business combinations (see Section 2.5.1).
• Lock-up options (see Section 2.5.2).
• Contracts on the stock of consolidated subsidiaries (see Section 2.6.1).
• Contracts on the stock of a parent or other entity that is not consolidated (see Section 2.6.2).
• Contracts on the stock of an equity-method investee (see Section 2.6.3).
• Certain option combinations involving noncontrolling interests (see Section 2.6.4).
• Guarantee contracts (see Section 2.7).
• Contingently issuable contracts (see Section 2.8).
• Own-share lending arrangements in connection with convertible debt issuance (see Section 2.9).
2.1 Freestanding Contracts Indexed to, and Potentially Settled in, the Entity's Own Equity

### ASC 8150-40

<table>
<thead>
<tr>
<th>ASC Reference</th>
<th>Roadmap Discussion</th>
</tr>
</thead>
<tbody>
<tr>
<td>15-1</td>
<td>The guidance in this Subtopic applies to all entities.</td>
</tr>
<tr>
<td>15-2</td>
<td>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.</td>
</tr>
</tbody>
</table>

ASC 815-40 applies to both public business entities (including SEC registrants) and private companies.

The scope of ASC 815-40 focuses on contracts that have the following characteristics (ASC 815-40-15-2):

<table>
<thead>
<tr>
<th>Characteristic</th>
<th>ASC Reference</th>
<th>Roadmap Discussion</th>
</tr>
</thead>
<tbody>
<tr>
<td>Freestanding contract</td>
<td>The term “freestanding contract” is defined in ASC 815-40-20.</td>
<td>Section 3.2</td>
</tr>
<tr>
<td>Indexed to an entity's own stock</td>
<td>ASC 815-40-15 contains guidance to determine whether a contract is considered indexed to an entity's own stock.</td>
<td>Chapter 4</td>
</tr>
<tr>
<td>Potentially settled in an entity's own stock</td>
<td>ASC 815-40-25 addresses whether an entity has the ability to settle a contract in its own stock or could be forced to net cash settle.</td>
<td>Chapter 5</td>
</tr>
</tbody>
</table>

Unless a specific scope exception applies, therefore, the following types of contracts would be within the scope of ASC 815-40:

- A freestanding call option written by the entity that gives the holder a right to purchase equity shares of the entity.
- A freestanding call option that gives the entity a right to repurchase outstanding shares.
- A freestanding warrant issued by the entity to a shareholder giving it the right to subscribe to additional equity shares of the entity.
- A freestanding put option that gives the entity the right to sell shares to the writer of the option.
- A freestanding forward contract that commits the entity to issue additional equity shares or the resale of treasury shares.

Even though ASC 815-40-15-2 suggests that ASC 815-40 applies to contracts that are freestanding and indexed to, and potentially settled in, the entity’s own stock, some contracts that do not have all the characteristics of such contracts are subject to portions of ASC 815-40. For example:

- The indexation guidance and other equity classification conditions in ASC 815-40 apply not just to freestanding contracts but also to some embedded features that have all the characteristics of a derivative instrument in an entity's determination of whether such contracts are exempt from the scope of derivative accounting under ASC 815-10 (see Section 2.2).
- ASC 815-40-15-8A specifies that if an entity concludes that a contract is not indexed to the entity's own stock under ASC 815-40-15, the contract should be classified as an asset or a liability; that is, not as equity (see Section 6.3).
• ASC 815-40-25-4 provides guidance on a freestanding contract indexed to the entity's own stock that does not involve potential settlement in such stock. If the contract can be only net cash settled, it must be classified as an asset or a liability and accounted for at fair value with changes in fair value recognized in earnings.

ASC 815-40 does not directly apply to contracts that are themselves outstanding equity shares (e.g., common or preferred equity securities) rather than contracts on such shares. Nevertheless, some equity shares contain embedded features that may require evaluation under the indexation and equity classification guidance in ASC 815-40 (e.g., an equity conversion option in a convertible preferred stock contract, provided the option has the characteristics of a derivative instrument and is not clearly and closely related to the host contract; see Section 2.2).

ASC 815-40 does not apply to the counterparty of an equity-linked contract. From the counterparty's perspective, the contract is not on its equity. For example, if an entity writes a call option on its own equity to a third party, the holder of that call option would not apply ASC 815-40 to the contract, because from the counterparty's perspective, the contract is indexed to another entity's equity.

2.2 Derivative Instruments

2.2.1 Interaction With the Derivative Accounting Requirements

<table>
<thead>
<tr>
<th>ASC 815-40</th>
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</table>

15-5 The guidance in this paragraph through paragraph 815-40-15-8 applies to any freestanding financial instrument or embedded feature that has all the characteristics of a derivative instrument (see the guidance beginning in paragraph 815-10-15-83). That guidance applies for the purpose of determining whether that instrument or embedded feature qualifies for the first part of the scope exception in paragraph 815-10-15-74(a). That guidance does not address the second part of the scope exception in paragraph 815-10-15-74(a). The guidance also applies to any freestanding financial instrument that is potentially settled in an entity's own stock, regardless of whether the instrument has all the characteristics of a derivative instrument for purposes of determining whether the instrument is within the scope of this Subtopic.

15-9 For guidance on the interaction of this Subtopic and Subtopic 815-10, see paragraphs 815-10-15-74 through 15-78. For guidance on the interaction of this Subtopic and Subtopic 815-15, see paragraph 815-15-25-15.
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.

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).

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. [See Section 4.3.7.2.]

A derivative instrument is a financial instrument or other contract with all of the following characteristics:

a. Underlying, notional amount, payment provision. The contract has both of the following terms, which determine the amount of the settlement or settlements, and, in some cases, whether or not a settlement is required:
   1. One or more underlyings
   2. One or more notional amounts or payment provisions or both.

b. Initial net investment. The contract requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors.

c. Net settlement. The contract can be settled net by any of the following means:
   1. Its terms implicitly or explicitly require or permit net settlement.
   2. It can readily be settled net by a means outside the contract.
   3. It provides for delivery of an asset that puts the recipient in a position not substantially different from net settlement.
Some contracts on an entity's own equity have the characteristics of a derivative instrument under ASC 815-10. Such contracts may fall within the scope of both ASC 815-10 and ASC 815-40. Contracts on own equity that fall within the scope of ASC 815-10 are accounted for at fair value, with changes in fair value recognized in earnings. (While ASC 815 requires certain changes in fair value of derivative instruments designated in qualifying cash flow hedges to be recognized in other comprehensive income, ASC 815-20-25-15(h) does not permit an entity to designate a transaction involving the entity's own equity instruments as a hedged item in a cash flow hedge.)

ASC 815-10 describes the characteristics of a derivative instrument:

- **Underlying, notional amount, payment provision** — The instrument contains “[o]ne or more underlyings” and “[o]ne or more notional amounts or payment provisions or both.”
- **Initial net investment** — The instrument “requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors.”
- **Net settlement** — The instrument requires or permits net settlement, it “can readily be settled net by a means outside the contract” (i.e., a market mechanism), or it “puts the recipient in a position not substantially different from net settlement” (i.e., the underlying asset is readily convertible to cash or is itself a derivative).

A contract on an entity's own equity that does not meet the definition of a derivative instrument is outside the scope of ASC 815-10. For example, a freestanding warrant that requires physical settlement in private-company stock may not meet the net settlement characteristic in the definition of a derivative instrument. The issuer of a warrant that does not meet the definition of a derivative instrument would assess it under ASC 815-40 but not under ASC 815-10.

A contract on own equity that has the characteristics of a derivative instrument is within the scope of the derivative accounting requirements in ASC 815-10 unless a scope exception applies. Under ASC 815-10-15-74(a), certain contracts on own equity are exempt from those requirements. In assessing whether a contract on own equity qualifies for the scope exception, an entity applies ASC 815-40. A contract that qualifies as equity under the indexation guidance and equity classification conditions in ASC 815-40 would meet that scope exception.

ASC 815-10-15-75(a) explains that the scope exception from derivative accounting in ASC 815-10-15-74(a) does not apply to the counterparty of an equity-linked contract (e.g., the holder of a call option issued by the entity on its own stock). From the counterparty's perspective, the contract is not indexed to its own equity. In addition, ASC 815-10-15-75(b) specifies that the scope exception also does not apply to a contract that is indexed in part or in full to something other than the entity's own equity (e.g., a call option on the entity's own stock that has a strike price denominated in a currency other than the entity's functional currency). ASC 815-40-15 contains guidance on the determination of whether a contract is indexed to the entity's own equity (see Chapter 4).

ASU 2017-11 added ASC 815-10-15-75A, which implies that, after the ASU's adoption, the existence of a down-round feature does not preclude application of the scope exception from derivative accounting in ASC 815-10-15-74 that applies to contracts indexed to an entity's own stock and classified in stockholders' equity (see Section 4.3.7.2).
Under ASC 480-10-S99-3A and other SEC guidance, SEC registrants are required to classify certain redeemable equity securities in temporary equity (also known as mezzanine equity) outside of permanent equity (for a comprehensive discussion of the application of this guidance, see Chapter 9 of Deloitte's A Roadmap to Distinguishing Liabilities From Equity). In the evaluation of whether an item meets the scope exception for an entity’s own equity in ASC 815-10-15-74(a), temporary equity is considered equity (ASC 815-10-15-76).

Example 2-1

**Scope Exception**

An SEC registrant issues shares that contain an embedded written put option that permits the holder to put the shares back to the registrant in exchange for a cash payment; the registrant may be required to classify the shares in temporary equity under ASC 480-10-S99-3A. In evaluating whether the embedded put option qualifies for the scope exception in ASC 815-10-15-74(a) under the equity classification guidance in ASC 815-40 (e.g., in assessing whether the contract permits the issuer to settle in shares), the registrant would consider the shares to be equity shares even though they are presented outside of permanent equity.

2.2.2 Hybrid Contracts and Embedded Features

**ASC 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 . . . .

15-4 Item (a) in the preceding paragraph 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.

**ASC 815-15**

25-1 An embedded derivative shall be separated from the host contract and accounted for as a derivative instrument pursuant to Subtopic 815-10 if and only if all of the following criteria are met:

a. The economic characteristics and risks of the embedded derivative are not clearly and closely related to the economic characteristics and risks of the host contract.

b. The hybrid instrument is not remeasured at fair value under otherwise applicable generally accepted accounting principles (GAAP) with changes in fair value reported in earnings as they occur.

c. A separate instrument with the same terms as the embedded derivative would, pursuant to Section 815-10-15, be a derivative instrument subject to the requirements of this Subtopic. (The initial net investment for the hybrid instrument shall not be considered to be the initial net investment for the embedded derivative.)

An entity may issue debt or equity securities or other nonderivative contracts that contain embedded features indexed to, and potentially settled in, the entity’s own stock (e.g., convertible securities or redeemable equity securities). ASC 815-40-15-3(a) indicates that hybrid contracts (e.g., convertible debt) and embedded features (e.g., a conversion option embedded in debt) are exempt from the scope of ASC 815-40. This means that the guidance in ASC 815-40 does not directly apply to such contracts and features.
Nevertheless, the indexation and equity classification guidance in ASC 815-40 applies to an embedded derivative instrument in the determination of whether the instrument qualifies for the scope exception from derivative accounting in ASC 815-10-15-74(a) for contracts on an entity's own equity. ASC 815-15-25-1 requires certain embedded features to be bifurcated and accounted for as derivative instruments. For an embedded feature to be bifurcated, three conditions must be met:

1. The hybrid instrument (i.e., the combination of the embedded feature and its host contract) is not being measured at fair value with changes in fair value recorded immediately through earnings.
2. The embedded feature — if issued separately — would be accounted for as a derivative instrument under ASC 815-10.
3. The embedded feature is not clearly and closely related to the host contract (i.e., the feature and the contract possess different economic characteristics and risks).

An embedded feature that qualifies as equity under ASC 815-40 fails to satisfy the second bifurcation condition above because it would qualify for the scope exception in ASC 815-10-15-74(a) for certain contracts on own equity. Such a feature would be exempt from derivative accounting. An entity evaluates whether this scope exception is available by using the indexation guidance and conditions for equity classification in ASC 815-40.

Conversely, an embedded feature that does not qualify as equity under ASC 815-40 and meets the three bifurcation conditions in ASC 815-15 would be separated from its host contract and accounted for separately as a derivative instrument.

**Example 2-2**

**Embedded Derivatives**

An entity has issued a debt security that gives the counterparty the right to convert the security into the entity's stock. The equity conversion feature (1) meets all the characteristics of a derivative in ASC 815-10-15-83 (e.g., because the stock is publicly traded and the number of shares received upon conversion can be rapidly absorbed by the market) and (2) otherwise meets the conditions for separation as an embedded derivative in ASC 815-15-25-1 (e.g., it is not clearly and closely related to its host debt contract, and the debt is not being remeasured at fair value with changes in fair value recognized in earnings). The entity would assess the conversion feature under the indexation and equity classification guidance in ASC 815-40 to determine whether it meets the scope exception from derivative accounting in ASC 815-10-15-74(a). If the conversion feature qualifies as equity under ASC 815-40, it would be exempt from derivative accounting. If it does not qualify as equity under ASC 815-40, it would be bifurcated as a derivative instrument under ASC 815-15 unless another scope exception is met.

Note that features embedded in conventional convertible debt are exempt from some of the equity classification conditions in ASC 815-40-25 (more on this in Section 5.5).

Because ASC 815-40 applies to embedded features only in the evaluation of whether they qualify for that scope exception, ASC 815-40 is not relevant for an embedded feature that meets any of the following criteria:

- The feature does not have all the characteristics of a derivative in ASC 815-10-15-83 (see Section 2.2.1).
- It is clearly and closely related to the host contract (ASC 815-15-25-1(a)).
- It is embedded in a hybrid instrument that is remeasured at fair value with changes in fair value recorded in earnings (ASC 815-15-25-1(b)).
• It meets any of the scope exceptions in ASC 815-10-15 or ASC 815-15-15 other than the one in ASC 815-10-15-74(a).

Although the scope exception in ASC 815-40-15-3(a) is limited to “derivative instruments,” and that term is defined in ASC 815-40-20 by reference to ASC 815-10, we believe that ASC 815-40 does not apply to an embedded feature irrespective of whether the feature has all the characteristics of a derivative instrument in ASC 815-10. That is how the guidance is applied in practice. This view is also consistent with the EITF’s rationale for providing the scope exception. When the EITF developed the scope exception’s wording as part of deliberating Issue 96-13, the current definition of a derivative instrument (i.e., that in ASC 815-10) did not yet exist. Issue Summary 1 of EITF Issue 96-13 (prepared June 19, 1996) states, “The Task Force decided to not include embedded contracts in the scope of the Issues comprising the 94-7 Framework [i.e., the accounting for financial instruments indexed to, and potentially settled in, a company’s own stock]. Accordingly, this Issue does not address written call options and warrants that are embedded in and not detachable from other financial instruments.”

Connecting the Dots
For further discussion of the accounting for equity conversion features embedded in debt instruments, see Deloitte’s A Roadmap to the Issuer’s Accounting for Convertible Debt.

2.3 Certain Repurchase Obligations and Variable-Share Contracts

### ASC 815-40

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

   e. Financial instruments that are within the scope of Topic 480 (see paragraph 815-40-15-12).

15-12 Paragraph 480-10-15-5 explains that Topic 480 does not apply to a feature embedded in a financial instrument that is not a derivative instrument in its entirety (for example, a written put option embedded in a nonderivative host contract) in analyzing the embedded feature as though it were a separate instrument as required by paragraph 815-15-25-1(c). Therefore, this Subtopic applies in evaluating those embedded features under Subtopic 815-15.

Contracts on own equity that are required to be accounted for as liabilities or assets under ASC 480-10 are outside the scope of ASC 815-40. Therefore, an entity does not apply ASC 815-40 to a contract on own equity unless it has first determined that ASC 480-10 is not applicable.

ASC 480-10 applies to mandatorily redeemable financial instruments issued in the form of shares (see Chapter 4 of Deloitte’s A Roadmap to Distinguishing Liabilities From Equity) as well as the following types of freestanding financial instruments:

- Obligations, other than outstanding shares, to repurchase the issuer’s equity shares by transferring assets (see Chapter 5 of Deloitte’s A Roadmap to Distinguishing Liabilities From Equity).
- Certain obligations to issue a variable number of shares (see Chapter 6 of Deloitte’s A Roadmap to Distinguishing Liabilities From Equity).

The scope of ASC 480-10 is limited to freestanding financial instruments and does not include embedded features (e.g., an embedded written put option in an equity share issued by the entity). We discuss the applicability of ASC 815-40 to embedded features in Section 2.2.2.

For a comprehensive discussion of the application of ASC 480-10, see Deloitte’s A Roadmap to Distinguishing Liabilities From Equity.
2.3.1 Obligations to Repurchase Shares by Transferring Assets

<table>
<thead>
<tr>
<th>ASC 480-10</th>
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<tbody>
<tr>
<td><strong>25-8</strong> An entity shall classify as a liability (or an asset in some circumstances) any financial instrument, other than an outstanding share, that, at inception, has both of the following characteristics:</td>
</tr>
<tr>
<td>a. It embodies an obligation to repurchase the issuer’s equity shares, or is indexed to such an obligation.</td>
</tr>
<tr>
<td>b. It requires or may require the issuer to settle the obligation by transferring assets.</td>
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</table>

As discussed in more detail in Chapter 5 of Deloitte’s A Roadmap to Distinguishing Liabilities From Equity, contracts other than outstanding shares that require — or could require — the issuer to repurchase its equity shares (or are indexed to such an obligation) by transferring assets are accounted for as liabilities (or potentially as assets) under ASC 480-10. For example, a forward purchase contract on an entity’s own equity shares or a written put option on the entity’s own equity shares is classified as a liability if the issuer could be required to physically settle the contract by delivering cash in exchange for the issuer’s equity shares. Similarly, a forward purchase or written put option contract that permits the counterparty to net cash settle the contract would be classified as an asset or a liability. These requirements apply even if the purchase obligation is contingent on the occurrence or nonoccurrence of an event (unless it is solely within the entity’s control) or upon the counterparty’s exercise of an option.

ASC 480-10 applies to contracts that require or could require delivery of the entity’s redeemable equity securities (e.g., warrants, written call options, and forward sales) if the entity could ultimately be forced to redeem those securities by transferring assets. This is the case even if the redeemable equity securities would be classified within equity (including temporary equity) when issued. For example, if an entity issues a warrant that permits the holder to purchase the entity’s equity shares, that warrant is classified as a liability if the underlying equity shares contain a redemption requirement that is not solely within the entity’s control (e.g., an investor put option embedded in preferred stock). Although the warrant is required to be classified as a liability, the redeemable equity securities may qualify for classification as equity or temporary equity once issued. Similarly, a written call option or a forward sale contract on redeemable equity securities would be classified as a liability under ASC 480-10 if the entity could be required to transfer assets even if the obligation to transfer assets is embedded in the shares underlying the option or forward.

If, under the redemption feature, the entity could be required to transfer assets, a contract on redeemable stock is classified as a liability under ASC 480-10 regardless of the timing of the potential redemption requirement (e.g., immediately after exercise of a warrant or at some date in the future) or the redemption price (e.g., fair value or a fixed price). In addition, such a contract is classified as a liability even if the redemption feature is conditional on a defined contingency (such as a change in control, a reduction in the issuer’s credit rating, a conversion, or a failure to have a registration statement declared effective by the SEC by a designated date), unless the contingency is solely within the control of the issuer.

If an entity could not be required to transfer assets under a freestanding contract on redeemable equity securities, the contract may be within the scope of ASC 815-40. For example, the following types of contracts on redeemable equity securities would potentially be within the scope of ASC 815-40 unless another scope exception applies:

- A purchased call option that permits the entity to repurchase redeemable equity securities, at its option (because the entity has no obligation to repurchase the redeemable equity securities).
- A purchased put option that permits the entity to issue (sell) redeemable equity securities, at its option (because the entity has no obligation to issue redeemable equity securities).
2.3.1.1 Put Warrants

**ASC 815-40**

**55-16** Put warrants are frequently issued concurrently with debt securities of the entity, are detachable from the debt, and may be exercisable only under specified conditions. The put feature of the instrument may expire under varying circumstances, for example, with the passage of time or if the entity has a public stock offering. Under Subtopic 470-20, a portion of the proceeds from the issuance of debt with detachable warrants must be allocated to those warrants.

**55-17** Put warrants are instruments with characteristics of both warrants and put options. The holder of the instrument is entitled to do any of the following:

a. Exercise the warrant feature to acquire the common stock of the entity at a specified price
b. Exercise the put option feature to put the instrument back to the entity for a cash payment
c. Exercise both the warrant feature to acquire the common stock and the put option feature to put that stock back to the entity for a cash payment.

**55-18** Because the contract gives the counterparty the choice of cash settlement or settlement in shares, entities should report the proceeds from the issuance of put warrants as liabilities and subsequently measure the put warrants at fair value with changes in fair value reported in earnings as required by Topic 480. That is, a put warrant that embodies an obligation to repurchase the issuer's equity shares, or is indexed to such an obligation, and that requires or may require a transfer of assets is within the scope of that Topic and therefore is to be recognized as a liability.

A put warrant is an example of a contract that is required to be classified as a liability under ASC 480-10. Even though the warrant gives the counterparty an option to purchase the entity's stock, the contract is classified as a liability in its entirety under ASC 480-10 if the entity could be forced to repurchase the warrant for cash or other assets because it represents an obligation that is indexed to an obligation to repurchase the entity's equity shares, and the entity may be required to transfer cash or other assets (see Section 5.1 of Deloitte's *A Roadmap to Distinguishing Liabilities From Equity*). Alternatively, the counterparty may have the right to put the stock it received upon exercise of the warrant back to the entity for cash. In that case, the contract embodies an obligation to repurchase equity shares for cash (see Section 5.2.1 of Deloitte's *A Roadmap to Distinguishing Liabilities From Equity*). Because put warrants fall within the scope of ASC 480-10, they are outside the scope of ASC 815-40.

2.3.2 Contracts to Issue a Variable Number of Shares

**ASC 480-10**

**25-14** A financial instrument that embodies an unconditional obligation, or a financial instrument other than an outstanding share that embodies a conditional obligation, that the issuer must or may settle by issuing a variable number of its equity shares shall be classified as a liability (or an asset in some circumstances) if, at inception, the monetary value of the obligation is based solely or predominantly on any one of the following:

a. A fixed monetary amount known at inception (for example, a payable settleable with a variable number of the issuer's equity shares)
b. Variations in something other than the fair value of the issuer's equity shares (for example, a financial instrument indexed to the Standard and Poor's S&P 500 Index and settleable with a variable number of the issuer's equity shares)
c. Variations inversely related to changes in the fair value of the issuer's equity shares (for example, a written put option that could be net share settled).

See paragraph 480-10-55-21 for related implementation guidance.
Sometimes entities use their own shares as “currency” to settle an obligation in which the number of shares delivered depends on the value of the obligation. If a financial instrument embodies an obligation that the entity must or may settle in shares, the entity could be required to classify the contract as a liability (or, potentially, an asset) even if the instrument does not contain an obligation to transfer cash or other assets. As discussed in more detail in Chapter 6 of Deloitte's *A Roadmap to Distinguishing Liabilities From Equity*, ASC 480-10 identifies three circumstances in which a share-settleable contract would be classified as a liability. A contract that embodies an obligation that the issuer must or may settle in a variable number of equity-classified shares is classified as a liability if, at inception, the obligation’s monetary value is based solely or predominantly on:

- A fixed monetary amount known at inception.
- Variations in something other than the issuer’s equity shares.
- Variations inversely related to changes in the fair value of the entity’s equity shares.

This guidance applies not only to contracts that require share settlement but also to contracts that the issuer may elect to settle in either assets or a variable number of shares. For financial instruments other than outstanding shares, this guidance applies irrespective of whether the obligation is conditional or unconditional.

The following are examples of contracts that would be accounted for as liabilities or assets under this guidance:

- A net-share-settled forward repurchase contract whose value is inversely related to the entity’s stock price (e.g., because the forward price is fixed).
- A net-share-settled written put option whose value is inversely related to the entity’s stock price (e.g., because the strike price is fixed).
- A contract to issue a variable number of equity shares whose value is based solely or predominantly on variations in something other than the entity’s equity shares (e.g., the S&P 500 Index).
- A prepaid variable share forward on the entity’s stock that obligates the entity to deliver shares with a monetary value that is predominantly a fixed monetary amount known at inception.
- Stock-settled debt.
2.4 Share-Based Payments

ASC 815-40-20 — Glossary
Share-Based Payment Arrangements
An arrangement under which either of the following conditions is met:

a. One or more suppliers of goods or services (including employees) receive awards of equity shares, equity share options, or other equity instruments.

b. The entity incurs liabilities to suppliers that meet either of the following conditions:
   1. The amounts are based, at least in part, on the price of the entity’s shares or other equity instruments. (The phrase at least in part is used because an award may be indexed to both the price of the entity’s shares and something other than either the price of the entity’s shares or a market, performance, or service condition.)
   2. The awards require or may require settlement by issuance of the entity’s shares.

The term shares includes various forms of ownership interest that may not take the legal form of securities (for example, partnership interests), as well as other interests, including those that are liabilities in substance but not in form. Equity shares refers only to shares that are accounted for as equity.

Also called share-based compensation arrangements.

ASC 815-40 does not apply to a contract issued as compensation for employee service (see Section 2.4.1) or to acquire goods or services other than employee service (see Section 2.4.2) if the contract is subject to ASC 718 or, before the adoption of ASU 2018-07, ASC 505-50. Nevertheless, ASC 815-40 applies to equity-linked contracts issued to nonemployee investors to establish a market-based measure of the grant-date fair value of stock options (see Section 2.4.3). In June 2018, the FASB issued ASU 2018-07, which (1) updates the scope of ASC 718 to include share-based payment transactions for acquiring goods or services from nonemployees and (2) supersedes ASC 505-50. For effective date and transition guidance related to this ASU, see Section 2.4.4.

2.4.1 Contracts Issued as Compensation for Employee Service

ASC 815-40

15-3 The guidance in this Subtopic does not apply to any of the following: . . .
   b. Contracts that are issued to compensate employees . . .

Pending Content (Transition Guidance: ASC 718-10-65-11)

15-3 The guidance in this Subtopic does not apply to any of the following: . . .
   b. Contracts that are issued to compensate grantees in a share-based payment arrangement . . .
ASC 815-40 (continued)

15-5A The guidance in this paragraph through paragraph 815-40-15-8 does not apply to share-based payment awards within the scope of Topic 718 for purposes of determining whether instruments are classified as liability awards or equity awards under that Topic. Equity-linked financial instruments issued to investors for purposes of establishing a market-based measure of the grant-date fair value of employee stock options are not within the scope of Topic 718 themselves. Consequently, the guidance in this paragraph through paragraph 815-40-15-8 applies to such market-based employee stock option valuation instruments for purposes of making the determinations described in [ASC 815-40-15-5].

Pending Content (Transition Guidance: ASC 718-10-65-11)

15-5A The guidance in this paragraph through paragraph 815-40-15-8 does not apply to share-based payment awards within the scope of Topic 718 for purposes of determining whether instruments are classified as liability awards or equity awards under that Topic. Equity-linked financial instruments issued to investors for purposes of establishing a market-based measure of the grant-date fair value of employee stock options are not within the scope of Topic 718 themselves. Consequently, the guidance in this paragraph through paragraph 815-40-15-8 applies to such market-based share-based payment stock option valuation instruments for purposes of making the determinations described in paragraph 815-40-15-5.

ASC 718-10

35-10 A freestanding financial instrument issued to an employee in exchange for past or future employee services that is subject to initial recognition and measurement guidance within this Topic shall continue to be subject to the recognition and measurement provisions of this Topic throughout the life of the instrument, unless its terms are modified when the holder is no longer an employee. Only for purposes of this paragraph, a modification does not include a change to the terms of an award if that change is made solely to reflect an equity restructuring provided that both of the following conditions are met:

a. There is no increase in fair value of the award (or the ratio of intrinsic value to the exercise price of the award is preserved, that is, the holder is made whole) or the antidilution provision is not added to the terms of the award in contemplation of an equity restructuring.

b. All holders of the same class of equity instruments (for example, stock options) are treated in the same manner.

Pending Content (Transition Guidance: ASC 718-10-65-12)

35-10 A freestanding financial instrument issued to a grantee in exchange for goods or services received (or to be received) that is subject to initial recognition and measurement guidance within [ASC 718] shall continue to be subject to the recognition and measurement provisions of [ASC 718] throughout the life of the instrument, unless its terms are modified after a nonemployee vests in the award and is no longer providing goods or services, or a grantee is no longer an employee. Only for purposes of this paragraph, a modification does not include a change to the terms of an award if that change is made solely to reflect an equity restructuring provided that both of the following conditions are met:

a. There is no increase in fair value of the award (or the ratio of intrinsic value to the exercise price of the award is preserved, that is, the holder is made whole) or the antidilution provision is not added to the terms of the award in contemplation of an equity restructuring.

b. All holders of the same class of equity instruments (for example, stock options) are treated in the same manner.
ASC 718-10 (continued)

35-12 Once the classification of an instrument is determined, the recognition and measurement provisions of this Topic shall be applied until the instrument ceases to be subject to the requirements discussed in paragraph 718-10-35-10. Topic 480 or other applicable GAAP, such as Topic 815, applies to a freestanding financial instrument that was issued under a share-based payment arrangement but that is no longer subject to this Topic. This guidance is not intended to suggest that all freestanding financial instruments shall be accounted for as liabilities pursuant to Topic 480, but rather that freestanding financial instruments issued in share-based payment transactions may become subject to that Topic or other applicable GAAP depending on their substantive characteristics and when certain criteria are met.

35-14 An entity may modify (including cancel and replace) or settle a fully vested, freestanding financial instrument after it becomes subject to Topic 480 or other applicable GAAP. Such a modification or settlement shall be accounted for under the provisions of this Topic unless it applies equally to all financial instruments of the same class regardless of whether the holder is (or was) an employee (or an employee’s beneficiary). Following the modification, the instrument continues to be accounted for under that Topic or other applicable GAAP. A modification or settlement of a class of financial instrument that is designed exclusively for and held only by current or former employees (or their beneficiaries) may stem from the employment relationship depending on the terms of the modification or settlement. Thus, such a modification or settlement may be subject to the requirements of this Topic. See paragraph 718-10-35-10 for a discussion of changes to awards made solely to reflect an equity restructuring.

Pending Content (Transition Guidance: ASC 718-10-65-12)

35-14 An entity may modify (including cancel and replace) or settle a fully vested, freestanding financial instrument after it becomes subject to Topic 480 or other applicable GAAP. Such a modification or settlement shall be accounted for under the provisions of this Topic unless it applies equally to all financial instruments of the same class regardless of the holder of the financial instrument. Following the modification, the instrument continues to be accounted for under that Topic or other applicable GAAP. A modification or settlement of a class of financial instrument that is designed exclusively for and held only by grantees (or their beneficiaries) may stem from the employment or vendor relationship depending on the terms of the modification or settlement. Thus, such a modification or settlement may be subject to the requirements of this Topic. See paragraph 718-10-35-10 for a discussion of changes to awards made solely to reflect an equity restructuring.

ASC 815-40 does not apply to contracts subject to ASC 718 that are issued as compensation for employee service. Such contracts include, but are not limited to, stock appreciation rights and stock options given to employees in exchange for employee service. The entity would apply ASC 718 to determine whether the contracts should be classified as equity or as liabilities or as assets and how to account for them.

A contract originally issued as compensation to an employee in a share-based payment arrangement subject to ASC 718 may become subject to ASC 815-40 after its issuance if its terms are modified and the holder is no longer an employee. If the terms are modified and the holder is no longer an employee, ASC 718 ceases to apply unless the modification is made solely to reflect an equity restructuring that meets the criteria in ASC 718-10-35-10 (i.e., “[t]here is no increase in fair value of the award (or the ratio of intrinsic value to the exercise price of the award is preserved, that is, the holder is made whole) or the antidilution provision is not added to the terms of the award in contemplation of an equity restructuring [and all] holders of the same class of equity instruments . . . are treated in the same manner.”

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If a contract originally issued as compensation to an employee in a share-based payment arrangement subject to ASC 718 becomes subject to ASC 815-40, the classification of the contract as equity or as an asset or a liability may change because of the application of ASC 815-40. A contract originally issued for employee service that meets the conditions for liability classification under ASC 480-10 would be excluded from the scope of ASC 815-40 (see Section 2.3).

**Changing Lanes**

ASU 2018-07 only changes the accounting for contracts issued to nonemployees to acquire goods or services. It does not affect the applicability of ASC 815-40 to contracts issued as compensation to an employee in a share-based payment arrangement subject to ASC 718.

### 2.4.2 Contracts Issued to Acquire Goods or Services Other Than Employee Service

<table>
<thead>
<tr>
<th>ASC 815-40</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>15-3</strong> The guidance in this Subtopic does not apply to any of the following: . . .</td>
</tr>
<tr>
<td>c. Contracts that are issued to acquire goods or services from nonemployees when performance has not yet occurred . . .</td>
</tr>
</tbody>
</table>

**Pending Content (Transition Guidance: ASC 718-10-65-11)**

| **15-3** The guidance in this Subtopic does not apply to any of the following: . . . |
| c. Subparagraph superseded by Accounting Standards Update No. 2018-07 |

| **55-1** Both of the following are within the scope of this Subtopic based on the criteria in paragraph 815-40-15-2: . . . |
| b. Contracts issued to acquire goods or services from nonemployees when performance has occurred. |

**Pending Content (Transition Guidance: ASC 718-10-65-11)**

| **55-1** Both of the following are within the scope of this Subtopic based on the criteria in paragraph 815-40-15-2: . . . |
| b. Subparagraph superseded by Accounting Standards Update No. 2018-07 |

<table>
<thead>
<tr>
<th>ASC 505-50</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>30-13</strong> The counterparty's performance is complete when the counterparty has delivered or, in the case of sales incentives, purchased the goods or services, despite the fact that at that date the quantity or all the terms of the equity instruments may yet depend on other events (this would occur, for example, if a target stock price requirement has not been met when the counterparty has delivered the goods or services).</td>
</tr>
</tbody>
</table>

**Pending Content (Transition Guidance: ASC 718-10-65-11)**

| **30-13** Paragraph superseded by Accounting Standards Update No. 2018-07 |
Before the adoption of ASU 2018-07, ASC 505-50 applies to contracts to acquire goods or services other than employee service (e.g., access to a leased asset). After the ASU’s adoption, entities apply the guidance in ASC 718 to account for such transactions.

In addition, before the adoption of ASU 2018-07, awards issued in whole or in part as consideration for goods or services other than employee services generally become subject to other applicable GAAP once performance is complete and the awards are no longer subject to ASC 505-50. Therefore, ASC 815-40 may apply to contracts on an entity’s own equity that represent share-based payments to acquire goods or services from nonemployees once performance has occurred (unless the contracts are subject to ASC 480-10). After the ASU’s adoption, such contracts generally are subject to ASC 718 unless they are modified after the good has been delivered, the service has been rendered, any other conditions necessary to earn the right to benefit from the contracts have been satisfied, and the nonemployee is no longer providing goods or services (see ASC 718-10-35-10 as amended by ASU 2018-07). However, once a convertible debt instrument issued to a nonemployee is fully vested (i.e., performance is complete; see ASC 718-10-35-9A, which was added by ASU 2018-07), it is no longer within the scope of ASC 718. Paragraph BC23 of ASU 2018-07 states:

The Board received feedback indicating that convertible instruments granted in exchange for goods or services (convertible instrument awards) rarely occur in practice. As such, the Board decided to preserve the current accounting result for convertible instrument awards rather than delay the issuance of this Update by having to deliberate the accounting for convertible instrument awards. The Board also noted that its current project on distinguishing liabilities from equity (including convertible debt) is better suited to address concerns, if any, with the current accounting model for convertible instrument awards.

Both ASC 505-50-15-3(c) (before the adoption of ASU 2018-07) and ASC 718-10-15-5(b) (after the adoption of ASU 2018-07) exempt from their scope payment transactions involving equity instruments granted to a lender or an investor that provides financing to the issuer. For example, if an entity obtains a loan in exchange for issuing a contract on its own equity, that contract would not be within the scope of ASC 505-50 or ASC 718, but it would be evaluated under ASC 815-40 and any other applicable guidance (including ASC 480-10).
2.4.3 Stock Option Appreciation Rights Securities

ASC 815-40

15-5A The guidance in this paragraph through paragraph 815-40-15-8 does not apply to share-based payment awards within the scope of Topic 718 for purposes of determining whether instruments are classified as liability awards or equity awards under that Topic. Equity-linked financial instruments issued to investors for purposes of establishing a market-based measure of the grant-date fair value of employee stock options are not within the scope of Topic 718 themselves. Consequently, the guidance in this paragraph through paragraph 815-40-15-8 applies to such market-based employee stock option valuation instruments for purposes of making the determinations described in [ASC 815-40-15-5].

Pending Content (Transition Guidance: ASC 718-10-65-11)

15-5A The guidance in this paragraph through paragraph 815-40-15-8 does not apply to share-based payment awards within the scope of Topic 718 for purposes of determining whether instruments are classified as liability awards or equity awards under that Topic. Equity-linked financial instruments issued to investors for purposes of establishing a market-based measure of the grant-date fair value of employee stock options are not within the scope of Topic 718 themselves. Consequently, the guidance in this paragraph through paragraph 815-40-15-8 applies to such market-based share-based payment stock option valuation instruments for purposes of making the determinations described in paragraph 815-40-15-5.

Equity-linked contracts issued to nonemployee investors for the purpose of establishing a market-based measure of the grant-date fair value of stock options are not exempt from the scope of ASC 815-40. For instance, an entity may issue stock option appreciation rights securities that pay third-party investors when grantees exercise options in a reference pool of granted stock options. On or near the option grant date, a market clearing price is determined for the securities through a competitive auction process. The entity uses the market price of the stock option appreciation rights securities to help determine the grant-date fair value of the referenced stock options. In this case, the securities would not qualify for the scope exception in ASC 815-40-15-3(b) for contracts issued to compensate grantees since they are not issued as compensation. This is the case even though the securities reference stock options that may qualify for the scope exception for contracts issued to compensate grantees in a share-based payment arrangement.
2.4.4 Transition Related to ASU 2018-07

ASC 718-10

65-11 The following represents the transition and effective date information related to Accounting Standards Update No. 2018-07, Compensation — Stock Compensation (Topic 718): Improvements to Nonemployee Share-Based Payment Accounting:

a. The pending content that links to this paragraph shall be effective for public business entities for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years.

b. The pending content that links to this paragraph shall be effective for all other entities for fiscal years beginning after December 15, 2019, and interim periods within fiscal years beginning after December 15, 2020.

c. Early adoption, including adoption in an interim period, of the pending content that links to this paragraph is permitted for:
   1. Public business entities for which financial statements have not yet been issued, but no earlier than the adoption of the pending content that links to paragraph 606-10-65-1
   2. All other entities for which financial statements have not yet been made available for issuance, but no earlier than the adoption of the pending content that links to paragraph 606-10-65-1.

If an entity early adopts the pending content that links to this paragraph in an interim period, any adjustments shall be reflected as of the beginning of the fiscal year that includes that interim period.

d. An entity shall apply the pending content that links to this paragraph in the same period in which it applies the pending content that links to paragraphs 718-10-65-12 through 65-14.

e. An entity shall apply the pending content that links to this paragraph on a modified retrospective basis through a cumulative-effect adjustment to retained earnings as of the beginning of the fiscal year in which the pending content that links to this paragraph is adopted. For purposes of determining the cumulative-effect adjustment, an entity shall:
   1. Assess only liability-classified awards that have not been settled by the date of adoption and equity-classified awards for which a measurement date has not been established
   2. Remeasure awards as defined in (e)(1) at fair value as of the adoption date rather than grant-date fair value
   3. Not remeasure assets that are completed. For example, finished goods inventory or equipment that has begun amortization would not be remeasured upon transition.

f. In the first interim period and fiscal year of adoption, an entity shall disclose both of the following:
   1. The nature of and reason for the change in accounting principle
   2. The cumulative effect of the change on retained earnings or other components of equity or net assets in the statement of financial position as of the beginning of the period of adoption.
2.5 Business Combinations

2.5.1 Contingent Consideration

ASC 815-40

55-1 Both of the following are within the scope of this Subtopic based on the criteria in paragraph 815-40-15-2:

a. Security price guarantees or other financial instruments indexed to, or otherwise based on, the price of the entity's stock that are issued in connection with a purchase business combination and that are accounted for as contingent consideration.

ASC 718-10 (continued)

65-12 The following represents the transition and effective date information related to Accounting Standards Update No. 2018-07, Compensation — Stock Compensation (Topic 718): Improvements to Nonemployee Share-Based Payment Accounting:

a. An entity shall apply the pending content that links to this paragraph in the same period in which it applies the pending content that links to paragraphs 718-10-65-11 and 718-10-65-13 through 65-14.

b. An entity shall apply the pending content that links to this paragraph on a modified retrospective basis through a cumulative-effect adjustment to retained earnings as of the beginning of the fiscal year in which the pending content that links to this paragraph is adopted. Upon adoption, an entity shall reevaluate the classification of nonemployee awards initially classified as equity before completion of performance and subsequently reclassified to liabilities upon completion of performance because of other guidance (for example, Topic 815 on derivatives and hedging).

c. For purposes of determining the cumulative-effect adjustment, an entity shall assess unsettled liability-classified awards that were previously classified as equity awards as of the adoption date. If a liability-classified award would have remained equity classified because of the application of the pending content that links to this paragraph, the guidance on the modification of an award from liability classification to equity classification in paragraphs 718-20-55-135 through 55-138 shall be applied.

d. In the first interim period and fiscal year of adoption, an entity shall disclose both of the following:
   1. The nature of and reason for the change in accounting principle
   2. The cumulative effect of the change on retained earnings or other components of equity or net assets in the statement of financial position as of the beginning of the period of adoption.

For public business entities, ASU 2018-07 is effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. For all other entities, the ASU is effective for fiscal years beginning after December 15, 2019, and interim periods within fiscal years beginning after December 15, 2020. Early adoption is permitted if financial statements have not yet been issued (for public business entities) or have not yet been made available for issuance (for all other entities), except that an entity may not adopt ASU 2018-07 before it adopts ASC 606.

For more information about the transition to ASU 2018-07, see Deloitte's June 21, 2018, Heads Up, and August 1, 2018, Financial Reporting Alert.
Contingent Consideration

Usually an obligation of the acquirer to transfer additional assets or equity interests to the former owners of an acquiree as part of the exchange for control of the acquiree if specified future events occur or conditions are met. However, contingent consideration also may give the acquirer the right to the return of previously transferred consideration if specified conditions are met.

In business combinations, the parties often agree to the contingent issuance of additional shares in the future or to a contingent return of shares. Contingent consideration is part of the total consideration transferred for the acquiree and therefore must be measured and recognized at fair value as of the acquisition date. Such arrangements permit the parties to proceed with a business combination without agreeing on the final purchase price. For example, the acquirer may agree to deliver a specified number of its own equity shares if the earnings of the acquired entity exceed a specified target in the year following the combination. Other examples of events that may trigger contingent consideration payments include reaching a specified stock price or reaching a milestone on a research and development project.

There is no scope exception in ASC 815-40 for equity-linked contracts accounted for as contingent consideration in a business combination. Accordingly, the acquirer determines whether contingent consideration should be classified as equity or as an asset or a liability in accordance with ASC 815-40 and any other applicable guidance (including ASC 480-10).

ASC 805-30-35-1 discusses how to recognize changes in fair value of contingent consideration other than measurement-period adjustments. Contingent consideration classified as equity is not remeasured, and its settlement is recognized in equity. Contingent consideration classified as an asset or a liability is remeasured to fair value in each reporting period, with changes in fair value recognized in earnings unless the consideration qualifies for recognition in other comprehensive income under the hedge accounting guidance in ASC 815.

Under ASC 805, adjustments made during the measurement period that pertain to facts and circumstances that existed as of the acquisition date are recognized as adjustments to goodwill. The acquirer must consider all pertinent factors in determining whether information obtained after the acquisition date should result in an adjustment to the provisional amounts recognized or whether that information was based on events that occurred after the acquisition date. For example, earnings targets that are met, changes in share prices, and FDA approvals are all changes that occur after the acquisition date. Changes in fair value resulting from these items are recognized in earnings and not as adjustments to goodwill.

For contracts that do not qualify as equity under ASC 815-40, the earnings effect of the contingent consideration arrangement may appear counterintuitive. For example, the acquirer may agree to transfer additional equity shares to the former owner if an acquiree’s earnings target is met. As the likelihood of meeting the earnings target increases, so does the fair value of a liability-classified contract (all else being equal), causing a loss to be recorded in earnings.
2.5.2 Lock-Up Options

**ASC 815-40**

15-6 The guidance in this paragraph applies to both the issuer and the holder of the instrument. Outstanding instruments within the scope of the guidance in paragraphs 815-40-15-5 through 15-8 shall always be considered issued for accounting purposes, except as discussed in the next sentence. Lock-up options shall not be considered issued for accounting purposes unless and until the options become exercisable.

**ASC Master Glossary**

**Lock-Up Options**

Contingently exercisable options to purchase equity securities of another party to a business combination, at favorable prices, to encourage successful completion of that combination. If the merger is consummated as proposed, the options expire unexercised. If, however, a specified event occurs that interferes with the planned business combination, the options become exercisable.

Unless a scope exception applies, contracts that are only contingently exercisable (e.g., equity-linked contracts that become issuable or exercisable upon an IPO or other contingent event) are not exempt from ASC 815-40. One scope exception applies to lock-up options in business combinations. ASC 815-40-15-6 specifies that such options are “not . . . considered issued for accounting purposes unless and until [they] become exercisable.” Effectively, this means that no accounting recognition is given to such options before they become exercisable.

Although ASC 815-40 does not define or describe what is meant by “lock-up options,” the term is defined in the ASC master glossary. That definition limits the meaning to certain contingent options exchanged by parties to a contemplated business combination. The purpose of such options is to promote the completion of the business combination between the parties. The options are meant to “lock up” the acquiree and prevent it from being sold to other potential buyers. For instance, lock-up options might give the potential acquirer in a business combination the right to purchase additional equity of the target company at a favorable price in the event a third party purchases a large interest in the target company. In this case, the options are designed to discourage third parties from buying a large interest in the target company. If the business combination proceeds as planned, however, the options never become exercisable.

We believe that the FASB intended to limit its concept of lock-up options to those for which no consideration is exchanged or firmly committed; however, this limitation is not explicitly stated in the Codification. Before the Codification, the guidance on lock-up options was contained in paragraph 12 of EITF Issue 07-5, which carried forward the guidance on lock-up options in EITF Issue 01-6 and the definition of lock-up options in EITF Issue 97-9. The definition of lock-up options in EITF Issue 97-9 is similar to that in the ASC master glossary except for the clarification that no consideration is associated with such options:

> Often, parties to a business combination exchange, for no consideration, contingently exercisable options to purchase equity securities of the other entity, at favorable prices, to encourage successful completion of that combination. If the merger is consummated as proposed, the options expire unexercised. If, however, a specified event occurs that interferes with the planned business combination, the options become exercisable. These options are referred to in this Issue as “lock-up options.” [Emphasis added]
Further, Issue Summary 1, Supplement 1, of EITF Issue 01-6 (prepared October 26, 2001), which was discussed at the EITF's November 14–15, 2001, meeting, suggests that proponents of the nonrecognition of lock-up options had in mind instruments for which no tangible consideration has been exchanged or firmly committed:

View B proponents [i.e., the view that lock-up options should not be recognized before exercise] believe the issuer and holder of instruments within the scope of this Issue should only recognize those instruments when tangible consideration has been exchanged or firmly committed. Consequently, for any such instrument in which tangible consideration has been exchanged or firmly committed in the form of cash, services, or some other tangible consideration, those instruments are considered issued for accounting purposes.

Further, we believe that the guidance on lock-up options applies not just to freestanding contracts but also to embedded features (e.g., lock-up options embedded in loan commitments). The guidance that was ultimately included in EITF Issues 01-6 and 07-5 and in ASC 815-40-15-6 was based on View B in Issue Summary 1, Supplement 1, of EITF Issue 01-6. View B applies to both freestanding and embedded instruments.

### 2.6 Consolidation

#### 2.6.1 Contracts on the Stock of Consolidated Subsidiaries

**ASC 810-10**

| 45-17A | An equity-classified instrument (including an embedded feature that is separately recorded in equity under applicable GAAP) within the scope of the guidance in paragraph 815-40-15-5C shall be presented as a component of noncontrolling interest in the consolidated financial statements whether the instrument was entered into by the parent or the subsidiary. However, if such an equity-classified instrument was entered into by the parent and expires unexercised, the carrying amount of the instrument shall be reclassified from the noncontrolling interest to the controlling interest. |

**ASC 815-40**

| 15-5C | Freestanding financial instruments (and embedded features) for which the payoff to the counterparty is based, in whole or in part, on the stock of a consolidated subsidiary are not precluded from being considered indexed to the entity's own stock in the consolidated financial statements of the parent if the subsidiary is a substantive entity. If the subsidiary is not a substantive entity, the instrument or embedded feature shall not be considered indexed to the entity's own stock. If the subsidiary is considered to be a substantive entity, the guidance beginning in paragraph 815-40-15-5 shall be applied to determine whether the freestanding financial instrument (or an embedded feature) is indexed to the entity's own stock and shall be considered in conjunction with other applicable GAAP (for example, this Subtopic) in determining the classification of the freestanding financial instrument (or an embedded feature) in the financial statements of the entity. The guidance in this paragraph applies to those instruments (and embedded features) in the consolidated financial statements of the parent, whether the instrument was entered into by the parent or the subsidiary. The guidance in this paragraph does not affect the accounting for instruments (or embedded features) that would not otherwise qualify for the scope exception in paragraph 815-10-15-74(a). For example, freestanding instruments that are classified as liabilities (or assets) under Topic 480 and put and call options embedded in a noncontrolling interest that is accounted for as a financing arrangement under Topic 480 are not affected by this guidance. For guidance on presentation of an equity-classified instrument (including an embedded feature that is separately recorded in equity under applicable GAAP) within the scope of the guidance in this paragraph, see paragraph 810-10-45-17A. |
In consolidated financial statements, contracts indexed to, and potentially settled in, the equity shares of a consolidated subsidiary are analyzed in a manner similar to contracts on the parent entity's own stock unless the subsidiary is not a substantive entity. Thus, a contract on subsidiary stock could be within the scope of ASC 815-40 and qualify for equity classification in the consolidated financial statements even though it is not on the parent entity's own stock. This is the case irrespective of whether the parent or the subsidiary entered into the contract. An equity-classified contract on the stock of a consolidated subsidiary is presented as a component of noncontrolling interest in the consolidated financial statements.

If the subsidiary is not a substantive entity, a contract on that subsidiary’s stock is outside the scope of ASC 815-40 and does not qualify for equity classification regardless of whether the contract otherwise meets the conditions for equity classification in ASC 815-40. ASC 815-40 does not define what is meant by a “substantive entity.” The use of the term “substantive entity” in ASC 815-40-15-5C originated in EITF Issue 08-8. In deliberating that Issue, the EITF discussed whether to define the term but decided not to do so. Issue Summary 1, Supplement 1, of EITF Issue 08-10 (prepared January 6, 2009) suggests that judgment is required in the determination of whether an entity is a substantive entity. For example, a shell entity that holds commodities or stocks might not be a substantive entity.

2.6.2 Contracts on the Stock of a Parent or Other Entity That Is Not Consolidated

In the subsidiary's separate financial statements, the equity of its parent would not be considered part of the subsidiary's equity. Therefore, a contract indexed to, and potentially settled in, the parent's stock would be outside the scope of ASC 815-40 and could not be classified within equity in the subsidiary's separate financial statements.

For the same reason, a contract on the stock of an affiliated entity that is not consolidated by the reporting entity (e.g., a sister company within a group) would be outside the scope of ASC 815-40. Such a contract would not qualify as equity in the reporting entity's financial statements, although it might qualify as equity in the reporting entity's parent's financial statements if the parent consolidates the affiliated entity. See Section 5.2.7 for further discussion about the analysis under ASC 815-40-25 of contracts indexed to an entity's own equity that can be settled in the shares of another entity within a consolidated group.

2.6.3 Contracts on the Stock of an Equity-Method Investee

Equity shares issued by an equity-method investee are not considered part of the entity's own equity. Therefore, contracts indexed to, and potentially settled in, the equity shares of an equity-method investee would be outside the scope of ASC 815-40.
2.6.4 Certain Option Combinations Involving Noncontrolling Interests

ASC 815-40

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

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 . . . .

ASC 480-10

55-53 A controlling majority owner (parent) holds 80 percent of a subsidiary's equity shares. The remaining 20 percent (the noncontrolling interest) is owned by an unrelated entity (the noncontrolling interest holder). Simultaneous with the acquisition of the noncontrolling interest, the noncontrolling interest holder and the parent enter into a derivative instrument that is indexed to the subsidiary's equity shares. The terms of the derivative instrument may be any of the following: . . .

b. The parent has a call option to buy the other 20 percent at a fixed price at a stated future date, and the noncontrolling interest holder has a put option to sell the other 20 percent to the parent under those same terms, that is, the fixed price of the call is equal to the fixed price of the put option. (Derivative 2) . . .

55-55 Depending on how Derivative 2 was issued, one of three different accounting methods applies. If Derivative 2 was issued as a single freestanding instrument, under this Subtopic it would be accounted for in its entirety as a liability (or an asset in some circumstances), initially and subsequently measured at fair value. If the written put option and the purchased call option in Derivative 2 were issued as freestanding instruments, the written put option would be accounted for under this Subtopic as a liability measured at fair value, and the purchased call option would be accounted for under Subtopic 815-40. Under both of those situations, the noncontrolling interest is accounted for separately from the derivative instrument under applicable guidance. However, if the written put option and purchased call option are embedded in the shares (noncontrolling interest) and the shares are not mandatorily redeemable, the freestanding instrument shall be accounted for as discussed in paragraph 480-10-55-59 with the parent consolidating 100 percent of the subsidiary.

Pending Content (Transition Guidance: ASC 105-10-65-4)

55-55 Depending on how Derivative 2 was issued, one of three different accounting methods applies. If Derivative 2 was issued as a single freestanding instrument, under this Subtopic it would be accounted for in its entirety as a liability (or an asset in some circumstances), initially and subsequently measured at fair value. If the written put option and the purchased call option in Derivative 2 were issued as freestanding instruments, the written put option would be accounted for under this Subtopic as a liability measured at fair value, and the purchased call option would be accounted for under Subtopic 815-40. Under both of those situations, the noncontrolling interest is accounted for separately from the derivative instrument under applicable guidance. However, if the written put option and purchased call option are embedded in the shares (noncontrolling interest) and the shares are not otherwise classified as liabilities under the guidance in this Subtopic, the instrument shall be accounted for as discussed in paragraph 480-10-55-59 with the parent consolidating 100 percent of the subsidiary.
ASC 480-10 (continued)

55-57 In applying paragraphs 480-10-25-4 through 25-14 to determine classification, a freestanding financial instrument within this Subtopic’s scope is precluded from being combined with another freestanding financial instrument, unless combination is required under the provisions of Topic 815; therefore, unless under the particular facts and circumstances that Topic provides otherwise, freestanding derivative instruments in the scope of this Subtopic would not be combined with the noncontrolling interest.

55-58 This guidance is limited to circumstances in which the parent owns a majority of the subsidiary’s outstanding common stock and consolidates that subsidiary at inception of the derivative instrument. This guidance is limited to the specific derivative instruments described.

Written Put Option and Purchased Call Option Embedded in Noncontrolling Interest

55-59 If the derivative instrument in Derivative 2 is freestanding of the noncontrolling interest, it should be combined with the noncontrolling interest and accounted for as a financing. That is, the combination of option contracts should be viewed on a combined basis with the noncontrolling interest and accounted for as a financing of the parent’s purchase of the noncontrolling interest.

Pending Content (Transition Guidance: ASC 105-10-65-4)

55-59 If the derivative instrument in Derivative 2 is embedded in the shares (noncontrolling interest) and the shares are not otherwise classified as liabilities under the guidance in this Subtopic, the combination of options should be viewed on a combined basis with the noncontrolling interest and accounted for as a financing of the parent’s purchase of the noncontrolling interest.

55-60 Under that approach, the parent would consolidate 100 percent of the subsidiary and would attribute the stated yield earned under the combined derivative instrument and noncontrolling interest position to interest expense (that is, the financing would be accreted to the strike price of the forward or option over the period until settlement). No gain or loss would be recognized on the sale of the noncontrolling interest by the parent to the noncontrolling interest holder at the inception of the derivative instrument.

55-61 The risks and rewards of owning the noncontrolling interest have been retained by the parent during the period of the derivative instrument, notwithstanding the legal ownership of the noncontrolling interest by the counterparty. Combining the two transactions in this circumstance reflects the substance of the transactions; that the counterparty is financing the noncontrolling interest. Upon such combination, the resulting instrument is not a derivative instrument subject to Subtopic 815-10.

55-62 This accounting applies even if the exercise prices of the put and call options are not equal, as long as those exercise prices are not significantly different.

ASC 480-10-55-53 through 55-58 require certain embedded option combinations involving a noncontrolling interest of a consolidated subsidiary to be accounted for on a combined basis with the noncontrolling interest as a financing of the parent’s purchase of the noncontrolling interest. Such option combinations are exempt from the scope of ASC 815-40. This accounting treatment applies when:

• The parent holds 80 percent of the subsidiary’s equity shares and consolidates the subsidiary.
• The remaining 20 percent of the subsidiary’s equity shares (the noncontrolling interest) are held by a third party.
• Simultaneously with the acquisition of the noncontrolling interest, the parent and the holder of the noncontrolling interest enter into the following option combination:
  o The parent has a call option to purchase the noncontrolling interest at a fixed price on a stated future date.
  o The noncontrolling interest holder has a put option to sell the noncontrolling interest to the parent under the same terms. (ASC 480-10-55-62 suggests that the exercise prices do not need to be equal as long as they are not significantly different.)
• The options are embedded in the shares representing the noncontrolling interest (i.e., they are not considered freestanding instruments).
• The noncontrolling interest shares do not meet the definition of a mandatorily redeemable financial instrument (see Chapter 4 of Deloitte's A Roadmap to Distinguishing Liabilities From Equity).

We believe that this guidance applies irrespective of whether the noncontrolling interest is in the form of common stock or preferred stock. Further, the guidance applies even if the relative ownership interests of the parent and the holder of the noncontrolling interest differ from the levels assumed in the fact pattern described in ASC 480-10 (i.e., 80 percent and 20 percent), provided that the parent owns a majority of the subsidiary's outstanding common stock and consolidates the subsidiary at the inception of the arrangement (ASC 480-10-55-58). The guidance does not apply, however, if the option strike prices are based on a formula (e.g., EBITDA) that is not simply an indexation to interest rates rather than being fixed or if the options are contingent on the satisfaction of certain conditions (for further discussion, see Section 7.1 of Deloitte's A Roadmap to Distinguishing Liabilities From Equity).

In July 2018, the FASB issued ASU 2018-09, which clarifies a parent company's accounting for freestanding put and call options on noncontrolling interests. The ASU amends the wording of ASC 480-10-55-55 and 55-59 to make it consistent with the pre-Codification guidance in Statement 150 as well as ASC 480-10-25-15. After the adoption of ASU 2018-09, if a parent and the holder of a noncontrolling interest enter into put and call options on the noncontrolling interest and either the option combination or each option is considered to be a freestanding financial instrument (see Section 3.2.1) that is separate from the noncontrolling interest, the noncontrolling interest and the options would not be accounted for on a combined basis as a financing of the parent's purchase of the noncontrolling interest. Instead, the accounting for the options depends on whether they represent a single freestanding financial instrument (in which case the option combination is accounted for as an asset or a liability under ASC 480-10-25-8) or two separate freestanding financial instruments (in which case the put option is accounted for as a liability under ASC 480-10-25-8, and the call option is evaluated under ASC 815-40). Either way, the accounting differs from that specified for noncontrolling interests with embedded options in ASC 480-10-55-59 through 55-62, because the noncontrolling interest would be reflected in equity by the parent.

Before the adoption of ASU 2018-09, the implementation guidance in the first sentence of ASC 480-10-55-59 suggests that the options in ASC 480-10-55-53(b) should be combined with the noncontrolling interest and accounted for as a financing even if they are freestanding relative to the noncontrolling interest. That guidance conflicts with the prohibition in ASC 480-10-25-15 and ASC 480-10-55-57 against combining freestanding financial instruments unless combination is required under ASC 815. Further, it does not accurately represent U.S. GAAP as of the date of the FASB's Codification thereof (July 1, 2009). The guidance in ASC 480-10-55-59 through 55-61 was carried forward from the consensus in EITF Issue 00-4. However, the status section of EITF Issue 00-4 states, “Statement 150 [later codified in ASC 480-10] nullifies the consensuses reached in this issue unless the derivative . . . is not freestanding of the noncontrolling interest.” We therefore believe that before the adoption of ASU 2018-09, an entity is
not required to account for the options on a combined basis with the noncontrolling interest under ASC 480-10-55-59 if either the option combination or each option is considered to be a freestanding financial instrument that is separate from the noncontrolling interest under ASC 480-10 (see Section 3.2.1). The accounting instead depends on whether the options represent a single freestanding financial instrument (in which case the option combination is accounted for as an asset or a liability under ASC 480-10-25-8) or two separate freestanding financial instruments (in which case the put option is accounted for as a liability under ASC 480-10-25-8, and the call option is evaluated under ASC 815-40). Either way, the accounting differs from that specified in ASC 480-10-55-59 through 55-62 before the adoption of ASU 2018-09 because the noncontrolling interest would be reflected in equity by the parent. Alternatively, we believe that an issuer could elect to account for the option combination and the noncontrolling interest on a combined basis in a manner consistent with the guidance on options in the form of Derivative 2 that are embedded in the noncontrolling interest (see Section 7.1.2.1 of Deloitte’s A Roadmap to Distinguishing Liabilities From Equity) by applying ASC 480-10-55-59 literally (before the adoption of ASU 2018-09).

### ASC 105-10

<table>
<thead>
<tr>
<th>65-4</th>
<th>The following represents the transition and effective date information related to Accounting Standards Update No. 2018-09, Codification Improvements:</th>
</tr>
</thead>
<tbody>
<tr>
<td>a.</td>
<td>A public business entity, a not-for-profit entity that has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market, and an employee benefit plan that files or furnishes financial statements with or to the U.S. Securities and Exchange Commission shall apply the pending content that links to this paragraph for annual periods beginning after December 15, 2018, including interim periods within those annual periods.</td>
</tr>
<tr>
<td>b.</td>
<td>All other entities shall apply the pending content that links to this paragraph for annual periods beginning after December 15, 2019, and interim periods within annual periods beginning after December 15, 2020.</td>
</tr>
<tr>
<td>c.</td>
<td>An entity shall recognize and present separately the cumulative effect of the change in accounting principle of the pending content that links to this paragraph as an adjustment to the opening balance of retained earnings (or other appropriate components of equity or net assets in the statement of financial position) as of the beginning of the period in which it is first applied. The cumulative-effect adjustment is the difference between the amounts recognized in the statement of financial position before initial application of the pending content that links to this paragraph and the amounts recognized in the statement of financial position at initial application of the pending content that links to this paragraph.</td>
</tr>
<tr>
<td>d.</td>
<td>An entity may elect to apply the pending content that links to this paragraph retrospectively.</td>
</tr>
<tr>
<td>e.</td>
<td>Early application of the pending content that links to this paragraph is permitted for any fiscal year or interim period for which the entity’s financial statements have not yet been issued (public business entities) or for which financial statements are available to be issued (all other entities).</td>
</tr>
<tr>
<td>f.</td>
<td>An entity shall disclose the nature of a change in accounting principle to the pending content that links to this paragraph and the reason for the change.</td>
</tr>
</tbody>
</table>

For public business entities and certain other entities identified in ASC 105-10-65-4(a), the amendments to ASC 480-10-55-55 and 55-59 are effective for annual periods beginning after December 15, 2018, including interim periods within those annual periods. For all other entities, the amendments are effective for annual periods beginning after December 15, 2019, and interim periods within annual periods beginning after December 15, 2020.
Upon transition, entities may elect to apply the amendments in either of the following ways:

- Recognize the cumulative effect of the change (i.e., the difference between amounts recognized in the statement of financial position before and at initial application) as an adjustment to the opening balance of retained earnings as of the beginning of the period in which the change is first applied.
- Apply the amendments retrospectively for each prior reporting period presented.

Public business entities are permitted to early apply the amendments for any fiscal year or interim period for which they have not yet issued financial statements. Other entities are permitted to early apply the amendments for any fiscal year or interim period for which they have not yet made financial statements available to be issued.

### 2.7 Guarantee Contracts

**ASC 815-40**

<table>
<thead>
<tr>
<th>15-10</th>
<th>Topic 460 provides an exception from its initial recognition and initial measurement requirements, but not its disclosure provisions, for a guarantee for which the guarantor’s obligation would be reported as an equity item (rather than a liability) under generally accepted accounting principles (GAAP).</th>
</tr>
</thead>
<tbody>
<tr>
<td>15-11</td>
<td>If a contract under this Subtopic is required to be accounted for as a liability under this Subtopic and also meets the definition of a guarantee under Topic 460 (for example, a physically settled written put option), both this Subtopic and that Topic are consistent with respect to requiring the issuer to account for the contract at fair value at the initial measurement date. In that situation, the guarantee would also be subject to the disclosure requirements of Topic 460.</td>
</tr>
</tbody>
</table>

A contract indexed to, and potentially settled in, an entity’s own stock might fall within the scope of both ASC 815-40 and ASC 460-10.

ASC 460-10-15-4 states that with certain exceptions, ASC 460-10 applies to the following types of guarantee contracts:

- a. Contracts that contingently require a guarantor to make payments [including cash, financial instruments, other assets, shares of its stock, or provision of services] to a guaranteed party based on changes in an underlying that is related to an asset, a liability, or an equity security of the guaranteed party. . . .
- b. Contracts that contingently require a guarantor to make payments . . . to a guaranteed party based on another entity’s failure to perform under an obligating agreement (performance guarantees). . . .
- c. Indemnification agreements (contracts) that contingently require an indemnifying party (guarantor) to make payments to an indemniﬁed party (guaranteed party) based on changes in an underlying that is related to an asset, a liability, or an equity security of the indemniﬁed party.
- d. Indirect guarantees of the indebtedness of others, even though the payment to the guaranteed party may not be based on changes in an underlying that is related to an asset, a liability, or an equity security of the guaranteed party.

ASC 460-10-25-1(d) and ASC 460-10-30-1 exempt from the scope of the recognition and initial measurement guidance on guarantee contracts in ASC 460 “[a] guarantee for which the guarantor’s obligation would be reported as an equity item” (e.g., under ASC 815-40) rather than as a liability. However, the disclosure requirements for guarantees in ASC 460 would apply to such contracts unless a scope exception in ASC 460-10-15-7 applies (e.g., guarantees of an entity’s own future performance are excluded from the scope of ASC 460).
Example 2-3

**Guarantee Contracts**

Assume:

- An entity writes a call option indexed to, and potentially settled in, the entity's own stock that gives the holder the right to purchase equity securities of the option issuer in exchange for payment of cash by the holder.
- The entity knows that the holder of the call option is purchasing the option to cover a short position in the entity's equity securities.

In this example, the entity may conclude that the contract is within the scope of ASC 460 on the basis of ASC 460-10-15-4(a) since the issuer is required to transfer an equity security to the option holder as a result of the changes in a liability of the option holder (the underlying short position).

We believe that if the issuer has no factual basis on which to conclude that the holder of the call option is purchasing the option to cover a short position in the asset, the written call option is not within the scope of ASC 460 since the issuer does not have the information necessary to conclude that the option holder has an underlying short position.

### 2.8 Contingently Issuable Contracts

**ASC 815-40**

15-6 The guidance in this paragraph applies to both the issuer and the holder of the instrument. Outstanding instruments within the scope of the guidance in paragraphs 815-40-15-5 through 15-8 shall always be considered issued for accounting purposes, except as discussed in the next sentence. Lock-up options shall not be considered issued for accounting purposes unless and until the options become exercisable.

Unless a scope exception applies (such as the one for lock-up options (see Section 2.5.2)), contracts on an entity's own equity that are only contingently issuable, exercisable, or settleable are not exempt from ASC 815-40. Thus, a contract on own equity that becomes exercisable or settleable only upon the occurrence or nonoccurrence of a specified event (e.g., an IPO, a debt draw, or the meeting of a revenue target) is considered issued for accounting purposes and evaluated under ASC 815-40 unless excluded from the scope of that guidance. ASC 815-40 applies even if the specified event is within the entity's control. This is illustrated in the example in ASC 815-40-55-26, which implies that a warrant that is exercisable solely upon the occurrence of an IPO (which is an event that an entity typically has the ability to avoid) is within the scope of ASC 815-40. Further, ASC 815-40 applies even if no consideration is exchanged at inception.

Before the FASB's codification of U.S. GAAP, the guidance in ASC 815-40-15-6 was located in EITF Issue 07-5, which carried it forward from EITF Issue 01-6. The related EITF meeting materials (Issue Summary 1, Supplement 1, prepared October 26, 2001) identify the following arguments for treating as issued, for accounting purposes, instruments for which settlement is based on changes in the issuer's stock price and one or more defined contingencies:

[T]he contingency has implications only with respect to the measurement of the instrument and not with respect to whether the instrument has been issued for accounting purposes. [Since] one party (a) has agreed to give up an asset (for example, cash), (b) has agreed to perform (for example, a service), or (c) has agreed to some combination of (a) and (b), the instrument must be considered issued for accounting purposes. ... In other words, such instruments provide economic benefits to both of the parties to the contract and those benefits must be recognized upon the issuance of the instrument. [All] such instruments contain value since there would be no rationale or reason to issue or hold the instrument unless value exists.
Example 2-4

**Warrant That Vests on the Basis of Debt Draw**

Company A executes a credit facility with Bank B, which permits, but does not require, A to borrow $15 million. As part of the agreement, A provides B with a warrant, which becomes exercisable (vested) only if A elects to draw on the credit facility. Once vested, the warrant permits B to purchase 1 million shares of A's common stock. The warrant is viewed as outstanding under ASC 815-40 before the vesting condition has been met even though the contingency underlying the exercisability of the warrant is within the entity's control. Accordingly, A should evaluate the warrant under ASC 815-40 to determine whether it should account for it as a liability or equity instrument even if A has not yet drawn on the credit facility. (Note that before A draws on the credit facility, this warrant would be outside the scope of ASC 480-10 even if the underlying shares were to include a deemed liquidation feature or other redemption provision outside of A's control, provided that A has discretion to avoid a transfer of assets or equity shares by electing not to make any draw; see Section 2.2.1.3 of Deloitte's A Roadmap to Distinguishing Liabilities From Equity.)

Example 2-4A

**Warrants That Vest on the Basis of Debt Draws**

Company A executes a credit facility with Bank B, which permits, but does not require, A to borrow up to $10 million. As part of the agreement, A provides B with warrants, which become exercisable (vested) only if A elects to draw specified amounts on the credit facility. The warrants permit B to purchase the following number of shares:

- 200,000 shares for the first $2.5 million of debt drawn.
- 300,000 shares for the second $2.5 million of debt drawn.
- 500,000 shares for the remaining $5 million of debt drawn.

The warrants are viewed as outstanding under ASC 815-40 even if no amounts have been drawn. Accordingly, A should evaluate the warrants under ASC 815-40 to determine whether it should account for them as liabilities or equity instruments. Note that if the warrants are determined to be one unit of account (see Section 3.2), they would not be considered indexed to the entity's own stock under ASC 815-40-15, because the amount of debt draws affects the settlement amount. Since this underlying is not an input into the pricing of a fixed-for-fixed option on equity shares (see Sections 4.2.2.3 and 4.3.3), the warrants would be accounted for as liabilities under ASC 815-40.

Nevertheless, if an arrangement is not contractually binding, it is not recognized. For example, an arrangement is generally not considered contractually binding and would not be recognized if both parties have an unconditional right to cancel it (i.e., to “walk away”) without any penalty or right to recover damages. An entity should consult its legal advisers for assistance in determining whether an arrangement is contractually binding.

Example 2-4B

**Nonbinding Accelerated Share Repurchase (ASR) Transaction**

On June 15, 20X0, Company A entered into an ASR agreement with Bank B that clearly defined all significant terms of the transaction (see Section 3.2.5 for a description of an ASR transaction). The agreement included a cancellation provision under which both A and B had the right to terminate the ASR at any time before the settlement of the initial treasury stock repurchase on July 1, 20X0 (the prepayment date), by written notice to the other party, without any penalty or recourse for the other party to recover damages. The ASR should be initially recognized on the prepayment date when the cancellation right expired and the contract became binding.
### Example 2-5

**Nonbinding Plan of Reorganization in Bankruptcy**

An entity has filed for bankruptcy protection and has filed a proposed plan of reorganization that includes the issuance of shares and warrants to specified investors after approval by the bankruptcy court. The investors have made commitments to purchase the shares and warrants at specified prices. However, the bankruptcy court is under no legal obligation to accept the plan and has full discretion regarding whether to accept or reject it. In these circumstances, we believe that the entity would not recognize the capital commitments and warrants since they are not binding on the entity.

The guidance in ASC 815-40 on contingently issuable contracts differs from that on unvested share-based payment arrangements to acquire goods or services (see Section 2.4). ASC 505-50-599-1 states, in part:

> The SEC staff believes that if the issuer receives a right to receive future services in exchange for unvested, forfeitable equity instruments, those equity instruments should be treated as unissued for accounting purposes until the future services are received (that is, the instruments are not considered issued until they vest). Consequently, there would be no recognition at the measurement date and no entry should be recorded.

Similarly, footnote 1 of EITF Issue 01-1 (not codified) states:

> [ASC 718] and [ASC 505-50-599-1] provide that if the issuer receives a right to receive future services in exchange for unvested, forfeitable equity instruments, those equity instruments are unissued for accounting purposes until the future services are received (that is, the instruments are not considered issued for accounting purposes until they vest).

### 2.9 Own-Share Lending Arrangements in Connection With Convertible Debt Issuance

**ASC 470-20**

**05-12A** An entity for which the cost to an investment banking firm (investment bank) or third-party investors (investors) of borrowing its shares is prohibitive (for example, due to a lack of liquidity or extensive open short positions in the shares) may enter into share-lending arrangements that are executed separately but in connection with a convertible debt offering. Although the convertible debt instrument is ultimately sold to investors, the share-lending arrangement is an agreement between the entity (share lender) and an investment bank (share borrower) and is intended to facilitate the ability of the investors to hedge the conversion option in the entity's convertible debt.

**05-12B** The terms of a share-lending arrangement require the entity to issue shares (loaned shares) to the investment bank in exchange for a nominal loan processing fee. Although the loaned shares are legally outstanding, the nominal loan processing fee is typically equal to the par value of the common stock, which is significantly less than the fair value of the loaned shares or the share-lending arrangement. Generally, upon maturity or conversion of the convertible debt, the investment bank is required to return the loaned shares to the entity for no additional consideration.

**05-12C** Other terms of a share-lending arrangement typically require the investment bank to reimburse the entity for any dividends paid on the loaned shares. Typically, the arrangement precludes the investment bank from voting on any matters submitted to a vote of the entity's shareholders to the extent the investment bank is the owner of the shares.
ASC 470-20 provides recognition, measurement, earnings-per-share (EPS), and disclosure guidance related to an issuer’s accounting for equity-classified share-lending arrangements that are executed in contemplation of a convertible debt issuance. This guidance is designed for arrangements that have the following terms and characteristics:

- The issuer is lending its equity shares to the counterparty (i.e., it has issued its equity shares on loan).
- The issuer receives a nominal fee that is significantly less than the fair value of the shares and of the arrangement.
- The counterparty will return the loaned shares to the issuer by the arrangement’s maturity date for no additional consideration. If the counterparty is unable to return the loaned shares, it may be required to reimburse the issuer in cash.
- The arrangement qualifies as equity under GAAP.
- The arrangement was executed in contemplation of a convertible debt issuance or other financing.

In evaluating whether the contract qualifies as equity under GAAP, the issuer should consider the requirements in ASC 480-10 and ASC 815-40 (see Sections 4.3.5.11, 5.2.3.6, and 6.1.6).

Own-share lending arrangements usually derive their fair value from the difference between the contractual processing fee and a market-based rate that would typically be charged for lending such shares, adjusted as necessary to reflect the nonperformance risk of the share borrower. The terms of a share-lending arrangement issued in contemplation of a convertible debt issuance typically require an entity to issue its common shares to a counterparty (e.g., the bank) in exchange for a nominal processing fee. The processing fee is significantly less than the fair value of the shares and is typically less than a market fee that would be charged in a share-lending arrangement that is not issued in contemplation of a convertible debt issuance. The issuer may accept less than a market rate on the arrangement to promote the issuance of the convertible debt.

**Example 2-6**

Issuer A is in the process of issuing convertible debt. Before certain prospective investors agree to buy the convertible debt, however, they would like to ensure that they are able to economically hedge their exposure to A’s share price risk associated with the conversion option embedded in the debt. Accordingly, they seek to enter into derivative contracts on the underlying shares (such as options, forwards, or total return swaps) with Bank B that offset the “long” position in A’s share price risk that would result from an investment in the convertible debt. To economically hedge its exposure from writing such derivatives, B in turn seeks to borrow the underlying shares. By borrowing the shares, B can sell them short in the market to offset its “long” position in A’s share price risk that would be created by its derivative contracts with the investors.

Because a sufficient amount of underlying shares is not readily available to market participants (or the price is too high), B borrows the underlying shares by entering into a share-lending arrangement directly with A. The terms of the share lending arrangement require B to pay a nominal processing fee to A (e.g., the par value of the shares) that is significantly less than the agreement’s fair value. Issuer A is motivated to enter into the agreement because the pricing and successful completion of the convertible debt offering depend on the investors’ ability to enter into derivative contracts to hedge their equity price exposure, which in turn depend on B’s ability to borrow the shares from A. During the period that the shares are on “loan,” they are legally outstanding and the holder is legally entitled to dividends paid on them, although it must reimburse A for any dividends paid on the loaned shares. Upon conversion or maturity of the convertible debt, B must physically return the loaned shares to A for no consideration. If B defaults in returning the loaned shares, A is contractually entitled to a cash payment equal to the fair value of the loaned shares.
Chapter 3 — Contract Analysis

3.1 Identifying and Evaluating Contractual Terms

3.1.1 Document Review

In determining the appropriate accounting for a contract on an entity’s own equity, the entity should devote adequate time to reading the underlying legal documents. Terms that could be significant to the accounting analysis (e.g., contingent net cash settlement requirements or provisions that adjust the settlement amount) may be buried deep within the contract’s fine print. To properly apply the applicable accounting requirements, the entity needs to evaluate all the contractual terms, the legal and regulatory framework, and the relevant facts and circumstances.

In forming a view on the appropriate accounting for a contract, an entity cannot necessarily rely on the name given to the transaction (e.g., “equity derivative” or “accelerated share repurchase program”) or how it is described in summary term sheets, slide-show presentations, and marketing materials. Products with similar economics sometimes go by different names in the marketplace (e.g., products marketed by different investment banks), while products subject to different accounting may go by the same or similar names (e.g., a warrant on own equity can be designed in a variety of ways). Furthermore, the names given to contractual provisions in legal documents, such as conversion features or share settlement provisions, do not necessarily reflect their economics or how they would be identified and analyzed for accounting purposes; for example, certain redemption provisions may permit conversion features to be net settled (see Section 5.2.4.1). Minor variations in the way contractual terms are defined can have major accounting implications.

An individual contract may consist of multiple legal documents, all of which an entity should consider in identifying the contract’s terms. The entity should also consider, in identifying the terms of a contract on its own shares, whether the terms of the underlying shares could affect the accounting analysis of the contract. For example, if an entity issues a warrant on its own shares, and the shareholder agreement includes a down-round protection provision, that provision might affect the warrant’s classification before the entity’s adoption of ASU 2017-11 depending on the entity’s accounting policy regarding whether to assess indexation at the warrant level or by looking through to the underlying shares (see Section 4.3.10).

3.1.2 Legal Determinations

The application of some of the accounting guidance in ASC 815-40 relies on legal determinations. Therefore, the entity needs to consider the legal and regulatory framework within which the transaction takes place. Depending on such framework, for example, the entity cannot assume that it will be able to share settle a contract, which is one of the conditions for equity classification, even if the contract states that it will be settled in shares (see Section 5.3.2). Another condition for equity classification is that the counterparty’s claim in bankruptcy cannot have a higher priority than the claims of the holders of the underlying shares (see Section 5.3.7). In evaluating such conditions, the entity may need to seek advice from legal counsel.
3.1.3 ISDA Standard Documentation

Entities often execute and document contracts on their own equity by using standard documentation issued by the International Swaps and Derivatives Association (ISDA). Use of standard documentation can facilitate the negotiation process and enables the parties to elect contractual terms whose definitions are based on industry-wide conventions.

For example, a trade confirmation may (1) incorporate ISDA equity derivatives definitions and (2) supplement, form a part of, and be subject to an agreement in the form of the ISDA master agreement that sets out general terms between the parties. Further, the confirmation may identify adjustments, settlement methods, early termination provisions, and other terms that must be evaluated within the context of an ISDA master agreement and ISDA’s equity derivatives definitions and specify that the terms of the confirmation govern in the event of any inconsistency between the documents. In this case, the application of the indexation and equity classification guidance in ASC 815-40 depends on the elections and modifications an entity has made and how they are defined within the documents. Adjustment or cancellation provisions or netting arrangements may preclude equity classification unless the contracting parties agree to override them in the transaction confirmation (see Section 5.2.2).

In remarks at the 2007 AICPA Conference on Current SEC and PCAOB Developments, SEC Professional Accounting Fellow Ashley Carpenter said:

The [SEC] staff would like to remind management of the importance of carefully considering all of the applicable provisions in the transaction Confirmation and related ISDA Agreements in applying [ASC 815-40-25]. Considering the complexity of the issues, the staff encourages management and auditors to consult with the Office of the Chief Accountant when specific questions arise regarding the application of [ASC 815-40-25].

3.2 Unit of Account

<table>
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<th>ASC 815-40</th>
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</table>

15-5B The guidance in paragraphs 815-40-15-5 through 15-8 shall be applied to the appropriate unit of accounting, as determined under other applicable U.S. generally accepted accounting principles. For example, if an entity issues two freestanding financial instruments and concludes that those two instruments are required to be accounted for separately, then the guidance in paragraphs 815-40-15-5 through 15-8 shall be applied separately to each instrument. In contrast, if an entity issues two freestanding financial instruments and concludes that those two instruments are required to be linked and accounted for on a combined basis as a single financial instrument (for example, pursuant to the guidance in paragraph 815-10-15-8), then the guidance in paragraphs 815-40-15-5 through 15-8 shall be applied to the combined financial instrument.

<table>
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<tr>
<th>ASC Master Glossary</th>
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Unit of Account
The level at which an asset or a liability is aggregated or disaggregated in a Topic for recognition purposes.
In applying ASC 815-40, an entity should consider how to appropriately identify units of account (i.e., the “level at which an asset or a liability is aggregated or disaggregated” for accounting purposes). While a single contract may represent a unit of account, this is not always the case. Sometimes a single legal agreement consists of more than one unit of account that should be accounted for separately. Examples include:

- A contract that contains two or more components that individually each meet the definition of a freestanding contract, such as components that are legally detachable and separately exercisable (e.g., debt with a detachable warrant or a contingent consideration arrangement that is included in the terms of an acquisition agreement in a business combination).
- A contract that contains a registration payment arrangement (see Section 3.2.4).
- An accelerated share repurchase program (see Section 3.2.5).
- A hybrid contract with an embedded feature that is required to be bifurcated as a derivative, such as a debt contract with an embedded conversion option that has all the characteristics of a derivative and does not qualify as equity under ASC 815-40 (see Section 2.2).

Conversely, two separate agreements might for accounting purposes have to be combined and treated as a single unit of account (e.g., debt issued with a warrant that is not legally detachable and separately exercisable).

### 3.2.1 Concept of a “Freestanding Contract”

<table>
<thead>
<tr>
<th>ASC 815-40-20 — Glossary</th>
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</thead>
<tbody>
<tr>
<td><strong>Freestanding Contract</strong></td>
</tr>
<tr>
<td>A freestanding contract is entered into either:</td>
</tr>
<tr>
<td>a. Separate and apart from any of the entity’s other financial instruments or equity transactions</td>
</tr>
<tr>
<td>b. In conjunction with some other transaction and is legally detachable and separately exercisable.</td>
</tr>
</tbody>
</table>

ASC 815-40-20 defines a freestanding contract as one entered into either “[s]eparate and apart from any of the entity’s other financial instruments or equity transactions” or “[i]n conjunction with some other transaction and is legally detachable and separately exercisable.” Therefore, we believe that an entity should consider the following questions in identifying freestanding contracts:

1. **Was the transaction entered into contemporaneously with and in contemplation of another transaction, or was it entered into separately and apart from other transactions?**

   The fact that a transaction was entered into separately and apart from any other transaction suggests that it is a unit of account that is separate from any other transaction. If it was entered into contemporaneously and in contemplation of another transaction, the entity should assess whether the transactions represent a single unit of account. For example, if warrants are issued in conjunction with a debt issuance of the same issuer, the issuer should consider whether the warrants should be treated as being embedded in the debt even if they are subject to a separate contractual agreement.

   The fact that a transaction was entered into contemporaneously or in conjunction with some other transaction, however, would not necessarily result in a conclusion that the transactions should be viewed on a combined basis as a single unit of account. The entity should also consider whether the items are legally detachable and separately exercisable (see below) and whether the combination guidance in ASC 815-10 applies (see Section 3.2.2).
A one-week period between transactions may be good evidence that the transactions are not contemporaneous if the entity is exposed to market fluctuations during this time. Even when transactions occur at different times, however, entities should consider all available evidence to ensure that no side agreements or other contracts were entered into that suggest that the transactions were entered into in contemplation of one another.

Options written by the acquired entity on its stock as of the date of a business combination are often viewed as effectively modifying previously existing shares. Such options are not considered to have been entered into separately and apart from the shares.

2. Is the item legally detachable?

Neither ASC 480 nor other GAAP provide guidance on the meaning of “legally detachable.” We believe that a presumption exists that to be legally detachable from another item, the item must be separately transferable from that item. If an item is separately exercisable but not considered legally detachable, it would not be a separate freestanding financial instrument under item (b) of the definition of a freestanding financial instrument.

An item is considered “legally detachable” if it can be transferred separately from another item in a single contractual agreement (or from another item in multiple contracts entered into at the same time) at the holder’s discretion (i.e., without limitations imposed by the counterparty). The fact that an item can be transferred independently from another item indicates that it is a separate unit of account even if the two items were entered into contemporaneously and have the same counterparty. This view is supported by the guidance in ASC 815-10-25-9, which states, in part:

Derivative instruments that are transferable are, by their nature, separate and distinct contracts.

Similarly, ASC 815-10-15-5 states, in part:

The notion of an embedded derivative . . . does not contemplate features that may be sold or traded separately from the contract in which those rights and obligations are embedded. Assuming they meet [the] definition of a derivative instrument, such features shall be considered attached freestanding derivative instruments rather than embedded derivatives by both the writer and the current holder.

However, a scenario in which two items cannot be transferred independently of one another suggests that each item is not a freestanding financial instrument under (b) in the definition of a freestanding financial instrument in ASC 480-10-20. For example, if a warrant “travels with” a bond and cannot be transferred separately from the bond, it may be an embedded feature in the bond.

A contract may be entered into in conjunction with some other item. For such a contract to be considered a freestanding instrument, an assessment must be performed of both the form and substance of the transaction, including the substance of the independent transferability of the item. In some circumstances, an item is unconditionally separately transferable by the holder but would have no economic value if the related item were not held, which would suggest that the separate transferability has no substance and the item is embedded in the related item (see further discussion in question 3). Similarly, the holder of shares not readily obtainable in the market may have a separately transferable put option that it can exercise only by delivering the same specific shares. In this case, the shares and the put option may represent a single, combined unit of account on the basis of an assessment of the substance of the transaction.
In other circumstances, an item may be separately transferred only with the consent of the counterparty. If an item may be separated from a related contract without any modification to the contractual terms (e.g., the contract specifically permits the item to be transferred if the issuer gives its consent and such consent cannot be unreasonably withheld), the legally detachable condition is, in substance, generally met since the counterparty has agreed to not withhold its consent. If, however, the counterparty can always prevent the separate transfer of the item at its discretion, the legally detachable condition is, in substance, most likely not met and therefore the item is not a freestanding financial instrument.

The SEC staff has indicated in informal discussions that it is possible, although not common, for two items that have been entered into contemporaneously with the same counterparty to be considered freestanding financial instruments solely on the basis of the items’ ability to be separately exercised (i.e., even though the contractual terms prevent the items from being transferred separately). This would generally be the case when a reasonable conclusion can be reached that the separate exercisability of one item is sufficient to establish that it is legally detachable from the related item (see Example 3-9A). However, when determining whether an item can be transferred separately, an entity must use significant judgment and consider the transaction's form and substance. We therefore strongly recommend that an entity consult with its independent accounting advisers when performing this assessment.

3. Can the item be exercised separately; or does its exercise result in the termination, redemption, or automatic exercise of a specifically identified item?

If an item can be freely exercised without terminating another item, it is considered to be “separately exercisable.” The fact that a warrant remains outstanding if a bond to which it is attached is redeemed, for example, suggests that the warrant is a freestanding financial instrument that is separate from the bond. Similarly, if a bond may remain outstanding after a net-share-settled conversion feature in the bond is exercised, the conversion feature may be a freestanding financial instrument.

Conversely, if the exercise of an item results in the termination of a specifically identified item, the first item would not be considered “separately exercisable” from the other item. For example, if a warrant can be exercised only by tendering a specific bond in a physical settlement, it may be a feature embedded in the bond. ASC 470-20-25-3 states, in part:

If stock purchase warrants are not detachable from [a] debt instrument and the debt instrument must be surrendered to exercise the warrant, the two instruments taken together are substantially equivalent to a convertible debt instrument.

Similarly, if a specific share is subject to a redemption requirement, the share and the redemption requirement may represent one unit of account even if they are documented in separate agreements. Thus, ASC 480-10-15-7C (as added by ASU 2017-11) states, in part:

Some entities have issued shares that are required to be redeemed under related agreements. If the shares are issued with a redemption agreement and the required redemption relates to those specific underlying shares, the shares are mandatorily redeemable.

4. Does the transaction involve multiple counterparties?

Contracts with different counterparties are treated as separate units of account even if they are issued contemporaneously or are transacted as a package. Thus, ASC 815-10-15-6 suggests that an option added or attached to an existing debt instrument by another party is not an embedded derivative because it does not have the same counterparty. Similarly, ASC 815-15-25-2 indicates that the notion of an embedded derivative in a hybrid instrument does not refer to provisions in separate contracts between separate counterparties.
Example 3-1

Separate Units of Account

An entity delivers a bond and a warrant on own equity to an underwriter for cash. The underwriter is a party to the warrant but holds the bond merely as an agent for a third-party investor. The terms and pricing of the bond sold to the third-party investor are not affected by the sale of the warrant to the underwriter. In this case, the bond and the warrant are two separate units of account because they involve different counterparties.

ASC 815-10-25-10 specifies that transactions that are entered into with a single party are treated as having the same counterparty even if some of them are structured through an intermediary. In consolidated financial statements, the reporting entity is the consolidated group. Therefore, the parent and the subsidiary would not be considered different parties in the consolidated financial statements. For example, if a parent entity writes a put option on subsidiary shares to the holder of those shares, we believe that it may be acceptable to view the option as being embedded in the shares in the consolidated financial statements even though the subsidiary technically is not a party to the option.

3.2.2 Combination Guidance

ASC 815-10 contains additional guidance to help an entity determine whether two or more separate transactions should be viewed as separate units of accounting or combined for accounting purposes. ASC 815-10-15-8 states, in part:

In some circumstances, an entity could enter into two or more legally separate transactions that, if combined, would generate a result that is economically similar to entering into a single transaction that would be accounted for as a derivative instrument under this Subtopic.

Nevertheless, ASC 815 ordinarily does not permit an entity to treat two or more freestanding financial instruments as a single combined unit of account. Derivatives Implementation Group Issue F6 (not codified) notes the following:

[ASC 815] is a transaction-based standard.

Similarly, ASC 815-10-25-6 states, in part:

This Subtopic generally does not provide for the combination of separate financial instruments to be evaluated as a unit.

However, if two or more freestanding financial instruments have characteristics suggesting that they were structured to circumvent GAAP, they may need to be combined and treated as a single unit of account. Specifically, ASC 815-10 requires two or more separate transactions to be combined and viewed in combination as a single unit of account for accounting purposes if they were entered into in an attempt to circumvent that subtopic's accounting requirements for derivatives (i.e., measured at fair value, with subsequent changes in fair value recognized in earnings except for qualifying hedging instruments in cash flow or net investment hedges). ASC 815-10-15-9 states that such combination is required if the transactions have all of the following characteristics:

- They “were entered into contemporaneously and in contemplation of one another.”
- They “were executed with the same counterparty (or structured through an intermediary).”
- They “relate to the same risk.”
- “There is no apparent economic need or substantive business purpose for structuring the transactions separately that could not also have been accomplished in a single transaction.”
ASC 815-10-25-6 identifies characteristics similar to those listed above from ASC 815-10-15-9 and adds the following commentary:

If separate derivative instruments have all of these characteristics, judgment shall be applied to determine whether the separate derivative instruments have been entered into in lieu of a structured transaction in an effort to circumvent GAAP. . . . If such a determination is made, the derivative instruments shall be viewed as a unit.

Note that the SEC staff has indicated that it will challenge the accounting for transactions that have been structured to circumvent GAAP. EITF Issue 02-2 (not codified) states, in part:

The SEC Observer encouraged the [FASB] to examine the broader issue of when to combine transactions and noted that, in the interim, the SEC staff will continue to challenge the accounting for transactions for which it appears that multiple contracts have been used to circumvent generally accepted accounting principles.

### 3.2.3 Application of the Unit of Account Guidance

#### 3.2.3.1 Examples

**Example 3-2**

**Units Consisting of Stock and Warrants**

An entity undertakes a placement offering, in which common shares and warrants to acquire common shares are issued simultaneously as one unit. If the warrants are legally detachable and can be exercised separately from the common stock after issuance, they are considered units of account separate from the common shares.

**Example 3-3**

**Issuance of Shares and Call Options**

An entity issues equity shares along with call options that permit the counterparty to acquire additional shares. The issuance of the shares and the options is documented in the same legal agreement. The equity shares and options are not publicly traded. The options cannot be readily settled outside the agreement. The shares remain outstanding upon exercise or expiration of the options. Because the rights associated with the shares extend beyond the term of the options, and the exercise of the options does not result in the termination of the existing shares, they are considered legally detachable and separately exercisable. Accordingly, the shares and the options are separate, freestanding contracts that represent separate units of account.

**Example 3-4**

**Issuance of Warrants and Put Options**

An entity issues stock purchase warrants on its stock to third-party investors. In conjunction with issuing the warrants, the entity enters into a warrant-holder rights agreement under which each holder has a put right that gives it a right to require the entity to purchase for cash any or all of the shares issued or issuable to the holders under the warrants. The put right cannot be sold separately from the shares issued or issuable, and those shares cannot be sold separately from the put rights. In other words, the put rights are directly linked to the shares that are issued or issuable under each warrant and accompany the shares if sold or transferred to another party. The put rights cannot be used to put back shares other than those issued or issuable under the warrants. In this example, the warrants and put rights are combined and viewed as one unit of account, even though they are contained in two separate legal documents. (The accounting for this instrument is addressed in Example 3-2 of Deloitte’s *A Roadmap to Distinguishing Liabilities From Equity*.)
Example 3-5

**Share Modification**

An entity enters into an option agreement that gives the entity a right to call a specific, outstanding equity security from the holder of that security. Although the counterparty maintains its right to transfer the underlying share to another investor, any future investor would continue to be bound by the terms of the option agreement attached to the share. Further, the investor must satisfy its obligation under the call feature by transferring back to the entity the specific underlying share to which the option agreement is attached. In these circumstances, we believe that the option agreement is not a separate unit of account and should be analyzed on a combined basis with the underlying share as a single unit of account. The entity would treat the option agreement as a modification of the original share.

Example 3-6

**Put Option on Noncontrolling Interest**

An entity holds 70 percent of the equity shares of another entity and consolidates that entity (i.e., the entities have a parent-subsidiary relationship). The remaining 30 percent of the shares (the noncontrolling interest) are held by a third party. After the parent acquires its 70 percent of the shares and the third party acquires its 30 percent, the parent entity writes a put option that permits the third party to sell all of its shares to the parent for a fixed price on or before a specified date. Unlike the put option, the shares have no expiration date. Upon exercise, the put option is physically settled. There is no mechanism to net cash or net share settle the option. Given the nature of its terms, the put option cannot be transferred separately from the noncontrolling interest, and the exercise of the put option results in the termination of the noncontrolling interest.

We believe that because it is not legally detachable and separately exercisable, the put option should be considered embedded in the noncontrolling interest rather than a freestanding financial instrument. Because redemption is not certain to occur, the entity would not classify the instrument (the combination of the noncontrolling interest and the put option) as a liability under ASC 480-10 (see Chapter 4 of Deloitte’s *A Roadmap to Distinguishing Liabilities From Equity*). In the parent's consolidated financial statements, the put option may be considered embedded in the noncontrolling interest irrespective of whether the option issuer is the parent or the subsidiary.

Example 3-7

**Issuance of Shares and Put Options**

An entity issues equity shares along with put options that give the counterparty the right to require the entity to redeem the same number of shares for cash. The options can be physically settled only through the exchange of shares for cash. The put options do not require delivery of any specifically identified shares. The shares issued with the put options are not the only shares available to settle the put options, because shares are readily obtainable elsewhere. In this example, the put options would not be considered embedded in the shares. (The accounting for the put options is addressed in Example 3-4 of Deloitte's *A Roadmap to Distinguishing Liabilities From Equity*.)
Example 3-8

Contract to Sell Stock Over Time

An entity enters into an agreement with an investor to sell multiple tranches of stock over time. The agreement specifies the sale of the following three tranches of preferred stock to an investor:

- The issuance of 10 million preferred shares for cash of $10 million at the closing of the agreement.
- The sale of an additional eight million preferred shares for $8 million two years after closing, contingent on the entity’s meeting a specified milestone target.
- The sale of an additional eight million preferred shares for $8 million four years after closing, contingent on the entity’s meeting an incremental milestone target.

If there is no restriction that would prevent the investor from transferring the preferred stock that it has already acquired to a third party while continuing to be a party to the sale of the future tranches of preferred stock, the future tranches would be analyzed as units of account (contingent forward contracts) separate from the initial tranche. This is the case even though the sales of the three tranches are documented in a single agreement. Note that this means that the entity may need to allocate a portion of the proceeds received in the initial closing of the agreement to the two future tranches if they have a fair value other than zero at inception (i.e., some of the $10 million received at closing of the initial sale of preferred shares may be attributable to the two contingent forward contracts).

Example 3-9

Transfer Restrictions

An entity issues a bond with a warrant. The agreement specifies that the counterparty may not transfer the bond or the warrant without the issuer’s consent. However, the agreement does not preclude the transfer of the warrant separately from the bond if the issuer were to give its consent. Further, the contract specifies that such consent cannot be unreasonably withheld. The exercise of the warrant does not result in the termination of the bond (i.e., the counterparty is not required to tender the bond as payment of the exercise price of the warrant). In these circumstances, the warrant is considered a freestanding financial instrument because it is both independently transferable and separately exercisable. The fact that the warrant contains a restriction that may preclude the counterparty from transferring it does not mean that the warrant is not a freestanding contract since the contract specifies that the issuer’s consent cannot be unreasonably withheld.
**Example 3-9A**

**Tranche Preferred Stock Agreement**

Entity X enters into a preferred stock purchase agreement with unrelated investors to sell two tranches of convertible redeemable preferred stock (the “preferred stock”). The purchase agreement stipulates the following:

- On the first closing date, which is the date of the purchase agreement, the investors will acquire 50,000 shares of preferred stock for $50 million.
- On the second closing date, the investors will acquire 25,000 additional shares of preferred stock for $25 million subject to a specified condition. The second closing will occur only if (1) a specific milestone related to X’s operations is achieved two years from the first closing date or (2) the specific milestone related to X’s operations is not achieved two years from the first closing date but the holders waive the milestone requirement and elect to purchase the additional shares of preferred stock (the “contingent purchase option”).

The purchase agreement stipulates that the holders of preferred stock issued in the first closing cannot transfer their contingent purchase options separately from the preferred shares acquired in the first closing (or vice versa). However, such holders have the right to convert those preferred shares into common stock before the date that is two years from the first closing date. The purchase agreement does not restrict the holders that convert preferred shares into common stock from selling those common shares. The only restrictions on selling common stock stem from restrictions under U.S. securities laws.

In this example, the contingent purchase option would be considered a freestanding financial instrument because it meets the “legally detachable and separately exercisable” condition. While the contingent purchase option cannot be legally detached from the preferred stock, the holders can, in substance, “detach” the two instruments because they can convert the preferred stock into common stock and sell those shares while retaining the contingent purchase option. This would be the case even if the contingent purchase option may not be separately transferred after the conversion into common stock of the preferred shares obtained in the first closing. It would not be appropriate to consider the preferred shares and the contingent purchase option a single combined financial instrument because the contingent purchase option would not become embedded in the common shares received upon conversion of the preferred stock purchased in the first closing.

### 3.2.3.2 Contingent Consideration Arrangements With Performance Targets

As discussed in Section 2.5.1, equity-linked contracts accounted for as contingent consideration in a business combination may be within the scope of ASC 815-40. Contingent consideration arrangements often specify that the issuance of shares under the arrangement depends on whether successive or cumulative performance targets (e.g., earnings or revenues) for the acquired entity are met. For example, an arrangement may require the entity to deliver (1) 100,000 of its equity shares if the subsidiary’s revenue exceeds $100 million in the first year after the acquisition and (2) an additional 50,000 of its equity shares if the subsidiary’s revenue exceeds $125 million in the second year after the acquisition. In this case, the entity should evaluate whether the contingent consideration arrangement contains one or multiple units of account.

The entity’s determination of whether the contingent arrangement contains one or multiple units of account may affect whether the arrangement qualifies as equity in whole or in part. As discussed in Section 4.2, a provision that affects whether a contract becomes exercisable or settleable (e.g., a contract that provides for the delivery of shares only if a revenue target is met) is an example of an exercise contingency. An exercise contingency that is based on an index calculated or measured solely by reference to the operations of a consolidated subsidiary that is a substantive entity does not preclude equity classification (see Section 4.2). An adjustment made to the settlement amount on the basis of revenue, however, precludes equity classification (see Section 4.3). This means that the contract potentially would qualify as equity if it is settleable only if a specified earnings target is met, but it would not qualify as equity if the number of shares that will be delivered upon settlement is not fixed but depends on the level of earnings.
If an entity determines that an arrangement includes multiple payment conditions, triggers, or targets that are independent of one another and if met would result in the issuance of specified consideration regardless of whether the other targets were met, each target-based payment is treated as a separate unit of account (contract) that must be assessed for classification. If the payment conditions or targets are cumulative or not independent of one another, the arrangement is considered one contract that requires delivery of a variable number of shares.

The following are examples that illustrate this approach to identifying the appropriate units of account for contingent consideration arrangements:

<table>
<thead>
<tr>
<th>Contingent Consideration Arrangement</th>
<th>Analysis</th>
</tr>
</thead>
<tbody>
<tr>
<td>The acquirer is required to deliver 10,000 of its equity shares to the seller if the acquired entity has earnings of at least $100 million in the year after the acquisition (otherwise, no shares will be delivered).</td>
<td>One unit of account. There is only one payment condition and target.</td>
</tr>
<tr>
<td>The acquirer is required to deliver 10,000 of its equity shares if the acquired entity has earnings of at least $100 million in the first year after the acquisition (otherwise, no shares will be delivered at the end of the first year). In addition, the acquirer is required to deliver 10,000 of its equity shares if the acquired entity has earnings of at least $100 million in the second year after the acquisition (otherwise, no shares will be delivered at the end of the second year).</td>
<td>Two units of account. There are two independent payment conditions and targets.</td>
</tr>
<tr>
<td>The acquirer is required to deliver 10,000 of its equity shares to the seller if the acquired entity has earnings of at least $100 million in the year after the acquisition. The acquirer will deliver an additional 5,000 shares if earnings in that year exceed $125 million. Otherwise, no shares will be delivered.</td>
<td>One unit of account. There are two targets, but they cover the same period, and that period has multiple outcomes.</td>
</tr>
<tr>
<td>The acquirer is required to deliver 10,000 of its equity shares if the acquired entity has earnings of at least $100 million in the first year after the acquisition (otherwise, no shares will be delivered at the end of the first year). In addition, the acquirer is required to deliver 10,000 of its equity shares if the acquired entity has cumulative earnings of at least $200 million in the first two years following the acquisition (otherwise, no shares will be delivered at the end of the second year).</td>
<td>Two units of account. There are two targets that cover different periods.</td>
</tr>
</tbody>
</table>

### 3.2.4 Registration Payment Arrangements

**ASC 815-40**

Subtopic 825-20 requires that an entity recognize and measure a *registration payment arrangement* (see paragraph 825-20-15-3) as a separate unit of account from the financial instrument(s) subject to that arrangement. Accordingly, under that Subtopic (see paragraphs 825-20-25-2 and 825-20-30-2), a financial instrument that is both within the scope of this Subtopic and subject to a registration payment arrangement shall be recognized and measured in accordance with this Subtopic without regard to the contingent obligation to transfer consideration pursuant to the registration payment arrangement.
**ASC Master Glossary**

**Registration Payment Arrangement**
An arrangement with both of the following characteristics:

a. It specifies that the issuer will endeavor to do either of the following:
   1. File a registration statement for the resale of specified financial instruments and/or for the resale of equity shares that are issuable upon exercise or conversion of specified financial instruments and for that registration statement to be declared effective by the U.S. Securities and Exchange Commission (SEC) (or other applicable securities regulator if the registration statement will be filed in a foreign jurisdiction) within a specified grace period
   2. Maintain the effectiveness of the registration statement for a specified period of time (or in perpetuity).

b. It requires the issuer to transfer consideration to the counterparty if the registration statement for the resale of the financial instrument or instruments subject to the arrangement is not declared effective or if effectiveness of the registration statement is not maintained. That consideration may be payable in a lump sum or it may be payable periodically, and the form of the consideration may vary. For example, the consideration may be in the form of cash, equity instruments, or adjustments to the terms of the financial instrument or instruments that are subject to the registration payment arrangement (such as an increased interest rate on a debt instrument).

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**ASC 825-20**

15-4 The guidance in this Subtopic does not apply to any of the following:

a. Arrangements that require registration or listing of convertible debt instruments or convertible preferred stock if the form of consideration that would be transferred to the counterparty is an adjustment to the conversion ratio. (Subtopic 470-20 provides guidance on accounting for convertible instruments with contingently adjustable conversion ratios.)

b. Arrangements in which the amount of consideration transferred is determined by reference to either of the following:
   1. An observable market other than the market for the issuer’s stock
   2. An observable index.

   For example, if the consideration to be transferred if the issuer is unable to obtain an effective registration statement is determined by reference to the price of a commodity. See Subtopic 815-15 for related guidance.

c. Arrangements in which the financial instrument or instruments subject to the arrangement are settled when the consideration is transferred (for example, a warrant that is contingently puttable if an effective registration statement for the resale of the equity shares that are issuable upon exercise of the warrant is not declared effective by the SEC within a specified grace period).

25-1 An entity shall recognize a registration payment arrangement as a separate unit of account from the financial instrument(s) subject to that arrangement.

25-2 The financial instrument(s) subject to the registration payment arrangement shall be recognized in accordance with other applicable generally accepted accounting principles (GAAP) (for example, Subtopics 815-10; 815-40; and 835-30) without regard to the contingent obligation to transfer consideration pursuant to the registration payment arrangement.

30-1 An entity shall measure a registration payment arrangement as a separate unit of account from the financial instrument(s) subject to that arrangement.
The financial instrument(s) subject to the registration payment arrangement shall be measured in accordance with other applicable generally accepted accounting principles (GAAP) (for example, Subtopics 815-10; 815-40; and 835-30) without regard to the contingent obligation to transfer consideration pursuant to the registration payment arrangement.

ASC 825-20 contains special unit-of-account guidance applicable to registration payment arrangements (also known as registration rights agreements). In connection with issuances of equity shares, debt securities, convertible instruments, and equity-linked contracts, an issuer may agree to pay amounts in case it is unable to deliver registered securities or maintain an effective registration. For example, a warrant or other equity-linked contract may require the issuer to:

- Use its “best efforts” to file a registration statement for the resale of shares and have the registration statement declared effective by the end of a specified grace period (e.g., within 90 to 180 days).
- Maintain the effectiveness of a registration statement for a period.

If the issuer fails to meet these conditions, the contract may require the issuer to make cash payments to the counterparty unless and until a registration statement is declared effective. For example, the contract may require the entity to pay the investor 2 percent of the contract purchase price in each month after the end of a 180-day grace period during which there is no registration statement in effect that covers the shares that will be delivered under the contract.

A registration payment arrangement, as defined in the ASC master glossary, is treated as a unit of account that is separate from any related contract on an entity’s own equity. This is the case even if the registration payment arrangement is included in the contract on own equity itself. This means that a contract could qualify for equity classification under ASC 815-40 even if it includes provisions that require the issuer to pay cash to the holder if the issuer is unable to deliver registered shares or maintain an effective registration statement, unless the contract itself would be net cash settled (see Section 5.2). Those provisions would instead be accounted for separately as a registration payment arrangement in accordance with ASC 825-20, provided that the arrangement meets the definition of a registration payment arrangement.

A registration payment arrangement that is within the scope of ASC 825-20 is treated as a contingent liability (ASC 825-20-30-3). This means that proceeds from the related financing transaction are allocated to the registration payment arrangement upon initial recognition only if there is a probable obligation to make payments under the arrangement that can be reasonably estimated (ASC 825-20-30-4). If the obligation becomes probable and can be reasonably estimated after inception, a contingent liability is recognized at that point with an offset to earnings. Any subsequent change in the amount of the contingent liability is also recognized in earnings (ASC 825-20-35-1). If the entity is required to deliver shares under the arrangement, the number of shares can be reasonably estimated, and the transfer is probable, the entity measures the contingent liability by using the issuer’s stock price as of the reporting date (ASC 825-20-30-5).
An arrangement that contains any of the following provisions would not be accounted for as a separate unit of account under ASC 825-20:

- The form of consideration transferred is a contingently adjustable conversion ratio in a convertible instrument.
- The payment is adjusted by reference either to an observable market other than the issuer’s stock (e.g., a commodity price) or to an observable index.
- The payment is made when the contract subject to the arrangement is settled (e.g., a payment that is made upon the exercise of an option on own stock that is subject to the arrangement).

Accordingly, an entity would consider such provisions in its analysis of the contract under ASC 815-40.

### 3.2.5 Accelerated Share Repurchase Programs

**ASC 505-30**

25-5 An accelerated share repurchase program is a combination of transactions that permits an entity to repurchase a targeted number of shares immediately with the final repurchase price of those shares determined by an average market price over a fixed period of time. An accelerated share repurchase program is intended to combine the immediate share retirement benefits of a tender offer with the market impact and pricing benefits of a disciplined daily open market stock repurchase program.

25-6 An entity shall account for such an accelerated share repurchase program as the following two separate transactions:

a. As shares of common stock acquired in a treasury stock transaction recorded on the acquisition date

b. As a forward contract indexed to its own common stock. Subtopic 815-40 provides guidance on the accounting for contracts that are indexed to an entity’s own common stock.

Example 1 (see paragraph 505-30-55-1) provides an illustration of an accelerated share repurchase program that is addressed by this guidance.

**Example 1: Accelerated Share Repurchase Program**

55-1 This Example illustrates the guidance in paragraph 505-30-25-5 by identifying the two separate transactions, namely a treasury stock purchase and a forward contract, that are present in what is sometimes described as an accelerated share repurchase program.

55-2 The treasury stock purchase is as follows.

55-3 Investment Banker, an unrelated third party, borrows 1,000,000 shares of Company A common stock from investors, becomes the owner of record of those shares, and sells the shares short to Company A on July 1, 1999, at the fair value of $50 per share. Company A pays $50,000,000 in cash to Investment Banker on July 1, 1999, to settle the purchase transaction. The shares are held in treasury. Company A has legal title to the shares, and no other party has the right to vote those shares.

55-4 The forward contract is as follows.

55-5 Company A simultaneously enters into a forward contract with Investment Banker on 1,000,000 shares of its own common stock. On the October 1, 1999, settlement date, if the volume-weighted average daily market price of Company A's common stock during the contract period (July 1, 1999, to October 1, 1999) exceeds the $50 initial purchase price (net of a commission fee to Investment Banker), Company A will deliver to Investment Banker cash or shares of common stock (at Company A's option) equal to the price difference multiplied by 1,000,000. If the volume-weighted average daily market price of Company A's common stock during the contract period is less than the $50 initial purchase price (net of a commission fee to Investment Banker), Investment Banker will deliver to Company A cash equal to the price difference multiplied by 1,000,000.
Under the guidance in paragraph 505-30-25-5, an entity would account for this accelerated share repurchase program as two separate transactions:

a. As shares of common stock acquired in a treasury stock transaction recorded on the July 1, 1999, acquisition date

b. As a forward contract indexed to its own common stock.

ASC 505-30-25 contains unit-of-account guidance for ASR programs. Under ASC 505-30-25-6, an entity accounts for an ASR as two separate units of account: a treasury stock repurchase and a separate forward contract on the entity’s shares. An entity should analyze the treasury stock repurchase and forward contract separately to determine how to account for each unit of account. Because ASC 815-40 contains an exception for financial instruments that are within the scope of ASC 480-10 (see Section 2.3), an entity should determine whether one or both units of account are within the scope of ASC 480-10 before considering whether ASC 815-40 applies.

The terms of ASRs vary. In a traditional ASR, an entity (1) repurchases a targeted number of its own shares at the current stock price immediately for cash and (2) simultaneously enters into a net-share-settled forward sale of the same number of shares indexed to the average stock market price over the contract period. Economically, the forward serves as a true-up mechanism for adjusting the price ultimately paid for the shares purchased. Its purpose is to reduce the number of outstanding shares immediately at a repurchase price that on a combined basis reflects the average stock market price over an extended period (e.g., the volume-weighted average price on each trading day during the contract period). On a combined basis, the initial share repurchase and the forward sale put the issuer in an economic position similar to that of having conducted a series of open market purchases of its own stock over a specified period.

Example 3-10

ASR Analysis

An entity makes an up-front cash payment and receives a specific number of shares from the counterparty (usually an investment bank). Upon settlement of the forward contract (typically within three to six months), the entity either (1) pays the counterparty an amount equal to any excess of the volume-weighted average daily market price (VWAP) of the entity's shares over the initial purchase price or (2) receives from the counterparty an amount equal to any excess of the initial purchase price over the VWAP. Often, the entity can choose to settle the forward contract with the counterparty in either cash or a variable number of shares. Under ASC 505-30, this transaction is analyzed as two units of account: a treasury stock repurchase and a net settled forward contract to sell the entity's stock over the contract period.

In practice, the settlement of the treasury stock repurchase often takes place one or a few days after the execution of the ASR (e.g., the initial share delivery date may be three business days after the transaction date), at which time the issuer pays cash and receives an initial number of shares. In such cases, the obligation to repurchase shares in exchange for cash is classified as a liability under ASC 480-10-25-8 (see Chapter 5 of Deloitte's A Roadmap to Distinguishing Liabilities From Equity) during the period between the ASR transaction date and the settlement date of the treasury stock repurchase (sometimes described as the "initial share delivery date" or the "prepayment date"). Note that in some ASR transactions, the payment of cash in the treasury stock repurchase occurs before the receipt of the initial shares, in which case ASC 480-10 may cease to apply once the obligation to pay cash has been settled.
In evaluating whether the forward component of an ASR is within the scope of ASC 480-10, the issuer should consider whether it embodies an obligation to transfer assets or a variable number of shares that meet the criteria in ASC 480-10-25-8 or ASC 480-10-25-14 (see Chapters 5 and 6 of Deloitte’s A Roadmap to Distinguishing Liabilities From Equity). Usually, an issuer is not required to classify as a liability under ASC 480-10 the forward contract component in a traditional ASR because it does not embody an obligation to repurchase shares for assets and does not involve an obligation to deliver a variable number of shares with a monetary value that moves inversely with — or is based on something other than — the price of the issuer’s stock. However, an issuer cannot assume that the forward contract component of an ASR is outside the scope of ASC 480-10 without analyzing its specific terms and features.

In some ASR transactions, a portion of the prepayment amount on the initial share delivery date represents a premium paid by the issuer to increase the forward sale price that the issuer will receive in the forward component of the transaction (relative to an at-market forward) rather than a payment for the shares to be received in the initial treasury stock repurchase. For example, the issuer may apply 20 percent of the prepayment amount to the forward component to reduce the likelihood that the forward component will ever dilute EPS. In that case, the issuer may be required to account for the forward component as an asset or a liability under ASC 480-10-25-8 in the period between the transaction date and the initial share delivery date if the forward component permits net share settlement. This is because the forward component embodies an obligation to pay cash (on the initial share delivery date) to repurchase shares (the issuer will receive shares on the forward settlement date if the stock price is less than the forward price).

If the forward component is outside the scope of ASC 480-10, the issuer considers the guidance in ASC 815-40 when it determines whether the forward should be accounted for as an asset or liability. The terms of an ASR often include rights for the counterparty to end the ASR early upon termination events defined by reference to ISDA’s equity derivatives definitions (e.g., merger events, tender offers, nationalization, insolvency, delisting, change in law, failure to deliver, insolvency filing, loss of stock borrow, increased cost of stock borrow, extraordinary dividends). Further, the contractual provisions often specify or permit the counterparty to make adjustments to the settlement terms upon the occurrence of such events (e.g., calculation agent adjustments, cancellation, and payment) and might require the entity to settle the contract net in cash. In evaluating an ASR’s forward-contract component under ASC 815-40, therefore, the entity should be mindful of the need to assess such terms under the indexation guidance and other equity classification conditions in ASC 815-40 (see Chapters 4 and 5).
Example 3-11

On December 30, an issuer enters into an ASR transaction that requires it to transfer a fixed amount of cash (a prepayment amount of $500 million) in exchange for a fixed number of its common shares (10 million initial shares) on the initial share delivery date (January 2). The issuer will either deliver or receive shares on the transaction's final settlement date (March 31). If the VWAP of the issuer’s common shares exceeds $50, the issuer will deliver shares; if the VWAP is less than $50, the issuer will receive shares. The number of shares that will be received or delivered is calculated as the prepayment amount ($500 million) divided by the VWAP over the contract period less the initial shares (10 million) already delivered.

In these circumstances, the treasury stock repurchase must be accounted for as a liability under ASC 480-10-25-8. In accordance with ASC 480-10-30-3, the issuer recognizes the liability on the ASR transaction date, which was initially measured “at the fair value of the shares at inception, adjusted for any consideration or unstated rights or privileges.” Simultaneously, in accordance with ASC 480-10-30-5, equity is “reduced by an amount equal to the fair value of the shares at inception.” Because under ASC 480-10-35-3(a) both the amount to be paid — $500 million — and the settlement date — January 2 — are fixed, the liability is measured at the present value of the amount to be paid at settlement — $500 million — with interest cost accruing at the rate implicit at inception during the period from the transaction date to the initial share delivery date. (Further, if any part of the prepayment amount represents a premium payment for the forward component of the accelerated share repurchase transaction, that portion would be accounted for separately as a liability measured at fair value under ASC 480-10-35-1, ASC 480-10-35-4A, or ASC 480-10-35-5 between the transaction date and the initial share delivery date, as discussed above.)

On the initial share delivery date, the liability for the treasury stock repurchase is extinguished by delivery of the prepayment amount. After the initial share delivery date, the transaction is outside the scope of ASC 480-10 and is therefore evaluated under other GAAP (including ASC 815-10 and ASC 815-40).
Chapter 4 — Indexation Guidance

4.1 Overview

ASC 815-40

15-7 An entity shall evaluate whether an equity-linked financial instrument (or embedded feature), as discussed in paragraphs 815-40-15-5 through 15-8 is considered indexed to its own stock within the meaning of this Subtopic and paragraph 815-10-15-74(a) using the following two-step approach:

a. Evaluate the instrument's contingent exercise provisions, if any.
b. Evaluate the instrument's settlement provisions.

15-8 Examples 2–21 (see paragraphs 815-40-55-26 through 55-48) illustrate the application of the guidance in paragraphs 815-40-15-5 through 15-7. These examples do not address whether an instrument (or embedded feature) is classified in equity (or would be classified in equity if freestanding). These examples also do not address whether the instrument is within the scope of Topic 480 or whether the instrument would be subject to the two-class method under Topic 260.

One of the conditions that must be met for a contract within the scope of ASC 815-40 (see Chapter 2) to qualify as equity is that the contract is considered indexed to the entity's own stock in accordance with ASC 815-40-15. This condition must be met because:

- If a freestanding contract is not considered indexed to the entity's own equity, it cannot be accounted for in equity but must be accounted for as an asset or a liability (irrespective of whether it meets the definition of a derivative) (see Section 6.3).
- If a freestanding derivative contract or an embedded derivative feature is not considered indexed to the entity's own equity, it does not qualify for the own-equity scope exception from derivative accounting in ASC 815-10-15-74(a) (see Section 2.2).

To determine whether a contract is considered indexed to the issuer's own equity, an entity performs a two-step analysis:

- Step 1 — Evaluate whether the contract contains any exercise contingencies and, if so, whether they disqualify the contract from being classified as equity (see Section 4.2).
- Step 2 — Assess whether the settlement terms are consistent with equity classification (see Section 4.3).
If an entity concludes that a contract is considered indexed to its own equity under ASC 815-40-15, the contract would not necessarily qualify as equity under ASC 815-40. The entity would also need to determine whether the equity classification conditions in ASC 815-40-25 are met (see Chapter 5).

Contracts on own equity prepared in accordance with standard ISDA documentation often include adjustments and termination events defined by reference to ISDA standard terms and definitions (see Section 3.1.3). When the EITF developed the indexation guidance that was later incorporated into ASC 815-40-15, the Task Force was mindful of such ISDA terms and definitions (e.g., ISDA’s 2002 equity derivatives definitions). Nevertheless, without analyzing the contract’s terms, an entity cannot assume that a contract prepared in accordance with standard ISDA documentation meets the indexation guidance in ASC 815-40-15. For example, an entity should assess whether it must make any adjustments in a commercially reasonable manner and whether the contract specifies any alterations to the ISDA definitions.

Example 4-1

ASR Adjustments

An ASR agreement may give the counterparty (e.g., an investment bank) the right to early terminate the ASR if certain contingent events occur that are defined by reference to ISDA’s equity derivatives definitions. Examples of termination events defined by ISDA include merger events, tender offers, nationalization, insolvency, delisting, change in law, insolvency filing, hedging disruption, increased cost of hedging, loss of stock borrow, and increased cost of stock borrow. The ASR may also specify additional termination events, for example, if the entity (1) declares an extraordinary cash dividend or a regular quarterly dividend in an amount greater than that specified in the agreement or (2) issues securities or share capital of another entity acquired or owned (directly or indirectly) by the entity as a result of a spin-off or other similar transaction — or any other type of securities (other than shares), rights, or warrants or other assets — for payment (cash or other consideration) at less than the prevailing market price.
4.2 Step 1: Evaluate Any Exercise Contingencies

4.2.1 The Concept of an Exercise Contingency

**Exercise Contingency**
A provision that entitles the entity (or the counterparty) to exercise an equity-linked financial instrument (or embedded feature) based on changes in an underlying, including the occurrence (or nonoccurrence) of a specified event. Provisions that accelerate the timing of the entity's (or the counterparty's) ability to exercise an instrument and provisions that extend the length of time that an instrument is exercisable are examples of exercise contingencies.

**Underlying**
A specified interest rate, security price, commodity price, foreign exchange rate, index of prices or rates, or other variable (including the occurrence or nonoccurrence of a specified event such as a scheduled payment under a contract). An underlying may be a price or rate of an asset or liability but is not the asset or liability itself. An underlying is a variable that, along with either a notional amount or a payment provision, determines the settlement of a derivative instrument.

Step 1 in the determination of whether a contract is considered indexed to an entity's own equity is to evaluate the contract's exercise contingencies, if any. The following provisions are examples of exercise contingencies:

<table>
<thead>
<tr>
<th>Type</th>
<th>Description</th>
<th>Examples</th>
</tr>
</thead>
<tbody>
<tr>
<td>Exercise condition</td>
<td>A provision that affects whether the contract becomes exercisable.</td>
<td>A warrant that becomes exercisable upon an IPO.</td>
</tr>
<tr>
<td>Settlement condition</td>
<td>A provision that affects whether a contract is settled.</td>
<td>An obligation to issue shares that is contingent on whether revenue has exceeded a specified threshold.</td>
</tr>
<tr>
<td>Acceleration provision</td>
<td>A provision that accelerates the timing of either the entity's or the counterparty's ability to exercise the contract or that accelerates the timing of the contract's settlement.</td>
<td>The counterparty's right to exercise the contract is accelerated upon a merger event, tender offer, hedging disruption, loss of stock borrow, nationalization, or delisting.</td>
</tr>
<tr>
<td>Extension provision</td>
<td>A provision that extends the timing of either the entity's or the counterparty's ability to exercise the contract or extends the timing of the contract's settlement.</td>
<td>A provision that extends the expiration date of an option upon an IPO.</td>
</tr>
<tr>
<td>Deferral provision</td>
<td>A provision that defers the timing of either the entity's or the counterparty's ability to exercise the contract or defers the timing of the contract's settlement.</td>
<td>A provision that delays the counterparty's ability to exercise an option if the entity lacks sufficient registered shares or that defers settlement if the counterparty's ownership of shares exceeds a specified level or the counterparty needs time to unwind related hedges.</td>
</tr>
</tbody>
</table>
Some, but not all, contracts contain exercise contingencies. Step 1 does not apply to a contract that does not contain an exercise contingency (e.g., an option contract that is exercisable at any time before expiration). The mere passage of time is not considered an exercise contingency; neither is a contingency that affects the calculation of the settlement amount of an instrument if the contingency does not alter the availability or timing of settlement (e.g., the occurrence of a specified event that affects the strike price of an equity-linked option that was currently exercisable). For example, if a contract specifies that the holder has a right to purchase 1,000 shares if a revenue target is not met and 2,000 shares if the revenue target is met, that provision would not be considered an exercise contingency because the contract is exercisable irrespective of whether the revenue target is met (albeit for a different number of shares). However, such a contingent provision should be evaluated under step 2 (see Section 4.3.5.6).

4.2.2 Effect of Exercise Contingencies on the Classification of a Contract

<table>
<thead>
<tr>
<th>Type</th>
<th>Description</th>
<th>Examples</th>
</tr>
</thead>
<tbody>
<tr>
<td>Termination provision</td>
<td>A provision that results in the contract's termination (also sometimes called “cancellation,” “forfeiture,” or “knock-out” provision).</td>
<td>A provision that terminates the contract upon a change in control, IPO, or insolvency.</td>
</tr>
</tbody>
</table>

Exercise contingencies that are based on an observable market or an observable index preclude a contract from being considered indexed to an entity's own equity unless they are based on either of the following:

- “The market for the issuer's stock.”
- “[A]n index calculated or measured solely by reference to the issuer’s own operations.”

Further, an exercise contingency that is based on something other than an observable market or observable index does not preclude equity classification.
**Example 4-2**

**Exercise Contingency Analysis**
RockyCo issues to certain investors warrants that permit the investors to purchase RockyCo's common shares at a fixed price if the common shares trade below $7 per share. (RockyCo's shares currently trade at $10 each.) If the share price does not drop below $7 before the warrants' expiration date, the warrants will expire.

The warrants issued by RockyCo contain a contingent exercise provision because they cannot be exercised unless RockyCo's common shares trade below $7. However, because the exercise contingency is based directly on the market price of RockyCo's common shares, the warrants are not precluded from being considered indexed to RockyCo's own equity.

Had the exercise contingency been based on the price of gold's dropping below a certain point, however, the warrants would not have been considered indexed to RockyCo's own equity because such a contingent exercise provision would have been based on “[a]n observable market, other than the market for the issuer’s stock.”

If a freestanding contract contains more than one exercise contingency, the contract would not be considered indexed to the entity's own stock unless all the contingencies are consistent with equity classification.

### 4.2.2.1 Exercise Contingencies Based on the Market for the Issuer’s Stock
If an equity-linked contract can be exercised only if the issuer's stock exceeds a specified price, that exercise contingency would not preclude the contract from being considered indexed to the entity's own equity and classified as equity, because the issuer's stock price is considered to be based on the market for the issuer's stock. The term “market for the issuer's stock” includes not only the price of the entity's common or preferred stock but also:

- The stock price of a consolidated subsidiary that is a substantive entity (see Section 2.6.1).
- The price of a convertible debt or equity security in the evaluation of whether an equity conversion option embedded in the convertible security qualifies as being indexed to the entity's own equity.

Examples of exercise contingencies in convertible instruments that would be considered to be based on the market for the issuer's stock include:

- A provision that permits the instrument to be converted if the entity's stock price exceeds a certain dollar amount (a market price trigger).
- A provision that permits the instrument to be converted into the entity's equity shares if the instrument trades for an amount that is less than a specified percentage (e.g., 98 percent) of its if-converted value (a parity provision).

### 4.2.2.2 Exercise Contingencies Based on the Issuer’s Operations
An exercise contingency based on an index calculated solely by reference to the issuer's own operations (e.g., sales of at least $100 million) does not preclude a conclusion that the contract is indexed to the entity's own equity. Similarly, we believe that an exercise contingency that is based on an index calculated solely by reference to the operations of a consolidated subsidiary that is a substantive entity would not preclude such a conclusion by analogy to ASC 815-40-15-3 (see Section 2.6.1).
Exercise contingencies that are based on other observable markets (e.g., an option that is exercisable only if the market price of gold exceeds a certain level) or observable indexes (e.g., an option that is exercisable only if the CPI or S&P 500 exceeds a certain level) cause the instrument to be considered not indexed to the entity’s own equity.

### 4.2.2.3 Interaction Between Step 1 and Step 2

| 15-7B | If an instrument’s strike price or the number of shares used to calculate the settlement amount would be adjusted upon the occurrence of an exercise contingency, the exercise contingency shall be evaluated under Step 1 (see the preceding paragraph) and the potential adjustment to the instrument’s settlement amount shall be evaluated under Step 2 (see the guidance beginning in [ASC 815-40-15-7C]). |

An entity need not consider an instrument’s exercise contingency under step 2 if the contingency does not affect the settlement terms. For example, the entity would not need to consider under step 2 an exercise contingency that affects only (1) the entity’s ability to exercise or settle the instrument or (2) the timing thereof. In addition, an exercise contingency that merely results in the contract’s cancellation (i.e., it affects only whether the contract becomes settleable on the basis of its otherwise applicable settlement terms) does not require evaluation under step 2. However, some exercise contingencies also affect an instrument’s settlement terms, in which case the exercise contingencies should be evaluated under both step 1 and step 2. In other words, even if an exercise contingency is of a type that does not preclude equity classification under step 1, any associated adjustment to the settlement terms may preclude equity classification under step 2 (see Section 4.3.5.6 for an example).
### 4.2.3 Exercise Contingencies: Application Issues and Examples

The following table contains examples of exercise contingencies and our assessment of whether they would preclude the contract from being considered indexed to the entity's own stock:

<table>
<thead>
<tr>
<th>Exercise Contingencies That Do Not Preclude Equity Classification</th>
<th>Exercise Contingencies That Preclude Equity Classification</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Stock price of the issuer.</td>
<td>• Stock market index (e.g., S&amp;P 500).</td>
</tr>
<tr>
<td>• Stock price of a consolidated subsidiary that is a substantive entity.</td>
<td>• Commodity price (e.g., gold, natural gas, or oil).</td>
</tr>
<tr>
<td>• Revenue, net income, or EBITDA of the issuer.</td>
<td>• Foreign currency rate or index.</td>
</tr>
<tr>
<td>• Net assets of the issuer.</td>
<td>• Interest rate or index (e.g., LIBOR).</td>
</tr>
<tr>
<td>• Revenue, net income, or EBITDA of a consolidated subsidiary that is a substantive entity.</td>
<td>• CPI.</td>
</tr>
<tr>
<td>• A change in control or merger involving the issuer.</td>
<td>• The relation between the stock price of the issuer and a stock market index.</td>
</tr>
<tr>
<td>• An IPO of the issuer.</td>
<td>• The relation between (1) the issuer’s revenue, net income, or EBITDA and (2) the revenue, net income, or EBITDA of a competitor company.</td>
</tr>
<tr>
<td>• An exchange listing or filing of a registration statement by the issuer.</td>
<td></td>
</tr>
<tr>
<td>• Delisting of the issuer.</td>
<td></td>
</tr>
<tr>
<td>• An offering of additional securities by the issuer.</td>
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<tr>
<td>• A stock split or other dilutive event carried out by the issuer.</td>
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<tr>
<td>• Extraordinary dividends.</td>
<td></td>
</tr>
<tr>
<td>• The issuer’s settlement of another outstanding security of the issuer (e.g., pursuant to exercise of a call option by the issuer or a conversion by the investor).</td>
<td></td>
</tr>
<tr>
<td>• Cost of stock borrow on the entity's stock (including loss of stock borrow and increased cost of stock borrow).</td>
<td></td>
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<tr>
<td>• Nationalization.</td>
<td></td>
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<tr>
<td>• Insolvency.</td>
<td></td>
</tr>
<tr>
<td>• Change in law (e.g., a change in law that makes it illegal to be a party to the contract).</td>
<td></td>
</tr>
<tr>
<td>• Hedging disruption or increased cost of hedging related to the entity’s shares.</td>
<td></td>
</tr>
<tr>
<td>• Counterparty’s level of ownership of the entity’s shares.</td>
<td></td>
</tr>
<tr>
<td>• Event of default.</td>
<td></td>
</tr>
<tr>
<td>• Market disruption event (e.g., extended closure of stock exchange).</td>
<td></td>
</tr>
<tr>
<td>• A parity provision (convertible instruments only).</td>
<td></td>
</tr>
<tr>
<td>• The credit rating of the issuer (convertible instruments only).</td>
<td></td>
</tr>
</tbody>
</table>

---

1 An exercise contingency that is based on a parity provision or the credit rating of the issuer would generally be included only in the terms of a convertible instrument, not in those of a freestanding equity-linked contract. If an exercise contingency that is based on a parity provision or the credit rating of the issuer was included in the terms of a freestanding equity-linked financial instrument, the exercise contingency would generally preclude the freestanding financial instrument from being indexed to the reporting entity’s stock. See, however, Section 4.3.7.13.

2 See footnote 1.
Examples 2 through 21 in ASC 815-40-55 (listed in Appendix A of this Roadmap) illustrate the application of the indexation guidance in ASC 815-40-15. Five of the examples address how to apply step 1 of the indexation guidance in ASC 815-40-15 and involve the following exercise contingencies:

- IPO (Examples 2 and 5).
- Sales to third parties (Example 3).
- Increase in S&P 500 (Example 4).
- Market price trigger (Example 19).
- Parity provision (Example 19).
- Merger announcement (Example 19).

Examples 2, 3, and 4 are reproduced below. Examples 5 and 19 are addressed in our discussion of step 2 (see Sections 4.3.5.5 and 4.3.7.10).

**ASC 815-40**

**Example 2: Variability Involving Completion of an Initial Public Offering**

55-26 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; however, they only become exercisable if Entity A completes an initial public offering. The warrants are considered indexed to Entity A's own stock based on the following evaluation:

a. Step 1. The exercise contingency (that is, the initial public offering) is not an observable market or an observable index, so the evaluation of Step 1 does not preclude the warrants from being considered indexed to the entity's own stock. Proceed to Step 2.

b. Upon exercise, the settlement amount would equal the difference between the fair value of a fixed number of the entity's equity shares (100 shares) and a fixed strike price ($10 per share).

**Example 3: Variability Involving Sales Volume**

55-27 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; however, they only become exercisable after Entity A accumulates $100 million in sales to third parties. The warrants are considered indexed to Entity A's own stock based on the following evaluation:

a. Step 1. The exercise contingency (that is, the accumulation of $100 million in sales to third parties) is an observable index. However, it can only be calculated or measured by reference to Entity A's sales, so the evaluation of Step 1 does not preclude the warrants from being considered indexed to the entity's own stock. Proceed to Step 2.

b. Step 2. Upon exercise, the settlement amount would equal the difference between the fair value of a fixed number of the entity's equity shares (100 shares) and a fixed strike price ($10 per share).

**Example 4: Variability Involving Stock Index**

55-28 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; however, they only become exercisable if the Standard & Poor's S&P 500 Index increases 500 points within any given calendar year during that 10-year period. The warrants are not considered indexed to Entity A's own stock based on the following evaluation:

a. Step 1. The exercise contingency (that is, the increase of 500 points in Standard & Poor's S&P 500 Index) is based on an observable index that is not measured solely by reference to the issuer's own operations.

b. Step 2. It is not necessary to evaluate Step 2.
4.3 Step 2: Evaluate the Settlement Provisions

4.3.1 Effect of Settlement Terms on the Classification of a Contract

If after performing step 1 (see Section 4.2) an entity concludes that an instrument’s exercise contingency provisions (if any) would not preclude a conclusion that the instrument is indexed to the entity’s own stock, the entity must perform step 2 to evaluate the instrument’s settlement terms. Under step 2, an equity-linked instrument is considered indexed to the entity’s own stock if either of the following two conditions is met:

- The instrument is a “fixed-for-fixed” forward or option on equity shares.
- The instrument is not fixed for fixed, but the only variables that could affect the instrument’s settlement amount are inputs used in the pricing (fair value measurement) of a fixed-for-fixed forward or option on equity shares.

A contract that does not meet either of these conditions does not qualify as equity. Conversely, if the contract is considered indexed to the entity’s own stock under both step 1 and step 2, the contract could qualify for classification as equity if it also meets the equity classification criteria in ASC 815-40-25 (see Chapter 5).

![Diagram](image-url)
4.3.2 The Concept of a Fixed-for-Fixed Forward or Option on Equity Shares

ASC 815-40

15-7C An instrument (or embedded feature) shall be considered indexed to an entity's own stock if its settlement amount will equal the difference between the following:

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

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

An equity-linked instrument is considered a fixed-for-fixed forward or option on the entity's equity shares if the instrument's settlement amount will always equal the difference between (1) the "fair value of a fixed number of the entity's equity shares" and (2) a fixed monetary amount denominated in the reporting entity's functional currency.

Example 4-3

Fixed-for-Fixed Option

Entity X issues freestanding warrants that allow the holder to purchase a fixed number of 1,000 shares of X's common stock for a fixed amount of $10 per share. There are no exercise contingencies and no potential adjustments to the exercise price or number of common shares underlying the warrants. As a result, the warrants are indexed to X's stock because they are considered a fixed-for-fixed option on equity shares. That is, the holder will receive a fixed number of X's shares for a fixed price.

The difference between the fair value of the equity shares underlying a contract and a contract's strike price is sometimes referred to as the contract's intrinsic value. If the fair value of each share on the exercise date is $15, the intrinsic value is $5 per share ($15 – $10) and the settlement amount is $5,000 (1,000 shares × $5 per share).

For a contract to qualify as fixed for fixed, it does not need to involve a gross physical exchange of the full stated amount of cash for the full stated number of shares. A contract that involves a net settlement (e.g., a net number of shares equal in fair value to the settlement amount) could also qualify as fixed for fixed provided that the settlement amount equals the difference between the fair value of a fixed number of the entity's equity shares and a fixed amount of cash.

In the evaluation of whether a contract qualifies as a fixed-for-fixed option or forward on the entity's equity shares, indexation to the fair value of the equity shares of a consolidated subsidiary does not preclude equity classification provided that the subsidiary is a substantive entity (see Section 2.6.1).

Under ASC 815-40-25-27, a contract must explicitly limit the number of shares to be delivered in a share settlement to be classified in stockholders' equity (see Section 5.3.4). The existence of a “share cap” in the contract's terms solely to meet this condition would not preclude a conclusion that a contract is a fixed-for-fixed forward or option on equity shares.

Some contracts have more than one potential settlement amount that is contingent on the occurrence or nonoccurrence of a specified event (e.g., whether an operational target is met). Such contracts are not considered fixed for fixed even if each of those potential settlement amounts would have been considered fixed for fixed when assessed separately.
Example 4-4

More Than One Potential Settlement Amount

Entity X issues a freestanding warrant that allows the holder to purchase a fixed number of shares of X's common stock (900 shares) for a fixed amount of $10 per share if the entity's revenue is less than $500 million. If the entity's revenue equals or exceeds $500 million, the holder has the right to purchase a different, fixed number of shares (1,000 shares) for a fixed amount of $10 per share. There are no exercise contingencies or other potential adjustments to the exercise price or number of common shares underlying the warrant. Entity X determines that the warrant represents only one freestanding financial instrument. The warrant is therefore not considered fixed for fixed because the number of shares that will be delivered under the contract differs depending on whether the revenue target is met (i.e., the settlement amount varies on the basis of revenue). The contingency is not analyzed as an exercise contingency because the contract is exercisable irrespective of whether the revenue target is met.

If the contract instead had specified that it was exercisable only if the entity's revenue equaled or exceeded $10 million for 1,000 shares at $10 per share, it would have been considered fixed for fixed. That contract would have contained an exercise contingency based on revenue that would have been evaluated under step 1, but the settlement amount would not have varied on the basis of revenue.

As discussed in Section 2.2, an entity applies the indexation and equity classification guidance in ASC 815-40 in determining whether an embedded feature (e.g., an equity conversion option embedded in convertible debt) qualifies for the scope exception from derivative accounting in ASC 815-10-15-74(a). An equity conversion option that gives the holder the right to convert a fixed stated principal amount of a bond issued by the entity and denominated in the entity's functional currency into a fixed number of the entity's own equity shares is considered a fixed-for-fixed option on equity shares if there are no potential adjustments to the settlement terms.

Similarly, a conversion option embedded in a preferred stock instrument that gives the counterparty a right to buy a fixed number of the entity's equity shares for a fixed stated amount of the preferred stock instrument issued by the entity would be considered a fixed-for-fixed option on equity shares when (1) the preferred stock host is considered a debt host contract in the evaluation of embedded derivatives and (2) there are no potential adjustments to the settlement terms. If the host contract in a convertible preferred stock instrument is considered an equity host, the embedded equity conversion option will be clearly and closely related to its host contract. Such an option is not separated from its host contract under ASC 815-15 irrespective of whether it would have qualified for the scope exception from derivative accounting in ASC 815-10-15-74(a). Therefore, the option is not assessed under the indexation and equity classification guidance in ASC 815-40 (see Section 2.2.2).

Under ASC 480-10-S99-3A and other SEC guidance, SEC registrants are required to classify certain redeemable equity securities in temporary equity outside of permanent equity (for a comprehensive discussion of the application of this guidance, see Chapter 9 of Deloitte's A Roadmap to Distinguishing Liabilities From Equity). In evaluating whether an embedded feature (e.g., a written put option embedded in the entity's preferred stock) meets the scope exception for certain contracts on own equity in ASC 815-10-15-74(a), an entity treats temporary equity as equity even though it is presented outside of permanent equity (ASC 815-10-15-76).
## 4.3.3 Provisions That Adjust the Settlement Amount

<table>
<thead>
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<th>ASC 815-40</th>
</tr>
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</table>

**15-7D** An instrument's strike price or the number of shares used to calculate the settlement amount are not fixed if its terms provide for any potential adjustment, regardless of the probability of such adjustment(s) or whether such adjustments are in the entity's control. If the instrument's strike price or the number of shares used to calculate the settlement amount are not fixed, the instrument (or embedded feature) shall still be considered indexed to an entity's own stock if the only variables that could affect the settlement amount would be inputs to the fair value of a fixed-for-fixed forward or option on equity shares.

**15-7E** A fixed-for-fixed forward or option on equity shares has a settlement amount that is equal to the difference between the price of a fixed number of equity shares and a fixed strike price. The fair value inputs of a fixed-for-fixed forward or option on equity shares may include the entity's stock price and additional variables, including all of the following:

- a. Strike price of the instrument
- b. Term of the instrument
- c. Expected dividends or other dilutive activities
- d. Stock borrow cost
- e. Interest rates
- f. Stock price volatility
- g. The entity's credit spread
- h. The ability to maintain a standard hedge position in the underlying shares.

Determinations and adjustments related to the settlement amount (including the determination of the ability to maintain a standard hedge position) shall be commercially reasonable.

**15-7F** An instrument (or embedded feature) shall not be considered indexed to the entity's own stock if its settlement amount is affected by variables that are extraneous to the pricing of a fixed-for-fixed option or forward contract on equity shares. An instrument (or embedded feature) shall not be considered indexed to the entity's own stock if either:

- a. The instrument's settlement calculation incorporates variables other than those used to determine the fair value of a fixed-for-fixed forward or option on equity shares.
- b. The instrument contains a feature (such as a leverage factor) that increases exposure to the additional variables listed in the preceding paragraph in a manner that is inconsistent with a fixed-for-fixed forward or option on equity shares.

Equity-linked instruments commonly include provisions that result in adjustments to the exercise price or to the number of shares for which the instrument can be settled. Such adjustments may be specified directly in the contract (e.g., antidilution provisions) or incorporated into the contract by reference to adjustments defined in standard documentation for equity derivatives (e.g., ISDA terms related to hedge disruption or loss of stock borrow).
Examples 2 through 21 in ASC 815-40-55 (listed in Appendix A of this Roadmap) illustrate the application of the indexation guidance in ASC 815-40-15. Seventeen of the examples address how to apply step 2 of the indexation guidance in ASC 815-40-15 to contracts that contain settlement adjustments. Those examples involve adjustments related to the following:

- The entity’s stock price (Examples 8, 13, 15, 16, and 19; see Sections 4.3.5.1 and 4.3.7.10).
- Dividends (Examples 12 and 17; see Sections 4.3.5.3 and 4.3.7.1).
- Dilutive events (Example 17; see Section 4.3.7.1).
- Down-round protection (Example 9; see Section 4.3.7.2).
- Table with axes of stock price and time (Example 19; see Section 4.3.7.10).
- Interest rates (Examples 13 and 14; see Section 4.3.5.2).
- Merger announcement (Example 6; see Section 4.3.7.5).
- Cost of stock borrow (Example 12; see Section 4.3.5.4).
- Sales revenue (Example 7; see Section 4.3.5.6).
- Price of gold (Example 5; see Section 4.3.5.5).
- Foreign currency (Examples 11, 18, and 20; see Section 4.3.8).
- Stock option exercise behavior (Example 21; see Section 4.3.5.8).
- Contingent redemption for a fixed monetary amount (Example 10; see Section 4.3.7.11).

An equity-linked instrument that permits adjustments to the settlement amount is not considered indexed to the reporting entity’s stock unless the only variables that could affect the instrument’s settlement amount (i.e., the exercise price or forward price, or the number of shares used to calculate the settlement amount) are inputs used in the pricing (fair value measurement) of a fixed-for-fixed forward or option on the entity’s equity shares or, after the adoption of ASU 2017-11, adjustments are made in accordance with a down-round feature (see Section 4.3.7.2). If each potential adjustment to the settlement terms is consistent with the inputs used in the pricing of a fixed-for-fixed forward or option on equity shares (e.g., stock price and strike price), the instrument is considered indexed to the entity’s own stock. Accordingly, an entity must evaluate whether any adjustments to the settlement amount that are specified in the contract meet this requirement.

There are two types of inputs:

- An **explicit input** is an underlying (other than the occurrence or nonoccurrence of a specified event) that could affect the settlement amount of the contract (i.e., the exercise price or forward price, or the number of equity shares used to calculate the settlement amount). Examples of explicit inputs include a specific interest rate, security price, commodity price, foreign exchange rate, inflation rate, credit rating, prepayment index, or other index or indexes of specified prices or rates.

- An **implicit input** is an assumption about the occurrence or nonoccurrence of a specified event that could affect the settlement amount of an equity-linked instrument (i.e., the exercise price or forward price or the number of equity shares used to calculate the settlement amount).
For example, there may be an implicit assumption in the pricing of a contract that no dilutive event affecting the underlying equity securities will occur (e.g., stock split). Other examples of implicit inputs include the occurrence or nonoccurrence of the following events:

- An IPO or a subsequent offering of securities by the issuer.
- A tender offer for the securities of the issuer.
- A change of control or merger involving the issuer.
- Bankruptcy or insolvency of the issuer.
- The incurrence of transaction costs to dispose of equity securities received upon settlement of an equity-linked option.

### 4.3.4 Evaluating Explicit Inputs

In the determination of the price (or fair value) of an equity-linked financial instrument, standard pricing models (e.g., the Black-Scholes-Merton option pricing model) require certain explicit inputs. Such inputs may include the exercise (or forward) price of the instrument, the term of the instrument, expected dividends, interest rates, and stock price volatility.

To evaluate whether adjustments to the settlement provisions that are based on an explicit input preclude a contract (or an embedded feature) from being considered indexed to an entity's own stock, the reporting entity considers the three questions below, assessing each explicit input separately. These considerations are relevant regardless of whether the explicit input (1) affects the exercise price or forward price of the instrument or the number of equity shares used to calculate the settlement amount or (2) results in an immediate settlement of the instrument at an adjusted settlement amount. If an adjustment that is based on an explicit input indicates that the instrument is not indexed to the entity's own stock, the contract does not qualify as equity.

1. **Is the explicit input used in the pricing (fair value measurement) of a fixed-for-fixed forward or option on equity shares?**

   For the contract to be considered indexed to the entity's stock, the answer must be yes. If the answer is no, the contract does not qualify as equity irrespective of whether it meets the other conditions for equity classification.

   If the settlement terms are adjusted in response to changes in an input used in the pricing (fair value measurement) of a fixed-for-fixed forward or option on equity shares, those adjustments do not necessarily preclude the contract from being considered indexed to the reporting entity's stock. If, however, the settlement amount varies in response to changes in explicit inputs other than those used in the pricing (fair value measurement) of a fixed-for-fixed forward or option on equity shares (i.e., extraneous variables), the instrument is not considered indexed to the reporting entity's stock. In this case, the contract must be classified as an asset or a liability.
The table below includes examples of explicit inputs that may or may not preclude equity classification if an adjustment is made to the settlement amount in response to a change in the explicit input.

<table>
<thead>
<tr>
<th>Permissible (Equity Classification Not Precluded)</th>
<th>Not Permissible (Equity Classification Precluded)</th>
</tr>
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<tbody>
<tr>
<td>• The issuer’s stock price (including a weighted-average price over a reasonable period; see Section 4.3.5.1).</td>
<td>• Revenue, net income, EBITDA, or other operating metric of the issuer (unless the formula is designed to equal or closely approximate the fair value of the entity’s stock; see Section 4.3.5.6).</td>
</tr>
<tr>
<td>• The stock price of a consolidated subsidiary that is a substantive entity (see Section 2.6.1).</td>
<td>• The authorized and unissued common shares of the issuer.</td>
</tr>
<tr>
<td>• The exercise (or forward) price of the instrument.</td>
<td>• The number of outstanding common shares of the issuer (unless the terms of the instrument are adjusted solely to offset the effect of a dilutive event).</td>
</tr>
<tr>
<td>• The term of the instrument.</td>
<td>• A commodity price (e.g., gold; see Section 4.3.5.5).</td>
</tr>
<tr>
<td>• Expected dividends on the instrument (see Section 4.3.5.3).</td>
<td>• A foreign currency index or rate (see Section 4.3.8).</td>
</tr>
<tr>
<td>• Cost of borrowing the entity’s stock (cost of stock borrow; see Section 4.3.5.4).</td>
<td>• An inflation rate.</td>
</tr>
<tr>
<td>• Risk-free interest rates (i.e., LIBOR, the federal funds rate, or the U.S. Treasury rate; see Sections 4.3.5.2, 4.3.5.9, and 4.3.5.10).</td>
<td>• Stock option exercise behavior (see Section 4.3.5.8).</td>
</tr>
<tr>
<td>• Stock price volatility (see Section 4.3.5.4A).</td>
<td></td>
</tr>
<tr>
<td>• The entity’s credit spread (generally only for convertible instruments).</td>
<td></td>
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</tbody>
</table>

2. **Could a change in the explicit input (other than the reporting entity’s stock price) affect the settlement amount in a manner inconsistent with how a change in the input would affect the pricing (fair value measurement) of a fixed-for-fixed forward or option on equity shares?**

For the contract to be considered indexed to the entity’s stock, the answer must be no. If the answer is yes, the contract does not qualify as equity irrespective of whether it meets the other conditions for equity classification.

An adjustment in response to a change in an explicit input does not necessarily need to reflect the whole effect that the variable would have had on the fair value of a fixed-for-fixed forward or option on equity shares. If, however, a contract contains a feature (such as a leverage factor) that results in greater exposure to an input (other than the reporting entity’s stock price) than the exposure to the input in the pricing (fair value measurement) of a fixed-for-fixed forward or option on equity shares, the contract is considered not indexed to the reporting entity’s stock and must be classified as an asset or a liability. Similarly, if a change in an explicit input (other than a change based solely on the reporting entity’s stock price) affects the settlement amount of the instrument in a manner inconsistent with the effect that the underlying would have on the pricing (fair value measurement) of a fixed-for-fixed forward or option on equity shares (e.g., the underlying affects the settlement amount inversely), the contract is considered not indexed to the entity’s own equity.
Thus, there are two common situations in which a change in an explicit input (other than the reporting entity’s stock price) affects the settlement amount in a manner inconsistent with the effect that a change in the input would have on the pricing (fair value measurement) of a fixed-for-fixed forward or option on equity shares:

- The underlying is leveraged (e.g., the interest rate input in a forward equity share contract is based on two times the change in LIBOR).
- The underlying affects the settlement amount inversely (e.g., the interest rate input into the pricing of a written call option is adjusted upward for a decrease in interest rates).

3. **Could a change in the explicit input (other than the reporting entity’s stock price) result in a settlement at a fixed monetary amount?**

For the contract to be considered indexed to the entity’s stock, the answer must be no. If the answer is yes, the contract does not qualify as equity irrespective of whether it meets the other conditions for equity classification.

If a change in the input (other than a change based solely on the reporting entity’s stock price) could result in a settlement amount equal to a fixed monetary amount, the contract is considered not indexed to the reporting entity’s stock. This is because the effect of the change in the underlying would result in a settlement amount that is inconsistent with such effect on the pricing (fair value measurement) of a fixed-for-fixed forward or option on equity shares. For example, an equity-linked instrument that allows the holder to purchase 1,000 shares of a reporting entity’s common stock for $10 per share, but that will be settled for $5 per share upon a specified change in an interest rate, is not indexed to the reporting entity’s stock.

### 4.3.5 Explicit Inputs: Application Issues and Examples

#### 4.3.5.1 Adjustments Based on the Entity’s Stock Price

The entity’s stock price is an explicit input used in the pricing (fair value measurement) of a fixed-for-fixed forward or option on equity shares. Similarly, the stock price of a consolidated subsidiary is a permissible input as long as the subsidiary is a substantive entity (see Section 2.6.1).

Examples 8, 13, 15, and 16 in ASC 815-40-55 illustrate that the following types of adjustments related to the entity’s stock price would not necessarily preclude a conclusion that the contract is considered indexed to the entity’s own stock:

- A cap on the stock price (Examples 8 and 15).
- A floor on the stock price (Example 15).
- The use of a weighted-average stock price over a period instead of the current stock price (Example 13).
- Variability in the number of shares used to determine the settlement amount depending on the entity’s stock price (Example 16). (Note that for such a contract, an entity should consider whether ASC 480-10 would apply instead of ASC 815-40 (see Chapter 6 of Deloitte’s *A Roadmap to Distinguishing Liabilities From Equity*).)
ASC 815-40

Example 8: Variability Involving Stock Price Cap

55-32 This Example illustrates the application of the guidance beginning in paragraph 815-40-15-5. Entity A purchases net-settled call options that permit it to buy 100 shares of its common stock for $10 per share. However, the maximum appreciation on the call options is capped when Entity A’s stock price reaches $15 per share (that is, the counterparty’s maximum obligation is $500 [($15 − $10) × 100 shares]). The call options have 10-year terms and are exercisable at any time. The call options are 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 equal the difference between the fair value of a fixed number of the entity’s equity shares (100 shares) and a fixed strike price when Entity A’s stock price is between the $10 stated exercise price and the $15 price cap. However, whenever Entity A’s stock price exceeds $15, the strike price of the call options increases and decreases in amounts equal to the corresponding increases and decreases in Entity A’s stock price, such that the intrinsic value of each call option always equals $5. Because the only variable that can affect the settlement amount is the entity’s stock price, which is an input to the fair value of a fixed-for-fixed option contract, the call options are considered indexed to the entity’s own stock.

Example 13: Variability Involving Average Stock Price

55-38 This Example illustrates the application of the guidance beginning in paragraph 815-40-15-5. Entity A enters into a net-settleable forward contract to sell 100 shares of its common stock in 1 year for an amount equal to $10 per share plus interest calculated at a variable interest rate (Federal Funds rate plus a fixed spread). The share price used to determine the settlement amount is based on the volume-weighted average daily market price of Entity A’s common stock for the 30-day period before the settlement date. The forward contract is considered indexed to Entity A’s own stock based on the following evaluation:

a. Step 1. The instrument does not contain an exercise contingency. Proceed to Step 2.

b. Step 2. The settlement amount will not equal the difference between the fair value of a fixed number of the entity’s equity shares (100 shares) and a fixed strike price. However, the only variables that cause the settlement amount to differ from a fixed-for-fixed settlement amount are the 30-day volume-weighted average daily market price of Entity A’s common stock and an interest rate index. The pricing inputs of a fixed-for-fixed forward contract include the entity’s stock price and interest rates. Additionally, the floating interest rate feature does not introduce a leverage factor or otherwise increase the effects of interest rate changes on the instrument’s fair value.

Example 15: Variability Involving Stock Price Cap and Floor

55-40 This Example illustrates the application of the guidance beginning in paragraph 815-40-15-5. Entity A enters into a net-settled forward contract to sell 100 shares of its common stock in 1 year for $1,000. However, the maximum amount payable to the counterparty at maturity is capped when Entity A’s stock price is greater than or equal to $15 per share (that is, Entity A’s maximum obligation is $500 [($15 − $10) × 100 shares]). Additionally, the maximum amount receivable from the counterparty at maturity is capped when Entity A’s stock price is less than or equal to $5 per share (that is, the counterparty’s maximum obligation is $500 [($5 − $10) × 100 shares]). The forward contract is considered indexed to Entity A’s own stock based on the following evaluation:

a. Step 1. The instrument does not contain an exercise contingency. Proceed to Step 2.

b. Step 2. The settlement amount would equal the difference between the fair value of a fixed number of the entity’s equity shares (100 shares) and a fixed strike price ($1,000) when Entity A’s stock price is between $5 and $15. However, whenever Entity A’s stock price is greater than or equal to $15 at maturity, the amount payable to the counterparty always equals $500. Additionally, whenever Entity A’s stock price is less than or equal to $5 at maturity, the amount receivable from the counterparty always equals $500. Because the only variable that can affect the settlement amount is the entity’s stock price, which is an input to the fair value of a fixed-for-fixed forward contract, the instrument is considered indexed to the entity’s own stock.
Chapter 4 — Indexation Guidance

ASC 815-40 (continued)

**Example 16: Variability Involving Cap on Shares Issued**

55-41 This Example illustrates the application of the guidance beginning in paragraph 815-40-15-5. Entity A enters into a forward contract to sell a variable number of its common shares in 1 year for $1,000. If Entity A’s stock price is equal to or less than $10 at maturity, Entity A will issue 100 shares of its common stock to the counterparty. If Entity A’s stock price is greater than $10 but equal to or less than $12 at maturity, Entity A will issue a variable number of its common shares worth $1,000. Finally, if the share price is greater than $12 at maturity, Entity A will issue 83.33 shares of its common stock. The forward contract is considered indexed to Entity A’s own stock based on the following evaluation:

a. Step 1. The instrument does not contain an exercise contingency. Proceed to Step 2.

b. Step 2. The settlement amount will not equal the difference between the fair value of a fixed number of the entity’s equity shares and a fixed strike price ($1,000). Although the strike price to be received at settlement is fixed, the number of shares to be issued to the counterparty varies based on the entity’s stock price on the settlement date. Because the only variable that can affect the settlement amount is the entity’s stock price, which is an input to the fair value of a fixed-for-fixed forward contract on equity shares, the instrument is considered indexed to the entity’s own stock.

Similarly, we believe that a contract that is settled at the maximum (or minimum) stock price over a certain period (instead of the current stock price) would not preclude equity classification. Further, we believe that a volume-weighted average price does not preclude equity classification even if it excludes trades that do not satisfy the requirements of Rule 10b-18 of the Exchange Act.

A change-in-control provision may specify that the contract will become indexed to the equity shares of the acquirer in a business combination if all the entity’s stockholders receive stock of the acquiring entity. ASC 815-40 specifically states that such a clause does not preclude a conclusion that the contract is indexed to the entity’s own stock (ASC 815-40-55-5; see Section 5.2.3.4).

**4.3.5.2 Adjustments Based on the Risk-Free Market Interest Rate**

The risk-free market interest rate (e.g., LIBOR, the federal funds rate, or the U.S. Treasury rate) is an explicit input used in the pricing (fair value measurement) of a fixed-for-fixed forward or option on equity shares. For example, if a conversion option embedded in a debt security would be settled by the exchange of a fixed number of shares for a fixed principal amount plus interest accrued at a variable market rate, the conversion option would not be precluded from classification as equity.

Examples 13 and 14 in ASC 815-40-55 illustrate the application of step 2 to variability in a contract’s settlement terms involving interest rates:

- Example 13 (reproduced in Section 4.3.5.1) illustrates a forward contract for which variability in the settlement amount based on interest rates does not preclude equity classification. In the example, the forward price adjustment is based on the federal funds rate plus a fixed spread.

- Example 14 below illustrates a forward contract for which a change in interest rates affects the settlement amount in a manner inconsistent with the effect that a change in interest rates would have on the pricing (fair value measurement) of a fixed-for-fixed forward or option on equity shares. In the example, the interest rate used to adjust the forward price is inversely related to LIBOR. Accordingly, that contract does not qualify for equity classification.
**ASC 815-40**

*Example 14: Variability Involving Interest Rate Index*

55-39 This Example illustrates the application of the guidance beginning in paragraph 815-40-15-5. Entity A enters into a forward contract to sell 100 shares of its common stock in 1 year for an amount equal to $10 per share plus interest calculated at a variable interest rate that varies inversely with changes in the London Interbank Offered Rate (LIBOR) (similar to an “inverse floater,” as described in paragraphs 815-15-55-170 through 55-172). The forward contract is not considered indexed to Entity A’s own stock based on the following evaluation:

a. Step 1. The instrument does not contain an exercise contingency. Proceed to Step 2.

b. Step 2. The settlement amount will not equal the difference between the fair value of a fixed number of the entity’s equity shares (100 shares) and a fixed strike price. Although the number of shares that would be issued at settlement is fixed, the strike price varies inversely with changes in an interest rate index. The inverse floating interest rate feature increases the effects of interest rate changes on the instrument’s fair value (that is, the feature increases the instrument’s fair value exposure to interest rate changes) when compared to the exposure to interest rate changes of a fixed-for-fixed forward contract.

4.3.5.3 Adjustments Based on Dividends

The expected dividend on equity shares is an explicit input used in the pricing (fair value measurement) of a fixed-for-fixed forward or option on those equity shares. Example 12 in ASC 815-40-55 illustrates that variability in a contract’s settlement terms based on dividends would not necessarily preclude equity classification.

**ASC 815-40**

*Example 12: Variability Involving Dividend Distributions*

55-37 This Example illustrates the application of the guidance beginning in paragraph 815-40-15-5. Entity A enters into a forward contract to sell 100 shares of its common stock for $10 per share in 1 year. Historically, Entity A has paid a dividend of $0.10 per quarter on its common shares. Under the terms of the forward contract, if dividends per common share differ from $0.10 during any 3-month period, the strike price of the forward contract will be adjusted to offset the effect of the dividend differential (actual dividend versus $0.10) on the fair value of the instrument. Additionally, the terms of the forward contract provide for an adjustment to the strike price, using commercially reasonable means, to offset the effect of any increased cost of borrowing Entity A’s shares in the stock loan market on the fair value of the instrument. The forward contract is considered indexed to Entity A’s own stock based on the following evaluation:

a. Step 1. The instrument does not contain an exercise contingency. Proceed to Step 2.

b. Step 2. The only circumstances in which the settlement amount will not equal the difference between the fair value of 100 shares and $1,000 ($10 per share) are if dividends per common share differ from $0.10 during any 3-month period or if there is an increased cost of borrowing Entity A’s shares in the stock loan market. The adjustments to the strike price resulting from those events are intended to offset their effects on the instrument’s fair value. In those circumstances, the only variables that could affect the settlement amount (dividends and stock borrow cost) would be inputs to the fair value of a fixed-for-fixed forward contract on equity shares.
Some ASR transactions have a settlement amount that is adjusted by the counterparty if the entity declares dividends with an ex-dividend date that is earlier than the expected ex-dividend date specified in the agreement. The adjustment is intended to compensate the counterparty for the lost time value of money as a result of the dividends' being declared earlier than had been anticipated and thus earlier than had been priced into the contract. Such an adjustment is similar to an adjustment for dividends, stock borrow costs (anticipated dividends factor into the cost to borrow a stock), and interest rates. Thus, we believe that the adjustment would not preclude the ASR transaction from being considered indexed to the entity's common stock, because expected dividends, stock borrow costs, and interest rates are inputs into the pricing of a fixed-for-fixed forward on equity shares.

4.3.5.4 Adjustments Based on Cost of Stock Borrow

Like risk-free market interest rates, the cost of borrowing the entity's shares in the stock loan market ("cost of stock borrow") is an explicit input used in the pricing (fair value measurement) of a fixed-for-fixed forward or option on equity shares.

The following is an example of an adjustment based on the cost of stock borrow:

If Counterparty determines, using its commercially reasonable judgment, that its actual cost of borrowing a number of Shares equal to the Base Shares to hedge its exposure to the Transaction exceeds a weighted-average rate equal to 50 basis points per annum, over any consecutive 30-day period, then, at Company's election, either (A) Calculation Agent will reduce Forward Price to compensate Counterparty for the amount by which such cost exceeded a weighted-average rate equal to 50 basis points per annum during that period or (B) Borrow Cost Threshold will be reduced to 50 basis points per annum after that period.

Example 12 in ASC 815-40-55 (reproduced in Section 4.3.5.3) illustrates that variability in a contract's settlement terms based on the cost of stock borrow would not necessarily preclude equity classification.

4.3.5.4A Adjustments Based on Stock Price Volatility

As noted in ASC 815-40-15-7E, volatility is an explicit input in a standard pricing model. Upon an early settlement, some option contracts on an entity's own equity require the entity to calculate the settlement amount by applying a standard option pricing model (such as the Black-Scholes option pricing model) that uses market-based explicit inputs that are current as of the settlement date, except that the volatility input is prespecified (e.g., a fixed 20 percent volatility assumption). Such prespecified volatility assumptions will generally not be consistent with the volatility assumption in the pricing of a fixed-for-fixed option on equity shares. For example, the 2002 ISDA Equity Derivatives Definitions refer to the use of "implied volatility" (as opposed to, e.g., historical volatility) in the determination of the amount paid upon early settlement of an option contract. Implied volatility is expected to change over time. A prespecified volatility will generally not be consistent with implied volatility or another volatility assumption that a market participant would use to estimate the fair value of an option on equity shares. There is a limited exception, however, for a prespecified volatility assumption that would be used in a Black-Scholes option pricing model, or other appropriate option pricing model, to calculate the settlement amount upon an early settlement of an option contract. Such an assumption may not preclude the contract from being considered indexed to the entity's own equity if the volatility input is prespecified solely to ensure that the settlement amount is not adjusted for the volatility assumption that was used in the initial pricing of the contract. Said differently, the settlement amount is determined on the basis of an assumption that there was no change in this particular input so that the adjustment to the settlement amount does not neutralize the monetary effect on the counterparty as a result of the occurrence of a specified event that requires the contract's early settlement. This view is consistent with the guidance in ASC 815-40-55-45 and 55-46, which suggests that a contract may be considered
indexed to an entity's own equity even if the settlement amount is determined on the basis of an assumption of no change in relevant pricing inputs other than stock price and time. However, before concluding that an early settlement amount that is calculated by using an option pricing model that incorporates a prespecified volatility assumption does not preclude an option contract from being indexed to an entity's equity shares, an entity must consider the nature of the volatility assumption used in the initial pricing of the contract to determine whether the prespecified volatility assumption is actually consistent with the volatility assumption used in the initial pricing (i.e., that volatility changes actually do not affect the settlement amount of the contract). For example, if the prespecified volatility assumption used to calculate the option price upon an early settlement is the same volatility assumption used in the initial pricing, we would expect that the volatility assumption used reflects a constant annual volatility input.

4.3.5.5 Adjustments Based on a Commodity Price

A commodity price (e.g., the price of a precious metal, crude oil, natural gas, or electricity) is not an input used in the pricing (fair value measurement) of a fixed-for-fixed forward or option on equity shares. Therefore, a contract on an entity's own equity that includes such indexation cannot be classified as equity. Example 5 in ASC 815-40-55 below illustrates this scenario.

<table>
<thead>
<tr>
<th>ASC 815-40</th>
</tr>
</thead>
<tbody>
<tr>
<td>Example 5: Variability Involving a Commodity Price</td>
</tr>
<tr>
<td>55-29 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 in exchange for one ounce of gold. The warrants have 10-year terms; however, they only become exercisable if Entity A completes an initial public offering. The warrants are not considered indexed to Entity A's own stock based on the following evaluation:</td>
</tr>
<tr>
<td>a. Step 1. The exercise contingency (that is, the initial public offering) is not an observable market or an observable index, so the evaluation of Step 1 does not preclude the warrants from being considered indexed to the entity's own stock. Proceed to Step 2.</td>
</tr>
<tr>
<td>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 (100 shares) and a fixed strike price. Although the number of shares that would be issued at settlement is fixed, the strike price varies based on the price of one ounce of gold. The price of gold is not an input to the fair value of a fixed-for-fixed option on equity shares.</td>
</tr>
</tbody>
</table>

4.3.5.6 Adjustments Based on the Entity's Revenue

An entity's revenue is not an input used in the pricing (fair value measurement) of a fixed-for-fixed forward or option on the entity's shares. Therefore, a contract on own equity that includes an adjustment of the settlement amount based on the entity's revenue cannot be classified as equity.

Note that the evaluation of underlyings based on revenue differs in step 1 and step 2 of the indexation guidance in ASC 815-40-15:

- The fact that a contract contains an exercise contingency based on the entity's revenue does not preclude equity classification under step 1 (see Section 4.2). Thus, a contract on own equity that only becomes exercisable or settleable if revenue exceeds a certain target could be classified as equity provided it meets all the other conditions for equity classification. For example, a contingent consideration arrangement that specifies that the entity will deliver 100 shares if the acquired subsidiary's revenue exceeds a specified level could qualify as equity (provided the subsidiary is a substantive entity).
• An adjustment of the settlement amount based on the entity's revenue precludes equity classification under step 2. Thus, a contract in which the strike price or the number of shares specified in the contract is adjusted based on the entity's revenue cannot be classified as equity. For example, a contingent consideration arrangement that specifies that the entity will deliver 100 shares if revenue exceeds $10 million and 150 shares if revenue exceeds $20 million does not qualify as equity, because the settlement amount is adjusted based on revenue.

Example 7 in ASC 815-40-55 below illustrates the application of step 2 to a contract with a strike price that varies depending on the entity's revenue.

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**ASC 815-40**

**Example 7: Variability Involving Revenue Target**

55-31 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 an initial price of $10 per share. The warrants have 10-year terms and are exercisable at any time. However, the terms of the warrants specify that the strike price is reduced by $0.50 after any year in which Entity A does not achieve revenues of at least $100 million. 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 (100 shares) and a fixed strike price. Although the number of shares that would be issued at settlement is fixed, the strike price would be adjusted after any year in which Entity A does not achieve revenues of at least $100 million. . . . The amount of an entity's annual revenues is not an input to the fair value of a fixed-for-fixed option on equity shares.

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**Example 4-5**

**Adjustment Based on Revenue**

An entity enters into a contingent consideration arrangement in conjunction with a business combination. The arrangement requires the entity to deliver a variable number of shares to the seller if investment management and advisory fees earned by the acquired entity exceed specified levels. The entity delivers no shares if fees are less than $50 million. The entity delivers 0 to 5,000 shares, determined by straight-line interpolation, if fees are from $50 million to $75 million. The entity delivers 5,000 shares if fees exceed $75 million.

This arrangement includes an exercise contingency (fees earned) that does not preclude the arrangement from being considered indexed to the entity's own stock under step 1. In the evaluation of step 2, however, the variability in the settlement amount based on fees earned indicates that the contract is not indexed to the reporting entity's stock and that the contract must be classified as an asset or a liability.

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**4.3.5.7 Adjustments Based on a Percentage of Equity**

Some contracts are settled on the basis of a percentage of equity. For example, a warrant may specify that the counterparty will receive a variable number of shares on the basis of a fixed percentage (e.g., 5 percent) of the fully diluted equity of the entity. Because the number of outstanding common shares does not represent an input in the valuation of a fixed-for-fixed option or forward (except in antidilution adjustments; see Section 4.3.7.1), the contract is considered not indexed to the reporting entity's stock and must be classified as an asset or a liability.
Some contracts contain a limit (cap) on the number of shares that the entity will deliver to the counterparty on the basis of a fixed percentage of the total number of the entity's outstanding shares, voting power, or the entity's fully diluted equity. Such a cap does not preclude equity classification if (1) it does not adjust the strike price or the number of shares underlying the contract but instead results in a deferral of the settlement of the contract in excess of the cap and (2) the contract contains no requirement to cash settle the shares owed in excess of the cap (see Section 5.2.2). Note, however, that equity classification would be precluded if the cap was indexed to, or contingent on, an input that was not used in the pricing of a fixed-for-fixed forward or option on equity shares (e.g., shareholder approval).

**Example 4-5A**

**Share Cap Contingent on Holder’s Beneficial Ownership**

Company X has issued a warrant contract to issue common stock to Company Y. The warrant contract specifies that Y is not entitled to take delivery of any shares owed to it under the contract if, after such receipt, it would beneficially own more than 4.9 percent of the total number of X's outstanding common shares on a fully diluted basis. This beneficial ownership cap was included in the warrant contract to avoid regulatory reporting requirements that would otherwise apply if Y owned 5 percent or more of X's common stock. If any delivery of shares owed to Y is not made as a result of this provision, X's obligation to deliver such excess shares is not extinguished. However, X has no obligation to settle the excess shares in cash but must instead deliver them if or when Y no longer beneficially owns more than 4.9 percent of the total number of outstanding common shares. Thus, Y can obtain the excess shares by selling any shares it holds before exercise and any shares it receives upon exercise. The warrant contract is not precluded from being considered indexed to the entity's own equity under ASC 815-40-15 because the cap (1) represents a permissible exercise contingency (see Section 4.2.3) and (2) does not adjust the contract's settlement amount (see Section 4.2.2.3).

A beneficial ownership cap such as the one described above would not typically prevent an equity-linked contract from being indexed to the issuer’s stock, provided that the holder has the ability to either transfer or exercise the warrant in part so that the holder would always have the ability to realize the full economics of the contract. However, if an equity-linked contract contained a beneficial ownership cap, only allowed the holder to exercise or settle the contract on a single date, did not allow the holder to transfer the instrument in part, and subjected the holder to variability on settlement depending on the stated cap (i.e., the holder would never receive the shares in excess of the cap), the instrument would not meet the conditions to be considered indexed to the issuer’s common stock because the settlement amount depends on the number of outstanding common shares of the issuer, which is not an input into the pricing of a fixed-for-fixed option or warrant on equity shares.

**Example 4-5B**

**Share Cap Contingent on Shareholder Approval**

Company X has issued a contract to issue common stock. The contract limits the number of shares that will be delivered upon settlement to 19.9 percent of the voting power or 19.9 percent of the total number of shares of common stock outstanding before the issuance. The purpose of the cap is to ensure compliance with certain stock exchange rules, which require shareholder approval for certain issuances of common stock equal to 20 percent or more of the shares of common stock or 20 percent or more of the voting power outstanding before the issuance. The contract specifies that X has no obligation to settle excess shares in cash and that the cap is automatically removed if X obtains shareholder approval to issue the excess shares. As long as the contract represents a single unit of account, it would not qualify as equity under ASC 815-40-15 because it contains an adjustment to the settlement amount that is based on shareholder approval, which is not an input into the pricing of a fixed-for-fixed forward or option on equity shares (see Section 4.3.6.2).
### 4.3.5.8 Adjustments Based on Stock Option Exercise Behavior

Stock option exercise behavior is not an input used in the pricing (fair value measurement) of a fixed-for-fixed forward or option on the entity's shares. Therefore, a contract that requires adjustments to the settlement amount on the basis of this variable cannot be classified as equity. Example 21 in ASC 815-40-55 below illustrates this scenario.

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**ASC 815-40**

**Example 21: Variability Involving Securities Issued to Establish a Market-Based Measure of Employee Stock Option Value**

55-48 This Example illustrates the application of the guidance beginning in paragraph 815-40-15-5. Entity A issues a security to investors for purposes of establishing a market-based measure of the grant-date fair value of a grant of employee stock options. Under the terms of that market-based employee stock option valuation instrument, Entity A is obligated to make variable quarterly payments to the investors that are a function of the net intrinsic value received by a pool of Entity A's employees, based on actual stock option exercises by those employees each period. The market-based employee stock option valuation instrument has a 10-year term, consistent with the contractual term of the underlying employee stock options. The market-based employee stock option valuation instrument is not considered indexed to Entity A's own stock based on the following evaluation:

a. Step 1. The analysis of the exercise contingency (or contingencies) depends on the particular terms and features of the instrument. However, as indicated in Step 2 below, a market-based employee stock option valuation instrument would not be considered indexed to the entity's own stock.

b. Step 2. The settlement amount will not equal the difference between the fair value of a fixed number of the entity's equity shares and a fixed strike price. The instrument provides for variable quarterly payments to investors that are based on actual employee stock option exercises for the period. Because a variable that affects the instrument's settlement amount is employee stock option exercise behavior, which is not an input to the fair value of a fixed-for-fixed option or forward contract on equity shares, the instrument is not considered indexed to the entity's own stock.

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**Pending Content (Transition Guidance: ASC 718-10-65-11)**

**Example 21: Variability Involving Securities Issued to Establish a Market-Based Measure of Grantee Stock Option Value**

55-48 This Example illustrates the application of the guidance beginning in paragraph 815-40-15-5A. Entity A issues a security to investors for purposes of establishing a market-based measure of the grant-date fair value of a grant of stock options issued in a share-based payment transaction. Under the terms of that market-based stock option valuation instrument, Entity A is obligated to make variable quarterly payments to the investors that are a function of the net intrinsic value received by a pool of Entity A's grantees, based on actual stock option exercises by those grantees each period. The market-based stock option valuation instrument has a 10-year term, consistent with the contractual term of the underlying stock options. The market-based stock option valuation instrument is not considered indexed to Entity A's own stock based on the following evaluation:

a. Step 1. The analysis of the exercise contingency (or contingencies) depends on the particular terms and features of the instrument. However, as indicated in Step 2 below, a market-based stock option valuation instrument would not be considered indexed to the entity's own stock.

b. Step 2. The settlement amount will not equal the difference between the fair value of a fixed number of the entity's equity shares and a fixed strike price. The instrument provides for variable quarterly payments to investors that are based on actual stock option exercises for the period. Because a variable that affects the instrument's settlement amount is stock option exercise behavior, which is not an input to the fair value of a fixed-for-fixed option or forward contract on equity shares, the instrument is not considered indexed to the entity's own stock.
As discussed in **Section 2.4.3**, equity-linked contracts issued to nonemployee investors to establish a market-based measure of the grant-date fair value of stock options are within the scope of ASC 815-40 since they are not issued as compensation for goods or services. This is the case even though the contracts may refer to stock options that qualify for the scope exception for share-based payment arrangements.

### 4.3.5.9 Convertible Preferred Stock

When a convertible preferred stock instrument contains a host debt instrument, the evaluation of whether the embedded conversion option is considered indexed to the reporting entity’s stock is performed in the same manner as the evaluation of whether an embedded conversion option in a debt instrument is considered indexed to the reporting entity’s stock. ASC 815-40-15-7C indicates that “an issued share option that gives the counterparty a right to buy a fixed number of the entity's shares . . . for a fixed stated principal amount of a bond issued by the entity” is considered a fixed-for-fixed option on equity shares. An issued share option that gives the counterparty a right to buy a fixed number of the entity’s shares for a fixed stated amount of a preferred stock instrument issued by the entity would also be considered a fixed-for-fixed option on equity shares when the preferred stock host is considered a debt instrument and there are no potential adjustments to the settlement terms.

In certain situations, the number of shares issued upon conversion of a convertible preferred stock instrument varies on the basis of the amount, if any, of accrued and unpaid dividends (i.e., the conversion formula specifies that, upon conversion, the investor will receive a number of equity shares that is equal to the liquidation value of the preferred stock plus accrued and unpaid dividends divided by a fixed conversion price). When the number of shares issuable upon conversion of a convertible preferred stock instrument is affected by accrued and unpaid dividends, the monetary amount exchanged upon conversion would not be considered fixed (i.e., the exchange does not involve a fixed amount of a preferred stock instrument of the issuer in return for a fixed number of equity shares). In such cases, the entity should evaluate whether the variables that could affect the settlement amount (i.e., the accrued and unpaid dividends) would be considered an input used in the pricing (fair value measurement) of a fixed-for-fixed option on equity shares.

If the convertible preferred stock contains a host debt instrument, and the dividend is specified as a fixed coupon on the liquidation value or a variable coupon that varies on the basis of an interest rate index, this type of conversion formula would generally not preclude the embedded conversion option from being considered indexed to the reporting entity's stock under step 2. This is because fixed and variable interest rates would factor into the pricing of a fixed-for-fixed option on equity shares (see **Section 4.3.5.2**). However, the entity should consider whether the conversion formula introduces leverage or results in a fixed monetary settlement amount of the convertible preferred stock instrument (see **Section 4.3.4**).
4.3.5.10 Convertible Zero-Coupon Bond

As used in ASC 815-40-15-7C, the term “fixed stated principal amount” refers to the principal amount of the bond at its maturity. Therefore, an exchange of the issuer’s zero-coupon bond for a fixed number of the entity’s shares would qualify as a fixed stated principal amount of a bond issued by the entity. If the embedded conversion option does not contain variability in the settlement terms as a result of other terms, it would be considered a fixed-for-fixed option on equity shares and would therefore be considered indexed to the reporting entity’s stock. Otherwise, the issuer would need to evaluate other variability under step 2 of the two-step approach to conclude that the embedded conversion option was indexed to its stock.

Sometimes, the number of shares issued upon conversion of a convertible zero-coupon bond varies on the basis of the date of conversion (e.g., the conversion formula specifies that, upon conversion, the investor will receive a number of equity shares that is equal to the accreted value of the bond divided by a fixed conversion price). When the number of equity shares issuable upon conversion of a convertible zero-coupon bond is affected by accreted interest on the zero-coupon bond, the monetary amount exchanged upon conversion would not be considered fixed (i.e., the exchange does not involve a fixed amount of a debt instrument of the issuer in return for a fixed number of equity shares). In such cases, the entity should evaluate whether the variables that could affect the settlement amount (i.e., the accreted interest) would be considered an input used in the pricing (fair value measurement) of a fixed-for-fixed option on equity shares. Since interest rates are a variable in the pricing of a fixed-for-fixed option on equity shares (see Section 4.3.5.2), this type of conversion formula generally does not preclude the embedded conversion option from being considered indexed to the reporting entity’s stock under step 2 of the two-step approach. The effective yield on a zero-coupon bond is generally determined on the basis of risk-free interest rates and the issuer’s credit spread. The influence of the issuer’s credit spread on the effective yield does not invalidate this conclusion since the issuer’s credit spread is considered an input into the pricing (fair value measurement) of a fixed-for-fixed option embedded in a convertible instrument. However, the entity should consider whether the conversion formula introduces leverage or results in a fixed monetary settlement amount of the zero-coupon convertible bond (see Section 4.3.4).

4.3.5.11 Own-Share Lending Arrangements

For a share-lending arrangement on the entity’s own shares to be considered indexed to its own equity under ASC 815-40, any variables affecting the settlement amount of the share-lending arrangement should be inputs to the fair value (pricing) of a fixed-for-fixed forward or option on the entity’s equity shares. The variables that typically affect the fair value of a share-lending arrangement include the contractual processing fee, the market rate of borrowing the entity’s shares during the arrangement’s term, and the share borrower’s nonperformance risk. Such variables do not preclude a conclusion that the contract is indexed to the issuer’s own equity under ASC 815-40-15. If a share-lending arrangement contains other variables that affect the settlement amount, however, an entity should evaluate those variables to determine whether they preclude a conclusion that the contract is indexed to the issuer’s own equity shares. For example, a share-lending arrangement in contemplation of a settlement amount that is indexed to the S&P 500 Index or the price of gold does not qualify for equity classification. ASC 470-20 provides recognition, measurement, EPS, and disclosure guidance related to an issuer’s accounting for equity-classified share-lending arrangements on its own shares for those that are executed in contemplation of a convertible debt issuance (see Section 2.9).
4.3.6 Evaluating Implicit Inputs

4.3.6.1 Overview

ASC 815-40

15-7G Standard pricing models for equity-linked financial instruments contain certain implicit assumptions. One such assumption is that the stock price exposure inherent in those instruments can be hedged by entering into an offsetting position in the underlying equity shares. For example, the Black-Scholes-Merton option-pricing model assumes that the underlying shares can be sold short without transaction costs and that stock price changes will be continuous. Accordingly, for purposes of applying Step 2, fair value inputs include adjustments to neutralize the effects of events that can cause stock price discontinuities. For example, a merger announcement may cause an immediate jump (up or down) in the price of shares underlying an equity-linked option contract. A holder of that instrument would not be able to continuously adjust its hedge position in the underlying shares due to the discontinuous stock price change. As a result, changes in the fair value of an equity-linked instrument and changes in the fair value of an offsetting hedge position in the underlying shares will differ, creating a gain or loss for the instrument holder as a result of the merger announcement. Therefore, inclusion of provisions that adjust the terms of the instrument to offset the net gain or loss resulting from a merger announcement or similar event do not preclude an equity-linked instrument (or embedded feature) from being considered indexed to an entity’s own stock.

In the pricing of a contract under standard valuation models (e.g., the Black-Scholes-Merton option pricing model), certain assumptions are implicit. Some contracts permit adjustments to the settlement terms when such implicit assumptions are invalidated. For example, the pricing of a contract may assume that no dilutive event will occur. If such an event occurs (e.g., a dilutive event) and is inconsistent with an implicit assumption in the valuation model (e.g., no dilutive events will occur), an adjustment to the contract’s settlement terms (e.g., an antidilution adjustment) does not necessarily preclude the contract from being considered indexed to the reporting entity’s stock. However, if the settlement provisions are adjusted because of the occurrence or nonoccurrence of a specified event that does not invalidate an implicit assumption in a standard valuation model (e.g., the issuance of additional equity shares at a price equal to their fair value), the instrument is considered not indexed to the reporting entity’s stock.

Below are examples of implicit assumptions that may be contained in a standard valuation model used to determine the fair value of a fixed-for-fixed forward or option on equity shares. A neutralizing adjustment to the settlement amount in response to the invalidation of such an assumption would not preclude a conclusion that the contract is indexed to the entity’s own equity:

- **The investor is able to maintain a standard hedge position in the equity shares underlying the instrument (e.g., the shares underlying a forward or option on equity shares can be sold short without transaction costs)** — When an investor incurs transaction costs to sell shares short, has a loss of stock borrow, or is unable to maintain a standard hedge position (i.e., a hedging disruption event occurs, as further discussed below), an implicit assumption in standard valuation models is invalidated. Therefore, an adjustment to the settlement amount does not necessarily preclude the instrument from being considered indexed to the reporting entity’s stock.
• **Stock price changes will be continual** — Stock price discontinuities invalidate an implicit assumption to the extent that they result in a hedging disruption event. Occurrences that may cause a stock price discontinuity resulting in a hedging disruption event include:
  - A merger event or change in control involving an issuer (see Section 4.3.7.5).
  - A tender offer for an issuer's shares.
  - A termination of trading of an issuer's shares (e.g., a delisting).
  - A governmental or political event.
  - A natural disaster.

• **Dilutive events will not occur** (or, if they occur, the terms of the instruments will be adjusted solely to offset the effects of the dilutive events) — In standard valuation models, it is assumed that dilutive events will not occur (see Section 4.3.7.1). Dilutive events may include:
  - A stock split, subdivision, combination, reclassification, or recapitalization.
  - A stock dividend or distribution by an issuer.
  - A rights offering by an issuer.
  - An offering of additional common stock or equity-linked securities by an issuer at a price that is less than fair value (i.e., the current quoted market price for a public issuer).
  - A repurchase of common stock by an issuer at a price that is more than fair value (i.e., the current quoted market price for a public issuer).
  - A tender offer by an issuer at other than fair value of the issuer's stock (i.e., the current quoted market price for a public issuer).
  - A distribution by an issuer to all common shareholders of securities other than common stock, evidence of indebtedness, warrants, or other assets or property of the issuer.

• **The counterparty in a gain position will be paid the monetary value it is due upon settlement regardless of the form of settlement (i.e., cash, shares, or other assets)** — When the counterparty in a gain position is not paid the entire monetary value due upon settlement, an implicit assumption in standard valuation models is invalidated. In this case, an adjustment to the settlement amount does not necessarily preclude the instrument from being considered indexed to the reporting entity's stock. Implicit assumptions about the settlement amount may include the following:
  - If settlement of an equity-linked instrument is in shares instead of cash, the party receiving the shares will not incur transaction costs to dispose of those shares (see Section 4.3.7.6).
  - If an equity-linked instrument is issued by a public company, the fair value of the shares underlying the instrument is based on the quoted market price of the issuer's shares (i.e., shares that are registered for resale and listed on a stock exchange; see Sections 4.3.7.7 and 4.3.7.8).

• **The holder of an equity-linked instrument will be able to participate in any extraordinary distribution of cash or noncash consideration or other similar event that is provided to all holders of the issuer's common stock** — This is most commonly associated with a tender offer provision in which all holders of common stock are entitled to receive consideration associated with the offer. Certain tender offers for an entity's shares may be made by a third party. While a tender offer made by a third party is not considered a dilutive event (because the offer does not involve the issuer), if such an offer is available to all holders of the issuer's common stock (contractually or by law), an adjustment to the settlement terms solely to reflect a pro rata participation in the tender offer would not preclude the instrument from being considered indexed to the reporting entity's stock.
• The holder of an equity-linked instrument will be able to realize the remaining time value inherent in the instrument — The occurrence of certain events involving the issuer (e.g., a liquidation or change of control) may invalidate this implicit assumption. In this case, an adjustment to the settlement amount would not necessarily preclude the instrument from being considered indexed to the reporting entity's stock (see Section 4.3.7.10 for an example). That is, a provision that requires an appropriate adjustment to the settlement amount in the event of an early settlement of the instrument does not preclude the instrument from being considered indexed to the reporting entity's stock. Such adjustments are intended to compensate the counterparty for the "lost" time value upon such early settlements. They would not necessarily preclude the equity-linked instrument from being considered indexed to the reporting entity's stock, even though the fair value of the instrument under ASC 820 (based on a market participant's view of a similar instrument without such an adjustment provision) may not include any remaining time value because the specified event truncates any remaining time value in the instrument.

Below are examples of adjustments to the settlement amount that may not be associated with the invalidation of an implicit assumption in a standard valuation model. Such adjustments indicate that the contract is not indexed to the entity's own equity and thus cannot be classified as equity:

• An adjustment to protect the counterparty from the effect of a specified event on the stock price (e.g., a provision that results in settlement by using a stock price input that does not reflect the effect of the specified event on the fair value of the issuer's shares). An adjustment that protects the counterparty from adverse changes in the issuer's stock price (which is not permissible) differs from an adjustment that neutralizes the effect that a specified event would have on the remaining time value in an equity-linked instrument (which may be permissible).

• Before an entity's adoption of ASU 2017-11, an adjustment upon the offering of additional common shares or other equity-linked instruments at fair value, including a subsequent at-market offering of common stock or other equity-linked instruments at a price lower than the exercise price in an outstanding instrument (this is sometimes referred to as down-round protection; see Section 4.3.7.2).

• An adjustment upon the occurrence or nonoccurrence of an IPO (unless, after an entity's adoption of ASU 2017-11, the adjustment provision meets the definition of a down-round feature; see Section 4.3.7.4).

• An adjustment upon a change in the number of authorized and unissued common shares of an issuer.

• An adjustment upon a change in the number of outstanding common shares of an issuer that occurs as a result of a specified event other than a dilutive event.

• An adjustment under a provision that requires shareholder approval.

• An adjustment upon the bankruptcy or insolvency of the issuer unless the event results in a hedging disruption.

• An adjustment upon the delisting of the issuer's stock unless the event results in a hedging disruption.
### 4.3.6.2 Evaluating Adjustments Based on an Implicit Input

A reporting entity considers the three questions below when evaluating whether adjustments to the settlement provisions based on an implicit input preclude a contract (or embedded feature) from being considered indexed to its own stock. The entity evaluates each implicit input separately. These considerations are relevant regardless of whether the implicit input (1) affects the exercise price or forward price of the instrument or the number of equity shares used to calculate the settlement amount or (2) results in an immediate settlement of the instrument at an adjusted settlement amount:

1. **Does the adjustment to the settlement provisions result from the occurrence or nonoccurrence of a specified event that invalidates an implicit assumption used in the pricing (fair value measurement) of a fixed-for-fixed forward or option on equity shares?**

For the contract to be considered indexed to the entity's stock, the answer must be yes. If the answer is no, the contract does not qualify as equity irrespective of whether it meets the other conditions for equity classification.

A contract does not qualify as equity if its terms include an adjustment in response to the occurrence or nonoccurrence of a specified event unless the occurrence or nonoccurrence of the event is inconsistent with an implicit assumption in a standard valuation model used to determine the fair value of a fixed-for-fixed forward or option on equity shares.

The table below gives examples of events in response to which adjustments to the settlement amount may or may not preclude equity classification.

<table>
<thead>
<tr>
<th>Permissible (Equity Classification Not Precluded)</th>
<th>Not Permissible (Equity Classification Precluded)</th>
</tr>
</thead>
<tbody>
<tr>
<td>• The counterparty is unable to maintain a standard hedge position in the underlying shares (e.g., loss of stock borrow).</td>
<td>• Before an entity's adoption of ASU 2017-11, the entity offers additional common shares or other equity-linked instruments at fair value (e.g., a down-round protection feature; see Section 4.3.7.2).</td>
</tr>
<tr>
<td>• The counterparty experiences a hedge disruption event because of discontinuities in the price of the underlying shares (e.g., as a result of a merger event or change in control, tender offer, termination of trading, governmental or political event, or natural disaster; see Section 4.3.7.5).</td>
<td>• Occurrence or nonoccurrence of an IPO (unless, after an entity's adoption of ASU 2017-11, the adjustment provision meets the definition of a down-round feature; see Section 4.3.7.4).</td>
</tr>
<tr>
<td>• Dilutive events affecting the underlying shares (e.g., a stock split, subdivision, combination, reclassification, or recapitalization; see Section 4.3.7.1).</td>
<td>• A change in the entity's number of authorized and unissued common shares.</td>
</tr>
<tr>
<td>• The counterparty in a gain position does not receive the full monetary value it is due upon settlement depending on the form of settlement (e.g., as a result of transaction costs related to the disposition of shares received or a discount in the value of unregistered shares; see Sections 4.3.7.6, 4.3.7.7, and 4.3.7.8).</td>
<td>• A change in the number of outstanding common shares that occurs as a result of a specified event other than a dilutive event.</td>
</tr>
<tr>
<td>• The counterparty is unable to participate in any extraordinary distribution of cash or noncash consideration or other similar event in which all holders of underlying shares may participate (e.g., a tender offer made by a third party).</td>
<td>• A provision that requires shareholder approval.</td>
</tr>
<tr>
<td>• The counterparty is not able to realize the remaining time value inherent in the contract (i.e., loss of time value upon early settlement; see Section 4.3.7.10).</td>
<td>• The entity's bankruptcy or insolvency (unless the event results in a hedging disruption).</td>
</tr>
<tr>
<td>• Delisting of the underlying shares (unless the event results in a hedging disruption).</td>
<td></td>
</tr>
</tbody>
</table>
2. **Is the adjustment to the settlement terms consistent with the effect that the occurrence or nonoccurrence of the specified event had on the fair value of the instrument (i.e., does the adjustment offset — at least partially — the net gain or loss on the instrument that occurs as a result of the specified event)?**

For the contract to be considered indexed to the entity's stock, the answer must be yes. If the answer is no, the contract does not qualify as equity irrespective of whether it meets the other conditions for equity classification.

A contract does not qualify as equity if the contract terms include an adjustment in response to the occurrence or nonoccurrence of a specified event that is inconsistent with an implicit assumption in a standard valuation model unless the adjustment is consistent with the effect that the occurrence or nonoccurrence of the specified event has on the fair value of the instrument. Thus, adjustments to neutralize or partially offset the effects of events that invalidate an implicit assumption in a valuation model do not preclude a contract from being considered indexed to the reporting entity's stock (i.e., such adjustments do not preclude equity classification for the contract). In this context, “neutralize” means that the calculation of the adjustment to the settlement terms of the equity-linked instrument appropriately offsets the net gain or loss on the instrument that occurred as a result of the specified event.

Adjustments from implicit inputs do not necessarily have to result in a complete neutralization of the effect that the occurrence or nonoccurrence of a specified event has on the fair value of an equity-linked instrument (i.e., the net gain or loss on the instrument that occurs as a result of the specified event). However, an adjustment to the terms of an instrument to reflect more than 100 percent of the effect that the variable has on the fair value of a fixed-for-fixed forward or option on equity shares precludes an instrument from being indexed to the reporting entity's stock because the additional exposure is inconsistent with a fixed-for-fixed forward or option on equity shares.

Note that a contract may be considered indexed to the reporting entity's stock even if no adjustments are made upon the occurrence or nonoccurrence of an event that invalidates an implicit assumption. In a fixed-for-fixed forward or option on equity shares, no adjustments are made upon the occurrence of an event that is inconsistent with any of the implicit assumptions. Instead, the counterparty to the instrument is exposed to the risk of a change in the fair value of the instrument upon the occurrence or nonoccurrence of such events. Further, a contract may be considered indexed to the reporting entity's stock even if an adjustment upon the occurrence or nonoccurrence of an event that invalidates an implicit assumption only partially offsets the effect of the specified event.

For a contract to qualify as equity, the entity's adjustment cannot compensate the counterparty for adverse changes in the entity's share price that are not attributable to the effect of the specified event. This is because such an adjustment could “protect” the counterparty from an adverse price change that results from events other than an event that invalidates an implicit assumption. Similarly, an adjustment based on the difference between the pre-event share price and the post-event share price generally would preclude equity classification because the share price could have changed for reasons other than the event itself (ASC 815-40-55-42). The principle is that an adjustment should be designed to capture only the theoretical effect of the event that invalidates an implicit assumption (e.g., a dilutive event).
A settlement of an equity-linked instrument at its fair value as of the settlement date (i.e., that reflects the effect of a specified event) is not considered to have been affected by an implicit input because no additional value is exchanged between the counterparties (i.e., no adjustment is made for the net gain or loss resulting from the invalidation of an implicit input). However, when the settlement amount does not reflect fair value (e.g., the settlement amount will be adjusted to reflect the net gain or loss resulting from the occurrence of a specified event), the reporting entity must perform an additional evaluation to determine whether the equity-linked instrument is indexed to its stock.

Further, as discussed in the example below, an entity must determine the adjustment by using commercially reasonable means.

Example 4-6

Use of Commercially Reasonable Means to Determine Adjustment

Assume a contract provision adjusts the settlement terms to offset the net gain or loss that results from a discontinuous stock price change that causes a hedge disruption event. The adjustment is calculated on the basis of the difference between the change in fair value of the equity-linked instrument and the change in fair value of an offsetting delta-neutral hedge position that is determined by using commercially reasonable means. The provision, which does not protect the counterparty from a mere adverse change in stock price, does not preclude the equity-linked instrument from being considered indexed to the reporting entity's own stock because an implicit assumption used in the pricing (fair value measurement) of a fixed-for-fixed forward or option on equity shares is that a counterparty is able to maintain a delta-neutral hedge. The contract is not considered indexed to the entity's stock, however, if the adjustment is based on the counterparty's actual offsetting hedge position and the counterparty is not required to maintain a delta-neutral hedge position. This is because if the entity calculates an adjustment on the basis of the counterparty's actual hedging position, the adjustment is not considered to have been made in a commercially reasonable manner if there is any possibility that the counterparty's actual hedging position could differ from a delta-neutral hedging position.

Example 4-7

Assessment of Adjustment for Lost Time Value

There is an implicit assumption in the pricing (fair value measurement) of a fixed-for-fixed forward or option on equity shares that the holder of the contract will be able to realize the remaining time value inherent in the instrument. If certain events were to occur that would require early settlement of an equity-linked option contract, the holder would lose any remaining time value in the option. A provision that results in an adjustment to the exercise price of an option contract to reflect a settlement on the basis of the “theoretical value” of the contract (calculated on the basis of the remaining time to expiration as of the date of the specified event and the stock price of the issuer on the date of the occurrence of the specified event) does not preclude the instrument from being considered indexed to the reporting entity's stock. The adjustment provision is considered to appropriately compensate the counterparty for the lost time value that results from the occurrence of a specified event that invalidates an implicit assumption in the pricing of the option contract. It does not adjust the settlement terms to protect the counterparty against a potential adverse change in the issuer's stock price.
3. Could a change in an implicit input result in a settlement at a fixed monetary amount?

For the contract to be considered indexed to the entity's stock, the answer must be no. If the answer is yes, the contract does not qualify as equity irrespective of whether it meets the other conditions for equity classification.

If a change in an implicit input can result in a settlement based on a fixed monetary amount, the equity-linked instrument is not indexed to the reporting entity's stock (see Section 4.3.7.11 for an example). This is because the occurrence of the specified event would result in a settlement amount that would be inconsistent with the effect that the event would have had on the fair value of a fixed-for-fixed forward or option on equity shares.

Example 4-8

Fixed Monetary Settlement

A warrant allows the holder to purchase 1,000 shares of an entity's common stock for $10 per share. However, if there is a change of control of the issuer, the holder can require the entity to redeem the warrant for $20,000. The instrument is not indexed to the reporting entity's stock because of the potential for a fixed monetary settlement.

4.3.7 Implicit Inputs: Application Issues and Examples

4.3.7.1 Antidilution Adjustments

As discussed in Section 4.3.6, there is an implicit assumption in the pricing (fair value measurement) of a fixed-for-fixed forward or option on equity shares that dilutive events will not occur (or, if they occur, that the terms of the instrument will be adjusted solely to offset the effect of the dilutive events). When, therefore, an equity-linked instrument contains adjustments upon the occurrence of a dilutive event and the adjustments always result in the same intrinsic value for the equity-linked instrument both before and after the dilutive events, the adjustments do not preclude the instrument from being considered indexed to the reporting entity's stock. That is, if an adjustment is designed to offset or neutralize the effect of the dilutive event on the holder of the contract, it does not preclude equity classification.

Examples of such adjustments include those designed to offset or neutralize the effect of the following:

- The entity effects a share split or share combination.
- The entity issues shares of common stock as a dividend or distribution on all or substantially all shares of common stock.
- The entity issues to all or substantially all holders of common stock any rights, options, or warrants entitling them to subscribe for or purchase shares of common stock at a price per share that is less than the currently quoted sales price or fair value of such shares.
- The entity distributes to all or substantially all holders of its common stock (1) shares of its capital stock, evidence of indebtedness, other assets, or its property or (2) rights, options, or warrants to acquire its capital stock or other securities.
- The entity pays any cash dividend or distribution to all or substantially all holders of its common stock.
- The entity, or any of its subsidiaries, makes a payment on a tender offer or exchange offer for the entity's common stock to the extent that the cash and value of any other consideration included in the payment per share of common stock exceeds the currently quoted sales price or fair value of such shares.
- The entity repurchases shares of common stock at a price that exceeds the currently quoted sales price or fair value of such shares.
Antidilution Adjustments

Entity Y issues freestanding warrants that allow the holder to purchase 1,000 shares of Y's common stock for the present value of $10 per share any time before the warrants' expiration date. The exercise price and number of shares underlying the warrants are adjusted (1) upon a change in the risk-free interest rate (to reflect the change in the present value resulting from the change in the rate) and (2) if Y undertakes a stock split (the adjustment solely offsets the dilution caused by the stock split). In this case, the warrants are not fixed for fixed because the settlement amount will not always equal the difference between the fair value of a fixed number of equity shares and a fixed exercise price. However, the warrants are still considered indexed to Y's stock because (1) the risk-free interest rate is an explicit input used in the pricing (fair value measurement) of a fixed-for-fixed option on equity shares and there is no feature (such as a leverage factor) that increases exposure to that input in a manner that is inconsistent with a fixed-for-fixed option on equity shares and (2) an implicit assumption used in the pricing (fair value measurement) of a fixed-for-fixed option on equity shares is that a stock split will not occur (or that the exercise price and number of shares underlying the warrants will be adjusted to offset the dilution caused by the stock split).

Example 17 in ASC 815-40-55 below illustrates adjustments to offset the effect of dilutive events.

ASC 815-40

Example 17: Variability Involving Various Underlyings

55-42 This Example illustrates the application of the guidance beginning in paragraph 815-40-15-5. Entity A enters into a forward contract to sell 100 shares of its common stock for $10 per share in 1 year. Under the terms of the forward contract, the strike price of the forward contract would be adjusted to offset the resulting dilution (except for issuances and repurchases that occur upon settlement of outstanding option or forward contracts on equity shares) if Entity A does any of the following:

- Distributes a stock dividend or ordinary cash dividend
- Executes a stock split, spinoff, rights offering, or recapitalization through a large, nonrecurring cash dividend
- Issues shares for an amount below the then-current market price
- Repurchases shares for an amount above the then-current market price.

The contractual terms that adjust the forward contract's strike price are eliminating the dilution to the forward contract counterparty that would otherwise result from the occurrence of those specified dilutive events. The adjustment to the strike price of the forward contract is based on a mathematical calculation that determines the direct effect that the occurrence of such dilutive events should have on the price of the underlying shares; it does not adjust for the actual change in the market price of the underlying shares upon the occurrence of those events, which may increase or decrease for other reasons.

55-43 The forward contract is considered indexed to Entity A's own stock based on the following evaluation:

- Step 1. The instrument does not contain an exercise contingency. Proceed to Step 2.
- Step 2. The only circumstances in which the settlement amount will not equal the difference between the fair value of 100 shares and $1,000 ($10 per share) are upon the occurrence of any of the following:
  1. The distribution of a stock dividend or ordinary cash dividend
  2. The execution of a stock split, spinoff, rights offering, or recapitalization through a large, nonrecurring cash dividend
  3. The issuance of shares for an amount below the then-current market price
  4. The repurchase of shares for an amount above the then-current market price.

An implicit assumption in standard pricing models for equity-linked financial instruments is that such events will not occur (or that the strike price of the instrument will be adjusted to offset the dilution caused by such events). Therefore, the only variables that could affect the settlement amount in this example would be inputs to the fair value of a fixed-for-fixed option on equity shares.
Questions are often raised regarding how transaction costs should be treated in the determination of whether an adjustment arising from a dilutive event precludes an instrument from being considered indexed to the reporting entity's stock. For example, a provision may result in an adjustment to the settlement terms of an equity-linked instrument if an issuer sells additional common shares at less than fair value. The adjustment may be calculated on the basis of the difference between the actual number of common shares issued and the number of common shares that could have been purchased at the current quoted market price with the net proceeds (including transaction costs) received in the issuance. Alternatively, the adjustment may be calculated on the basis of the difference between the actual number of common shares issued and the number of common shares that could have been purchased at the current quoted market price with the gross proceeds (excluding transaction costs) received in the issuance.

We believe that whether transaction costs are included in, or excluded from, the calculation of adjustments from dilutive events should generally not affect the assessment of whether the equity-linked instrument is considered indexed to the reporting entity's stock. Transaction costs incurred by an issuer may affect the post-event fair value of the issuer's shares and thus could be included in a dilutive-type adjustment. Such costs could also be excluded because the exclusion results in an adjustment that does not fully neutralize the effect of the dilutive event and does not otherwise create leverage.

4.3.7.2 Down-Round Protection

A down-round feature (also known as price protection or a ratchet feature) is a term in an equity-linked financial instrument (e.g., a freestanding warrant contract or an equity conversion feature embedded within a host debt or equity contract) that triggers a downward adjustment to the instrument's strike price (or conversion price) if equity shares are issued at a lower price (or equity-linked financial instruments are issued at a lower strike price) than the instrument's then-current strike price. The purpose of the feature is to protect the instrument's counterparty from future issuances of equity shares at a more favorable price. For example, a warrant may specify that the strike price is the lower of $5 per share or the common stock offering price in any future offering of the shares. Similarly, a debt instrument may include an embedded conversion feature whose conversion price is the lower of $5 per share or the future offering price. Such provisions are frequently included in warrants, convertible shares, and convertible debt issued by private entities and development-stage companies.
Economically, a down-round-provision is different from an antidilution feature. An antidilution feature may be designed to adjust the terms of a contract in such a way that the holder is not worse off because of a dilutive event (e.g., stock split). As a result of the adjustment, the holder is protected against the effect of the dilutive event but is not in an economically better position than it was before the event. The holder of a down-round feature, however, can obtain equity shares at a more favorable price than before the event, giving it an advantage relative to existing holders of the underlying shares. The issuance of new equity shares is not dilutive to existing investors if the new investors pay fair value for the shares.

The FASB's definition of a down-round feature (as added by ASU 2017-11) does not explicitly refer to a down-round adjustment effected through an increase in the number of shares issuable under the contract instead of, or in addition to, a reduction of the strike price for an issuer that sells shares at a lower price or issues an equity-linked financial instrument with a lower strike price. On the basis of informal discussions with the SEC staff, however, we believe that it is acceptable to evaluate such an adjustment as a down-round feature if it economically achieves the same outcome as a down-round feature. For instance, if a contract specified an economically proportional increase to the number of shares issuable, the same economic outcome might be achieved. Alternatively, the same economic outcome might be achieved through a combination of a strike price reduction and an increase in the number of shares issuable. However, an adjustment effected through an increase in the number of shares issuable under the contract should not be evaluated as a down-round feature if it potentially could result in the transfer of more value than would be possible through a reduction in the strike price. In particular, the value of shares transferred could not exceed the value that would be transferred if the strike price were zero, because the strike price cannot be reduced to a negative amount. Further, an adjustment indexed to the number of outstanding shares (e.g., an adjustment based on a percentage of equity; see Section 4.3.5.7) would not meet the definition of a down-round feature.

We believe that to meet the FASB's definition of a down-round feature (as added by ASU 2017-11), the feature should not protect the holder against changes in inputs other than those directly related to the issuer's subsequent (1) issuance of any equity shares at a lower stock price or (2) issuance or repricing of any equity-linked financial instruments at a lower strike price. For example, a feature would not meet the definition of a down-round feature if it specifies that a substantively identical adjustment must be made to the contract's terms if the terms of any new convertible instrument issued by the entity are more favorable to the holder (e.g., a more favorable conversion rate, interest rate, or other term), because it could protect the holder against adverse changes in interest rates or other inputs unrelated to the types of adjustments that are contemplated by the definition of a down-round feature.

A financial instrument may contain a feature that requires a reduction to its strike price if the issuer subsequently modifies the terms of any other outstanding financial instrument so that its strike price is below that of the instrument with the feature. Although such a feature might be triggered even if the issuer has not issued any new financial instruments, we believe that it is acceptable to evaluate the feature as a down-round feature under ASC 815-40 since an instrument has come into existence whose strike price is below the currently stated strike price of the instrument with the feature. Conversely, we believe that a feature that requires a reduction in an instrument's strike price if a subsequent estimate of a share's value is below the instrument's current strike price would not meet the definition of a down-round feature because that definition does not contemplate adjustments to the strike price that are not triggered by the creation of an instrument with more favorable terms.

ASU 2017-11 amends the requirements in ASC 815-40-15 governing the evaluation of down-round features.
4.3.7.2.1 Analysis Before an Entity's Adoption of ASU 2017-11

Before an issuer adopts ASU 2017-11, a contract (or embedded equity conversion feature) that contains a down-round provision does not qualify as equity because such an arrangement precludes a conclusion that the contract is indexed to the entity's own stock under ASC 815-40-15 (as illustrated in ASC 815-40-55-33 and 55-34). A contract cannot be considered indexed to an entity's own equity under ASC 815-40-15 unless the only variables that could affect the settlement amount are inputs into the pricing of a fixed-for-fixed option or forward on the entity's equity shares (i.e., a contract whose settlement amount equals the difference between the fair value of a fixed number of the entity's equity shares and a fixed monetary amount or a fixed amount of a debt instrument). Neither the issuance of new equity securities at the current market price nor the issuance of an equity-linked financial instrument with a lower strike price than a previously issued instrument, however, is an input into the pricing of a fixed-for-fixed option or forward on equity shares.

At the 2008 AICPA Conference on Current SEC and PCAOB Developments, SEC Professional Accounting Fellow Adam Brown stressed the importance of properly evaluating down-round-protection features:

Instead of sharing views, my aim in this section is to alert registrants that issue call options — whether embedded in other instruments or freestanding — to a potential sleeper issue. . . . [ASC 815-40] contains 20 examples illustrating its application. In particular, [Example 9] addresses an exercise price reset feature that's common in many arrangements. It describes warrants that permit the holder to buy 100 shares of common stock for $10 per share, exercisable at any point for 10 years. However, the terms of the warrants specify that (a) if the company sells shares of its common stock for an amount less than $10 each, the strike price of the warrants is reduced to equal the issuance price of those shares, and (b) if the company issues an equity linked financial instrument with a strike price below $10, the strike price of the warrants is also reduced accordingly. Example [9] concludes that because of the reset feature, these warrants are not considered indexed to the company's own stock. Therefore, the warrants should be adjusted to fair value each period through earnings.

Example 9 in ASC 815-40-55 below illustrates how adjustments to a contract's settlement terms under a down-round-protection feature preclude equity classification before an entity's adoption of ASU 2017-11.

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**ASC 815-40**

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

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

- a. If the entity sells shares of its common stock for an amount less than $10 per share, the strike price of the warrants is reduced to equal the issuance price of those shares.
- b. If the entity issues an equity-linked financial instrument with a strike price below $10 per share, the strike price of the warrants is reduced to equal the strike price of the newly issued equity-linked financial instrument.

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

- 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.
After an entity adopts ASU 2017-11, a contractual provision that meets the FASB’s definition of a down-round feature does not affect the entity’s analysis of whether the related instrument or feature is indexed to the entity’s own stock under Step 2 of ASC 815-40-15. That is, the down-round feature does not preclude the entity from concluding that the instrument or feature that includes the down-round feature is indexed to the entity’s own stock.

For example, an entity’s evaluation of whether it is required to classify a freestanding warrant that gives the counterparty the right to acquire the entity’s common stock as a liability or equity under ASC 815-40 would not be affected by the existence of the down-round feature. Accordingly, if the warrant otherwise is considered indexed to the entity’s own equity under ASC 815-40-15 and meets the other condition for equity classification in ASC 815-40-25, it would be classified as equity. Similarly, in the analysis of whether an embedded conversion feature in a debt host contract must be bifurcated as an embedded derivative under ASC 815-15, the existence of a down-round provision would not prevent the contract from qualifying for the scope exception in ASC 815-10-15-74 that applies to contracts indexed to an entity’s own stock and classified in stockholders’ equity (see Section 2.2.2).

While instruments or features that contain down-round features are no longer expressly precluded from equity classification, however, such instruments or features may still not qualify for equity classification for other reasons (e.g., if the issuer could be forced to net cash settle the contract or feature; see Chapter 6).
4.3.7.2.3 Transition Related to ASU 2017-11

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| **65-4** The following represents the transition and effective date information related to Accounting Standards Update No. 2017-11, *Earnings per Share (Topic 260) and Derivatives and Hedging (Topic 815): Part I, Accounting for Certain Financial Instruments With Down Round Features*:

a. The pending content that links to this paragraph shall be effective as follows:

1. For public business entities, for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years
2. For all other entities, for fiscal years beginning after December 15, 2019, and interim periods within fiscal years beginning after December 15, 2020.

b. For all entities, early adoption of the pending content that links to this paragraph is permitted as of the beginning of an interim period for which financial statements (interim or annual) have not been issued or have not been made available for issuance.

c. An entity shall apply the pending content that links to this paragraph using one of the following methods:

1. Retrospectively to outstanding financial instruments with a down round feature 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.
2. Retrospectively to outstanding financial instruments with a down round feature for each prior reporting period presented in accordance with the guidance on accounting changes in paragraphs 250-10-45-5 through 45-10.

d. 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 method of applying the change
3. 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.

e. If the pending content that links to this paragraph is applied retrospectively in accordance with (c)(2), an entity shall provide both of the following disclosures:

1. A description of the prior-period information that has been retrospectively adjusted, if any
2. The effect of the change on income from continuing operations, net income (or other appropriate captions of changes in the applicable net assets or performance indicator), any other affected financial statement line item, and any affected per-share amounts for the current period and any prior periods retrospectively adjusted.

f. An entity that issues interim financial statements shall provide the disclosures in (d) through (e) in the financial statements of both the interim period of the change and the fiscal year of the change.

For public business entities, ASU 2017-11 is effective for annual reporting periods beginning after December 15, 2018, including interim periods within those annual reporting periods. For all other entities, the ASU is effective for annual reporting periods beginning after December 15, 2019, and interim periods within annual reporting periods beginning after December 15, 2020. Early adoption is permitted in any interim or annual period for which financial statements have not yet been issued or have not been made available for issuance.
Upon transition to ASU 2017-11, entities may elect to account for outstanding financial instruments with a down-round feature in either of the following ways:

- Recognize the cumulative effect of the change as an adjustment to the opening balance of retained earnings in the fiscal year and interim period of adoption. Paragraph BC47 of ASU 2017-17 notes that if the entity early adopts the amendments in an interim period, the adjustments should be reflected as of the beginning of the fiscal year that includes the interim period.

- Apply the amendments retrospectively for each prior reporting period presented in accordance with the guidance on accounting for changes in ASC 250-10-45-5 through 45-10.

If the classification of a freestanding financial instrument changes from liability to equity upon adoption of ASU 2017-11, the instrument is reclassified “on the basis of the proceeds received at issuance or on the basis of relative fair value, as applicable” (see paragraph BC50 of ASU 2017-11). The instrument is not reclassified on the basis of its current carrying amount as of the date of adoption.

If, before an entity’s adoption of ASU 2017-11, an embedded conversion feature was bifurcated from a convertible instrument under ASC 815-15 because of the existence of a down-round feature, and the conversion feature is no longer required to be bifurcated upon adoption of the ASU, the embedded derivative is recombined with the convertible instrument and prior gains and losses on the derivative are reversed. The instrument is not recombined on the basis of the current carrying amounts of the host instrument and the embedded derivative as of the date of adoption. Upon transition to ASU 2017-11, the entity will need to reevaluate whether to apply the guidance in ASC 470-20 on cash conversion features or beneficial conversion features (BCFs) to the conversion feature (e.g., a contingent BCF that was triggered before the ASU’s adoption). If such guidance applies, the convertible instrument is separated into liability and equity components as if the guidance in ASC 470-20 had been applied upon the instrument’s issuance or upon the trigger of the contingent BCF, as applicable.

In the period of adoption, entities must provide disclosures in accordance with ASC 250-10-50. Such disclosures should be included in the financial statements for both the interim period of the change and the fiscal year of the change.

4.3.7.3 Warrant on Convertible Preferred Stock With Down-Round Protection

[Section revised and renumbered as Section 4.3.10]

4.3.7.4 Adjustment Contingent on the Occurrence or Nonoccurrence of an IPO

The occurrence or nonoccurrence of an IPO is not an input used in the pricing (fair value measurement) of a fixed-for-fixed forward or option on the entity’s shares. Therefore, a provision that adjusts the settlement amount upon the occurrence of an IPO (e.g., adjusts to a different fixed price) indicates that the contract is not indexed to the entity’s own equity and would disqualify the contract from equity classification unless, after an entity’s adoption of ASU 2017-11, the adjustment provision meets the definition of a down-round feature. Keep in mind that to meet the definition of a down-round feature, the adjustment must be a reduction in the exercise price and can only be required if the IPO price is lower than the exercise price.
Example 4-10

Adjustment Contingent on Occurrence of an IPO

Reporting Entity X issues freestanding warrants that allow the holder to purchase 1,000 shares of X's common stock for $10 per share. The warrants are exercisable at any time for 10 years. The exercise price of the warrants is adjusted if there is an IPO of X, which is an implicit input. However, whether X has an IPO is not used in the pricing (fair value measurement) of a fixed-for-fixed option on equity shares. Therefore, the warrants are not considered indexed to X's stock and do not qualify as equity unless, after an entity's adoption of ASU 2017-11, the adjustment provision meets the definition of a down round feature (see Section 4.3.7.2).

4.3.7.5 Merger Adjustments

There is an implicit assumption in the pricing (fair value measurement) of a fixed-for-fixed forward or option on equity shares that a discontinuous stock price event will not affect the counterparty's ability to hedge the price risk inherent in the contract by using a delta-neutral strategy. If a discontinuous stock price event occurs as a result of a merger announcement, the terms of an equity-linked instrument related to the exercise price or the number of the entity's shares used to calculate the settlement amount may need to be adjusted to neutralize the effect that the discontinuous stock price event has on the counterparty's ability to maintain a delta-neutral hedging strategy. The calculation of the adjustment may be based on the difference between (1) the aggregate fair value of the contract and a standard delta-neutral hedging position immediately before the occurrence of the specified event and (2) the aggregate fair value of the contract and a standard delta-neutral hedging position immediately after the occurrence of the specified event. This results in an adjustment to the settlement terms for the effects of the hedging disruption as if the specified event had not occurred. The adjustment does not protect the counterparty from a change in stock price of the issuer as a result of a specified event. Accordingly, the adjustment does not preclude the contract from being considered indexed to the reporting entity's stock.

Example 6 in ASC 815-40-55 below illustrates these concepts.

ASC 815-40

Example 6: Variability Involving Merger Announcement

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 that if there is an announcement of a merger involving Entity A, the strike price of the warrants will be adjusted to offset the effect of the merger announcement on the net change in the fair value of the warrants and of an offsetting hedge position in the underlying shares. The strike price adjustment must be determined using commercially reasonable means based on an assumption that the counterparty has entered into a hedge position in the underlying shares to offset the share price exposure from the warrants. That strike price adjustment is not affected by the counterparty's actual hedging position (for example, the strike price adjustment does not differ in circumstances when the counterparty is over-hedged or under-hedged). The warrants are 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 equal the difference between the fair value of a fixed number of the entity's equity shares (100 shares) and a fixed strike price ($10 per share), unless there is a merger announcement. If there is a merger announcement, the settlement amount would be adjusted to offset the effect of the merger announcement on the fair value of the warrants. In that circumstance, the only variables that could affect the settlement amount would be inputs to the fair value of a fixed-for-fixed option on equity shares. For further discussion, see paragraphs 815-40-15-7E and 815-40-15-7G.
A change-in-control provision may specify that the contract will become indexed to the equity shares of the acquirer in a business combination if all the entity’s stockholders receive stock of the acquiring entity. ASC 815-40 specifically states that such a clause does not preclude a conclusion that the contract is indexed to the entity’s own stock (ASC 815-40-55-5; see Section 5.2.3.4).

4.3.7.6 Adjustments Based on the Counterparty’s Transaction Costs

There is an implicit assumption in the pricing of a fixed-for-fixed option on equity shares that the counterparty will receive the full monetary value it is due upon settlement irrespective of the form of settlement (e.g., cash or shares). This assumption does not apply if an entity elects to settle a contract in shares instead of cash, and the counterparty incurs transaction costs to dispose of those shares. Therefore, a commercially reasonable adjustment for transaction costs would not necessarily preclude equity classification. For example, some contracts include symmetrical make-whole provisions that guarantee that the proceeds will equal what a cash settlement would have been (see Sections 5.2.5 and 5.3.6).

Example 4-11

Adjustment Based on Counterparty’s Transaction Costs

An entity issues a stock purchase warrant that allows the counterparty to purchase 100,000 common shares. The issuer is allowed to settle the warrant in either cash or its common shares, at its option. The terms of the warrant also state that if the issuer elects share settlement, additional shares will be issued in an amount equal to the actual transaction costs incurred by the investor to dispose of the shares received within a reasonable period, up to a maximum of 1,000 additional common shares.

There is an implicit assumption in the pricing of a fixed-for-fixed option on equity shares that the party receiving the shares will not incur transaction costs to dispose of those shares. If the issuer elects to settle the stock purchase warrant in shares, this implicit assumption is invalidated because the investor will incur costs to dispose of such shares. The additional share delivery is intended to offset the investor’s actual transaction costs, not to exceed 1,000 additional shares.

In this example, the adjustment to the settlement terms may not fully offset the costs incurred by the investor, because it is possible that the fair value of an additional 1,000 shares is less than the actual transaction costs incurred by the investor. Nevertheless, because the adjustment is for an amount equal to or less than 100 percent of the actual transaction costs of the investor, the warrants may still be considered indexed to the issuer’s stock.

4.3.7.7 Adjustments Based on the Entity’s Inability to Deliver Registered Shares

A contract may specify that if the entity settles the contract by delivering unregistered shares (e.g., if securities laws preclude the entity from delivering registered shares), the number of unregistered shares it will deliver is greater than the number of registered shares it would otherwise have delivered. We believe that such an adjustment does not preclude equity classification if the difference is intended to account for any marketability discount applicable to the unregistered shares and the adjustment is determined by using commercially reasonable methods (see also Section 5.3.2). In this case, the value of the unregistered shares delivered is intended to approximate the value of the registered shares that would have otherwise been deliverable. For example, some contracts include symmetrical make-whole provisions that guarantee that the proceeds will equal what the value of a settlement in registered shares or cash would have been.
4.3.7.8 Adjustments to the Conversion Price of a Convertible Instrument Under a Registration Payment Arrangement

A convertible instrument may specify that the conversion price is adjusted if the issuer fails to file a registration statement for the resale of the shares underlying the contract or fails to have the registration statement declared effective by the end of a specified grace period. Such an adjustment is excluded from the scope of the guidance on registration payment arrangements in ASC 825-20 because it is related to the conversion ratio (see Section 3.2.4). Therefore, the adjustment provision is taken into account in the evaluation of the conversion feature under ASC 815-40-15.

If the adjustment compensates the holder merely for the difference between the fair value of registered and unregistered shares, the adjustment does not necessarily preclude equity classification for the conversion feature (see Section 5.3.2). If the feature compensates the holder for an amount in excess of the difference, however, the conversion feature does not qualify as equity because the adjustment is not consistent with the effect the failed registration statement has on the fair value of a fixed-for-fixed forward or option on the entity's equity shares.

4.3.7.9 Adjustments Based on a Formula or a Table

A contract may contain a formula or table that is used to calculate an adjustment to the settlement amount as a result of the occurrence or nonoccurrence of a specified event that invalidates an implicit assumption used in the pricing of a fixed-for-fixed forward or option on equity shares. The inputs into these provisions are often stock price and time. For instance, Example 19 in ASC 815-40-55 (see Section 4.3.7.10) illustrates a contractual adjustment to the settlement terms that (1) applies if the entity is acquired for cash before a specified date and (2) is defined “by reference to a table with axes of stock price and time.”

Example 4-11A

Make-Whole Table

Entity A has issued convertible notes. Each note is convertible into A's common stock at the holder's election at a conversion rate of 15 shares of common stock per $1,000 principal amount of notes. The terms of the notes specify that if a change in control, the sale of substantially all of A's assets, or another fundamental change (as defined in the terms of the notes) occurs and the holder elects to convert, A will adjust the conversion rate by increasing the number of shares that will be delivered upon conversion. The number of additional shares, if any, that will be delivered is determined by reference to the make-whole table below on the basis of (1) the effective date on which the fundamental change occurs and (2) the stock price as of that date. The adjustment to the conversion rate is designed to compensate the holder for the expected option value that the holder would lose as a result of the fundamental change. That is, the adjustment is intended to make the holder whole for the expected loss of the time value of money that would result from an early exercise of the conversion option. Accordingly, the aggregate fair value of the shares deliverable (including the make-whole shares) upon conversion is expected to approximate the fair value of the conversion option on the settlement date as long as there has been no change in relevant pricing inputs (other than stock price and time) since the instrument's inception. In no event will the conversion rate be increased to exceed 20.36 shares of common stock per $1,000 principal amount of notes.
Example 4-11A (continued)

<table>
<thead>
<tr>
<th>Effective Date</th>
<th>Stock Price</th>
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<tbody>
<tr>
<td></td>
<td>$45</td>
</tr>
<tr>
<td>March 15, 20X1</td>
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<td>5.36</td>
</tr>
<tr>
<td>March 15, 20X5</td>
<td>5.36</td>
</tr>
</tbody>
</table>

In the make-whole table above, the conversion option is not precluded from being considered indexed to A’s own stock because the adjustment (1) results from the occurrence of an event that invalidates an implicit assumption used in the pricing of a fixed-for-fixed option on equity shares (i.e., that the holder will realize the remaining time value inherent in the notes), (2) is directionally consistent with compensating the holders for lost time value (i.e., the number of additional shares that will be delivered is reduced as the stock price increases and as time to maturity decreases), (3) does not protect the holder from an adverse price change that is unrelated to the event, (4) is not leveraged (i.e., does not contain compensation in excess of expected lost time value), and (5) does not result in the delivery of shares worth a fixed monetary amount.

Although the inputs (stock price and time) for these types of provisions are explicit and are used in the pricing (fair value measurement) of a fixed-for-fixed forward or option on equity shares, a reporting entity is still required to evaluate whether the provisions are designed to neutralize (in whole or in part) the effect that the specified event would have on the fair value of the instrument or to protect the counterparty against an adverse change in the fair value of the instrument that is not attributable to the effect of the specified event. If, at the instrument’s inception, the provisions are designed to (if all other factors are held constant) neutralize no more than 100 percent of the effect that the specified event would have on the fair value of the instrument (i.e., the net gain or loss on the instrument that occurs as a result of the specified event), the provisions do not preclude the instrument from being considered indexed to the reporting entity’s stock. If, however, the provisions are designed in such a way that they could result in (1) protection against an adverse change in the fair value of the instrument that is not attributable to the effect of the specified event, (2) an adjustment to the terms of the instrument that exceeds the effect that the specified event would have on the fair value of the instrument (i.e., contains leverage), or (3) a settlement based on a fixed monetary amount, the provisions preclude the instrument from being considered indexed to the reporting entity’s stock (see Section 4.3.6).
4.3.7.10  **Example of a Make-Whole Provision in Contingent Convertible Debt**

Example 19 in ASC 815-40-55 below illustrates multiple types of exercise contingencies and adjustments that do not necessarily preclude equity classification for an equity feature embedded in a debt security under ASC 815-40-15:

- Exercise contingencies that depend on the following variables:
  - A market price trigger that is based on the entity’s stock price.
  - A parity provision that is based on the trading price of the convertible debt in which the equity feature being evaluated is embedded.
  - A merger announcement involving the entity.

- An adjustment to the settlement amount in the form of make-whole shares if the entity is acquired for cash before a specified date. The adjustment is defined by reference to a table with axes of stock price and time.

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**ASC 815-40**

**Example 19: Variability Involving Contingently Convertible Debt With a Market Price Trigger, Parity Provision, and Merger Provision**

55-45 This Example illustrates the application of the guidance beginning in paragraph 815-40-15-5. Entity A issues a contingently convertible debt instrument with a par value of $1,000 that is convertible into 100 shares of its common stock. The convertible debt instrument has a 10-year term and is convertible at any time after any of the following events occurs:

- Entity A’s stock price exceeds $13 per share (market price trigger).
- The convertible debt instrument trades for an amount that is less than 98 percent of its if-converted value (parity provision).
- There is an announcement of a merger involving Entity A.

55-46 The terms of the convertible debt instrument also include a make-whole provision. Under that provision, if Entity A is acquired for cash before a specified date, the holder of the convertible debt instrument can convert into a number of shares equal to the sum of the fixed conversion ratio (100 shares per bond) and the make-whole shares. The number of make-whole shares is determined by reference to a table with axes of stock price and time. That table was designed such that the aggregate fair value of the shares deliverable (that is, the fair value of 100 shares per bond plus the make-whole shares) would be expected to approximate the fair value of the convertible debt instrument at the settlement date, assuming no change in relevant pricing inputs (other than stock price and time) since the instrument’s inception. The embedded conversion option is considered indexed to Entity A’s own stock based on the following evaluation:

- Step 1. The market price trigger and parity provision exercise contingencies are based on observable markets; however, those contingencies relate solely to the market prices of the entity’s own stock and its own convertible debt. Also, the merger announcement exercise contingency is not an observable market or an index. Therefore, Step 1 does not preclude the warrants from being considered indexed to the entity’s own stock. Proceed to Step 2.
- Step 2. An acquisition for cash before the specified date is the only circumstance in which the settlement amount will not equal the difference between the fair value of 100 shares and a fixed strike price ($1,000 fixed par value of the debt). The settlement amount if Entity A is acquired for cash before the specified date is equal to the sum of the fixed conversion ratio (100 shares per bond) and the make-whole shares. The number of make-whole shares is determined based on a table with axes of stock price and time, which would both be inputs in a fair value measurement of a fixed-for-fixed option on equity shares.
Although the conclusion in step 2 of ASC 815-40-55-46 focuses on the axes in the table (i.e., stock price and time), the discussion refers to the table’s objective. Therefore, we believe that an entity is required to evaluate the design and purpose of an adjustment to the settlement terms of an equity-linked instrument that is based on a table in determining whether the adjustment meets the indexation requirements of ASC 815-40.

The adjustment to the terms of the embedded conversion option (i.e., the make-whole provision) results in the aggregate fair value of the shares deliverable upon settlement approximating the fair value of the convertible debt instrument on the settlement date, assuming no change in relevant pricing inputs (other than stock price and time) since the debt’s inception. On the basis of informal discussions with the FASB staff, we understand that the adjustment actually reflects a settlement at the “theoretical value” of the embedded conversion option. Such value is calculated on the basis of (1) the fair value of the underlying common shares, including the effect of the specified event that resulted in early settlement, and (2) an amount for time value, determined by using (a) the issuer's stock price, including the effect of the specified event that resulted in early settlement, and (b) the remaining time to contractual expiration as of the date of the specified event. That is, the adjustment provision compensates the counterparty for lost time value upon early settlement and does not result in a settlement that is based on the fair value of the convertible instrument. Because the lost time value is calculated on the basis of the time to expiration as of the adjustment date and the relevant share price on the adjustment date (which takes into account the effect that the event resulting in early settlement had on the issuer's share price), the provision does not preclude the instrument from being considered indexed to the reporting entity’s stock.

### 4.3.7.11 Contingent Obligation to Settle a Contract at a Fixed Monetary Amount

If a change in a variable (other than the entity’s stock price) could result in the contract’s settlement based on a fixed monetary amount, the contract cannot be classified as equity. Example 10 of ASC 815-40-55 below illustrates such a scenario.

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**Example 10: Variability Involving Regulatory Approval**

**55-35** 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 that if Entity A does not obtain regulatory approval of a particular drug compound within 5 years, the holder can surrender the warrants to Entity A for $2 per warrant (settleable in shares). The contingently puttable warrants are not considered indexed to Entity A’s own stock based on the following evaluation:

- **Step 1.** The instruments do not contain an exercise contingency. Proceed to Step 2.
- **Step 2.** The settlement amount would equal the difference between the fair value of a fixed number of the entity’s equity shares (100 shares) and a fixed strike price ($10 per share), unless regulatory approval of a particular drug compound is not obtained within 5 years. If that approval is not obtained within the allotted time period, the holder could elect to surrender the warrants to Entity A in exchange for $2 per warrant. The contingent obligation to settle the warrants by transferring consideration with a fixed monetary value if regulatory approval of a particular drug compound is not obtained within a specified time period does not represent an input to the fair value of a fixed-for-fixed option on equity shares. A freestanding equity-linked instrument that provides for a fixed payoff upon the occurrence of a contingent event which is not based on the issuer’s share price is not indexed to an entity’s own stock.
4.3.7.12 Bail-In Provisions

The European Union (EU)'s Bank Recovery and Resolution Directive (Directive 2014/59/EU; BRRD) specifies that resolution authorities in EU member states must be able to apply bail-in powers to banks and other financial institutions within the BRRD's scope. Such powers include the right to write down liabilities of a failing institution or convert such liabilities into the institution's equity (or both). Under BRRD Article 55, EU member states must, in certain circumstances, require institutions to include a bail-in provision in the contractual terms of some liabilities. Under such a provision, “the creditor or party to the agreement creating the liability [recognizes] that liability may be subject to the write-down and conversion powers and agrees to be bound by any reduction of the principal or outstanding amount due, conversion or cancellation that is effected by the exercise of those powers by a resolution authority” even if the contract otherwise is governed by laws outside of the EU.

On April 23, 2018, Deloitte participated in a discussion with the staff of the SEC's Office of the Chief Accountant about the impact of the EU bail-in provisions on an entity's evaluation of a contract on an entity's own equity under ASC 815-40. The specific fact pattern discussed with the SEC staff involved an equity-linked contract between an EU-domiciled bank with a U.S. branch and a U.S.-domiciled commercial entity (the issuer) that, other than having incorporated BRRD Article 55, was governed by New York state law. The SEC staff indicated that it would not object to a conclusion that the addition of a bail-in provision under BRRD Article 55 to a contract would not in itself prevent the contract from being classified in equity under ASC 815-40 if the contract otherwise qualifies for equity classification. The SEC staff also indicated that it would not object to an entity's decision to classify such types of contracts as liabilities on the basis of this provision. The SEC staff's view applies only to the fact pattern discussed herein.

4.3.7.13 Tax Integration of Capped Calls and Convertible Debt

Sometimes issuers purchase freestanding capped call options on their own equity shares in connection with the issuance of convertible debt to increase the effective conversion price of the combination of the debt and the capped call. Further, the contractual terms of the capped call may include a “tax cap” on the amount payable to the issuer if the capped call is settled early because of early conversion of the related convertible debt. The purpose of the tax cap is to help ensure that the capped call and the related convertible debt can be integrated (i.e., treated as a single, combined synthetic instrument) for tax purposes. Upon early settlement of the capped call because of the early conversion of the related convertible debt, the tax cap places a ceiling on the capped call's settlement amount (e.g., the lower of the capped call's fair value and the tax cap amount). That tax cap might be defined as the excess, if any, of the amount paid (in cash or shares) to the holder of the convertible debt upon early conversion over the original issue price of the convertible debt (e.g., $1,000). Alternatively, it might be defined as the excess, if any, of the amount paid (in cash or shares) to the holder of the convertible debt upon early conversion over an amount that varies solely as a function of time (e.g., as indicated in a table showing the projected “synthetic instrument adjusted price” of the combination of the convertible debt and the capped call for tax purposes at different settlement dates).

We believe that depending on its terms, a tax cap on the settlement amount of a capped call that is integrated with a related convertible debt instrument for tax purposes does not necessarily preclude the capped call from being considered indexed to the entity's own equity if it varies solely as a function of the conversion consideration paid upon early conversion, as function of time (e.g., as indicated in a table), or both. Paragraphs B9 and B21 of the Basis for Conclusions of FASB FSP APB 14-1 (superseded) acknowledge that many issuers of convertible debt purchase capped calls and integrate them with the convertible debt for tax purposes. Further, footnote 3 of the First Quarter 2012 EITF Agenda Report notes that a purchased call option in the context of a “convertible debt with bond hedge” transaction, which “may be popular due to tax benefits,” is an example of a contract that might qualify for equity
classification. Accordingly, it is reasonable to evaluate capped calls that are integrated with convertible debt for tax purposes against a fixed-for-fixed capped call linked to convertible debt; that is, it is not necessary to evaluate it against a traditional fixed-for-fixed option on the entity's own equity shares. In addition, holders of convertible debt typically act rationally on the basis of marketplace assumptions about the entity's stock price and the market price of the convertible debt, and uneconomical exercises can be ignored (e.g., the possibility of early conversion if it would involve a loss of time value). Moreover, ASC 815-40-55-46 implies that equity classification under step 1 of ASC 815-40-15 is not precluded for an exercise contingency in convertible debt that is related solely to the market prices of the entity's own stock and its own convertible debt. Therefore, the exercise contingency that is related to the capped calls may be appropriately analyzed as the event that permits early conversion of the convertible debt as opposed to conversion option exercise behavior. For these reasons, we believe that it is not necessary to analyze the capped call's settlement amount as being indexed to conversion option exercise behavior, which would have represented an impermissible input (see Section 4.3.5.8). However, the acceptability of a tax cap on the settlement amount of a capped call depends on a conclusion that in no circumstance can the settlement amount of the capped call exceed its fair value on the settlement date. Rather, we believe that the only acceptable tax caps are only those that have the effect of preventing the issuer from potentially receiving the full fair value of the capped call on the early settlement date.

4.3.8 Foreign Currency Provisions

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**15-71** The issuer of an equity-linked financial instrument incurs an exposure to changes in currency exchange rates if the instrument's strike price is denominated in a currency other than the *functional currency* of the issuer. An equity-linked financial instrument (or embedded feature) shall not be considered indexed to the entity's own stock if the strike price is denominated in a currency other than the issuer's functional currency (including a conversion option embedded in a convertible debt instrument that is denominated in a currency other than the issuer's functional currency). The determination of whether an equity-linked financial instrument is indexed to an entity's own stock is not affected by the currency (or currencies) in which the underlying shares trade.

**Example 11: Variability Involving a Currency Other Than the Entity's Functional Currency**

**55-36** This Example illustrates the application of the guidance beginning in paragraph 815-40-15-5. Entity A, whose functional currency is U.S. dollars (USD), issues warrants with a strike price denominated in Canadian dollars (CAD). The warrants permit the holder to buy 100 shares of its common stock for CAD 10 per share. Entity A’s shares trade on an exchange on which trades are denominated in CAD. The warrants have 10-year terms and are exercisable at any time. 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 strike price of the warrants is denominated in a currency other than the entity's functional currency, so the warrants are not considered indexed to the entity's own stock.

**Example 18: Variability Involving Forward Contract Settled in a Currency Other Than the Entity's Functional Currency**

**55-44** This Example illustrates the application of the guidance beginning in paragraph 815-40-15-5. Entity A, whose functional currency is US$, enters into a forward contract that requires Entity A to sell 100 shares of its common stock for 120 euros per share in 1 year. The forward contract is not considered indexed to Entity A's own stock based on the following evaluation:

a. Step 1. The instrument does not contain an exercise contingency. Proceed to Step 2.

b. Step 2. The strike price of the forward contract is denominated in a currency other than the entity's functional currency, so the forward contract is not considered indexed to the entity's own stock.
Example 20: Variability Involving Functional Currency Debt Convertible to a Stock That Trades in a Currency Other Than the Entity’s Functional Currency

55-47 This Example illustrates the application of the guidance beginning in paragraph 815-40-15-5. Entity A, whose functional currency is the Chinese yuan (CNY), issues a debt instrument denominated in CNY with a par value of CNY 1,000 that is convertible into 100 shares of its common stock. Entity A’s shares only trade on an exchange in which trades are denominated in US$. Those shares do not trade on an exchange (or other established marketplace) in which trades are denominated in CNY. The convertible debt instrument has a 10-year term and is convertible at any time. The embedded conversion option is considered indexed to Entity A’s own stock based on the following evaluation:

a. Step 1. The embedded conversion option does not contain an exercise contingency. Proceed to Step 2.

b. Step 2. Upon exercise of the embedded conversion option, the settlement amount would equal the difference between the fair value of a fixed number of the entity’s equity shares (100 shares) and a fixed strike price denominated in its functional currency (CNY 1,000 fixed par value of the debt). The determination of whether the embedded conversion option is indexed to the entity’s own stock is not affected by the currency (or currencies) in which the underlying shares trade.

If the contract’s exercise price, forward price, or conversion price is denominated in a currency other than the issuer’s functional currency (as determined under ASC 830), the contract is not considered to be indexed to the entity’s own equity even if the amount is fixed in that currency. This is the case even if the shares that would be delivered under the contract are traded or quoted in the foreign currency. (This is different from the guidance on employee stock compensation awards in ASC 718-10-25-14A.)

Some contracts include a strike price expressed in the functional currency, but the amount of functional currency varies in such a way that it equals a fixed amount of foreign currency translated into the functional currency at the spot rate on the date of exercise or settlement. Including a settlement term like this is economically the same as having a strike price denominated in the foreign currency. Although the strike price will be converted at the spot rate on the date of exercise such that payment will be made in the functional currency, the contract should be analyzed as if it were denominated in a foreign currency.

Example 4-12

Strike Price Denominated in Functional Currency

An entity’s functional currency is the U.S. dollar. The entity issues an option that gives the holder the right to purchase a fixed number of 1,000 equity shares. The contractual terms of the option describe the strike price as a U.S. dollar amount and require the holder to use U.S. dollars to pay the strike price upon the option’s exercise. The amount of U.S. dollars that will be paid upon exercise is defined as a fixed strike price of €10 converted to U.S. dollars at the spot foreign exchange rate on the date of settlement. The option is precluded from equity classification because the strike price effectively is denominated in a foreign currency from the perspective of the reporting entity.

ASC 815 prohibits an entity from separating derivative instruments into components on the basis of risk in determining the appropriate accounting for the instrument. Thus, an entity could not bifurcate a contract on its own equity that has a strike price denominated in a foreign currency into a contract with a strike price denominated in the functional currency and a contract exchanging functional currency and foreign currency (ASC 815-10-55-147).
4.3.9 Uneconomic Settlement Terms

4.3.9.1 Subjective Modification Provisions

ASC 815-40

15-7H Some equity-linked financial instruments contain provisions that provide an entity with the ability to unilaterally modify the terms of the instrument at any time, provided that such modification benefits the counterparty. For example, the terms of a convertible debt instrument may explicitly permit the issuer to reduce the conversion price at any time to induce conversion of the instrument. For purposes of applying Step 2, such provisions do not affect the determination of whether an instrument (or embedded feature) is considered indexed to an entity's own stock.

In some circumstances, the settlement terms contain subjective modification provisions that allow the issuer to unilaterally modify the terms of the instrument at any time. Such provisions do not affect the determination of whether an equity-linked instrument is considered indexed to the reporting entity's stock as long as the modifications benefit the counterparty. For example, if the terms permit the issuer to decrease the exercise price or increase the conversion rate, those terms would not preclude a conclusion that the instrument is indexed to the entity's own stock.

If a modification occurs, an entity should reconsider whether the equity-linked freestanding financial instrument (or embedded feature) is still considered indexed to the reporting entity's stock. The entity should also evaluate whether the modification has any accounting consequence in the period in which it occurs (e.g., as an induced conversion under ASC 470-20-40-13 or an effect on earnings per share under ASC 260-10-S99-2 or other guidance in ASC 260). For further discussion of the accounting for induced conversions, see Section 4.5.4 of Deloitte's *A Roadmap to the Issuer's Accounting for Convertible Debt*. For additional guidance on the calculation of earnings per share, see Deloitte's *A Roadmap to the Presentation and Disclosure of Earnings per Share*.

Example 4-13

Subjective Modification Provision in a Convertible Debt Instrument

The following is an example of a subjective modification provision in a convertible debt instrument:

The indenture permits us to increase the conversion rate, to the extent permitted by law and subject to the stockholder-approval requirements (if any) of any relevant national securities exchange or automated dealer quotation system, for any period of at least 30 days. We will give notice of at least 10 days of any such increase. In addition to the above increases, we may, as our board of directors deems advisable, increase the conversion rate to avoid or diminish any income tax to holders of our common stock resulting from any dividend or distribution of stock (or rights to acquire stock) or from any event treated as such for income tax purposes.

An example of a subjective modification provision is one that permits the entity to increase the conversion rate at its discretion, to the extent permitted by law if such an increase is to avoid or diminish any U.S. federal income tax to holders of the entity's common stock resulting from any dividend or distribution of stock (or rights to acquire stock) or from any event treated as such for U.S. federal income tax purposes.
4.3.9.2 **Right to Settle at Less Than Fair Value**

Some contracts include terms that give one or both of the parties the right to settle early at an amount that would always be unfavorable relative to settling the contract at its fair value (e.g., because of lost time value). We believe that a provision that gives one of the parties the right, but not the obligation, to settle early at an unfavorable price relative to the contract’s fair value would not prevent a contract from being considered indexed to the issuer’s stock as long as the settlement amount does not incorporate any extraneous factors into such early settlement.

4.3.10 **Contracts on Convertible Stock With Conversion Price Adjustments**

Sometimes entities issue warrants that permit the holder to purchase a fixed number of the entity’s nonredeemable convertible preferred shares for a fixed price. The preferred shares that the entity would deliver upon exercise of the warrants are convertible into a fixed number of the entity’s common shares at a fixed price except for an adjustment to the conversion price that precludes the conversion feature from being considered indexed to the entity’s own equity (e.g., variability involving a revenue target, see Section 4.3.5.6).

To determine whether this warrant potentially qualifies as equity, the entity needs to ascertain whether the conversion price adjustment in the preferred stock precludes a conclusion that the warrant is indexed to the entity’s own equity. (A similar issue arises for an embedded conversion option in a debt host; e.g., an option to convert debt into convertible preferred stock that has conversion price adjustments.)

In circumstances in which the following apply, we believe that two views are acceptable depending on the entity’s policy regarding whether to assess indexation to its own shares by (1) evaluating only the warrant’s direct exercise provision (the warrant-level view) or (2) “looking through” to all indirect exercise provisions (i.e., exercise provisions in instruments underlying the warrant — the look-through view):

- There are no other features in the warrant (excluding the conversion price adjustment) that would preclude the entity from concluding that the warrant is indexed to its own stock.
- The preferred stock underlying the warrant would, upon issuance, qualify for classification in permanent equity under ASC 480-10-S99-3A. If the preferred stock does not meet the conditions for classification in permanent equity under ASC 480-10-S99-3A, the warrant would be accounted for as a liability under ASC 480-10-25-8 because it embodies an obligation to issue an instrument (the convertible preferred stock) that may require a transfer of assets (see Section 5.2.1 of Deloitte’s *A Roadmap to Distinguishing Liabilities From Equity*). In determining whether the preferred stock qualifies for permanent equity classification, the entity should evaluate the liquidation preferences of the preferred stock (including “deemed liquidation” provisions) to identify features that may result in a conclusion that the stock is redeemable.
- The preferred stock is substantive (i.e., it is reasonably possible that an investor would exercise the warrant and not immediately convert the preferred stock into common stock).
- The conversion option in the preferred stock would not be required to be bifurcated from the preferred stock and accounted for separately as a derivative under ASC 815 once the holder exercises the warrant.
Once an entity adopts one of the two views as its accounting policy, it should consistently apply that policy. An entity’s ability to select an alternative accounting policy is limited to the analysis of whether a warrant is indexed to the reporting entity’s own stock under ASC 815-40-15 and should not be applied by analogy to the analysis of the entity’s ability to control settlement in shares upon exercise (see Chapter 5) or the classification of contracts under ASC 480-10 (see Deloitte’s *A Roadmap to Distinguishing Liabilities From Equity*).

**Warrant-Level View**

Under this view, the warrant is not precluded from being considered indexed to an entity’s own stock because of the conversion price adjustment. The number of preferred shares issuable upon the warrant’s exercise and the warrant’s exercise price are both fixed. Therefore, in accordance with ASC 815-40-15-7C, the warrant is not precluded from being considered indexed to the entity’s own stock. In this case, the entity does not look through the convertible preferred stock to assess whether the ultimate number of common shares to which the holder is entitled is fixed.

**Look-Through View**

Under this view, the warrant is not considered indexed to an entity’s own stock. The ultimate number of common shares to which the holder of the warrant is entitled (by first exercising the warrants into shares of convertible preferred stock and then converting those shares into shares of common stock) is variable because of the conversion price adjustment. Further, the adjustment provision in the convertible preferred stock is not an input in the pricing model for a fixed-for-fixed equity instrument.

This approach is analogous to the look-through view that an entity would apply to settlement provisions in determining the classification of warrants on puttable shares (i.e., an entity would consider the holder’s indirect right to settle in cash under the put right that is embedded in the puttable shares in assessing whether a warrant on puttable shares should be accounted for as a liability under ASC 480).
Chapter 5 — Classification Guidance

5.1 Overview
For a contract within the scope of the guidance (see Chapter 2) to qualify for equity classification under ASC 815-40, it is not sufficient that it is considered indexed to the entity's stock under ASC 815-40-15 (as discussed in Chapter 4). In addition, the contract must require or permit the issuing entity to share settle the contract (either physically or net in shares). Any provision that could require the issuer to net cash settle the contract precludes equity classification with limited exceptions. The likelihood of an event that would trigger a net cash settlement does not matter. Some contracts provide either the issuer or the counterparty with a choice of settlement method (i.e., physical, net shares, or net cash). In other contracts, the settlement method depends on the occurrence or nonoccurrence of a specified event. In these circumstances, the existence of settlement alternatives may affect the classification of the contract as either equity or an asset or a liability (see Section 5.2).

Even if a contract ostensibly requires or permits an entity to settle in shares (e.g., a warrant that requires physical settlement), the entity cannot assume that it has the ability to do so unless there are no circumstances in which it could be forced to net cash settle the contract. If such circumstances exist, then equity classification is generally prohibited. The accounting literature contains a series of conditions that must be met (see Section 5.3) and assessed continually (see Section 5.4) for an issuer to conclude that it is able to share settle a contract. Some of the conditions do not apply to conventional convertible debt (see Section 5.5).

Contracts on an entity’s own equity are often executed and documented by using ISDA standard documentation (see Section 3.1.3). For such contracts, the entity needs to consider not only the trade confirmation but also the provisions of any related master agreement and the applicable ISDA equity derivatives definitions in determining whether there are circumstances under which the entity could be forced to net cash settle the contract. For example, the ISDA documentation may include early settlement provisions that give the counterparty a right to net cash settle the contract in certain circumstances (see Section 5.2.2).
5.2 Settlement Methods

5.2.1 Overview

ASC 815-40

25-1 The initial balance sheet classification of contracts within the scope of this Subtopic generally is based on the concept that:

a. Contracts that require net cash settlement are assets or liabilities.

b. Contracts that require settlement in shares are equity instruments.

ASC 815-40-20 — Glossary

Net Share Settlement
The party with a loss delivers to the party with a gain shares with a current fair value equal to the gain.

Physical Settlement
The party designated in the contract as the buyer delivers the full stated amount of cash to the seller, and the seller delivers the full stated number of shares to the buyer.

Net Cash Settlement
The party with a loss delivers to the party with a gain a cash payment equal to the gain, and no shares are exchanged.

One of the conditions for equity classification is that the entity is required or permitted to share settle the contract. A share settlement can either be physical or net in shares. In a physical settlement, the parties exchange the full stated amount of cash specified by the contract's strike price or forward price and the full stated number of shares specified in the contract. In a net share settlement, the party in a loss position delivers a variable number of equity shares equal in value to the settlement amount to the party in a gain position.

Example 5-1

Settlement Methods
Entity A writes a call option on its own stock that permits the holder to purchase 100 shares of A's common stock at an exercise price of $10 per share. Entity A's stock price rises to $15 per share. Entity B, the holder of the option, exercises the option. If the contract specifies physical settlement, then:

Entity B pays A $1,000 (100 shares at $10 per share).
Entity A issues to B 100 shares with a fair value of $1,500.

If the contract specifies net share settlement (cashless exercise), then:

Entity A issues 33.33 of its shares' to B (100 shares – ($1,000 ÷ $15 per share)) [ = ($1,500 – $1,000) ÷ $15 per share].

If the contract is net cash settled, then:

Entity A makes a cash payment of $500 to B ($1,500 – $1,000).
A contract that will be physically settled may qualify as equity even if it involves the issuer's delivering cash and receiving shares. For example, a physically settled purchased call option on an entity's own stock is not disqualified from equity classification even though the entity would deliver cash and receive shares upon exercise. Similarly, a physically settled embedded written put option (e.g., in a puttable share) could qualify as equity even though the entity could be forced to deliver cash and receive shares if the counterparty were to exercise the put option.

Under ASC 480-10-S99-3A and other SEC guidance, SEC registrants are required to classify certain redeemable equity securities outside of permanent equity (for a comprehensive discussion of the application of this guidance, see Chapter 9 of Deloitte’s A Roadmap to Distinguishing Liabilities From Equity). In the evaluation of whether an embedded feature (e.g., a written put option embedded in the entity's preferred stock) meets the scope exception for own equity in ASC 815-10-15-74(a), temporary equity is considered equity even though it is presented outside of permanent equity (ASC 815-10-15-76). For example, if an SEC registrant issues equity shares that contain an embedded written put option that permits the holder to put the shares back to the registrant in exchange for a cash payment, the registrant may be required to classify the shares in temporary equity under ASC 480-10-S99-3A. In evaluating whether the embedded put option permits the issuer to settle in shares, the entity would consider the equity shares to be equity even though they are presented outside of permanent equity.

5.2.2 Effect of Net Cash Settlement Provisions

<table>
<thead>
<tr>
<th>ASC 815-40</th>
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</thead>
<tbody>
<tr>
<td><strong>25-7</strong> Contracts that include any provision that could require net cash settlement cannot be accounted for as equity of the entity (that is, asset or liability classification is required for those contracts), except in those limited circumstances in which holders of the underlying shares also would receive cash (as discussed in the following two paragraphs and paragraphs 815-40-55-2 through 55-6).</td>
</tr>
<tr>
<td><strong>25-8</strong> Generally, if an event that is not within the entity's control could require net cash settlement, then the contract shall be classified as an asset or a liability. However, if the net cash settlement requirement can only be triggered in circumstances in which the holders of the shares underlying the contract also would receive cash, equity classification is not precluded.</td>
</tr>
<tr>
<td><strong>25-9</strong> This Subtopic does not allow for an evaluation of the likelihood that an event would trigger cash settlement (whether net cash or physical), except that if the payment of cash is only required upon the final liquidation of the entity, then that potential outcome need not be considered when applying the guidance in this Subtopic.</td>
</tr>
</tbody>
</table>

Except in certain limited instances, if there are any circumstances under which an entity could be required to net cash settle a contract on its own equity (e.g., upon an early termination event identified in the contract), equity classification is prohibited. Such a contract cannot be classified as equity even if it is considered indexed to the entity's own equity under ASC 815-40-15. An entity is precluded from considering probability when assessing whether it could be required to net cash settle a contract. Equity classification would be prohibited even if net cash settlement could be required only upon the occurrence of a remote event. Conversely, a contract might qualify as equity even if the entity expects or intends to net cash settle a contract as long as it could not be forced to net cash settle.
The SEC's *Current Accounting and Disclosure Issues in the Division of Corporation Finance* (as updated November 30, 2006) notes the following as one of the most common reasons warrants must be classified as liabilities under ASC 815-40-25:

[T]he warrants could be required to be settled in cash if certain events occurred, such as delisting from the registrant's primary stock exchange or in the event of a change of control. . . . Even if delisting is not considered probable of ever occurring, the warrants would still be classified as a liability under the [ASC 815-40-25] analysis. Similarly, the likelihood that a change in control could occur is not a factor.

Contracts on own equity (e.g., those executed under ISDA standard documentation) often include early termination provisions that give the counterparty a right to early settle the contract in specified circumstances. If those circumstances are outside the entity's control and could require the entity to net cash settle the contract (e.g., because the counterparty obtains the right to terminate the contract net in cash under a “cancellation and payment” provision), the contract cannot be classified as equity. Examples of events that may be referred to in standard documentation and would be considered outside the entity's control include:

- The counterparty's ability to establish or maintain a hedge position against the contract by using commercially reasonable means (hedge disruption event).
- A material increase in the counterparty's cost of hedging (increased cost of hedging).
- The counterparty's inability to borrow the shares underlying the contract (loss of stock borrow).
- The counterparty's cost to borrow the shares underlying the contract exceeds a specified rate.

In remarks at the 2007 AICPA Conference on Current SEC and PCAOB Developments, Ashley Carpenter said:

[ASC 815-40-25] is clear that equity classification is precluded if an entity does not control the ability to share settle the contract. The [SEC] staff understands that the ISDA Agreements incorporated into many equity derivative contracts contain provisions that may allow the counterparty to net-cash settle the contract upon the occurrence of events outside the control of the entity. To address this issue, the transaction Confirmation often includes an overriding provision to allow the entity to share settle the contract upon the occurrence of events outside its control. Absent this provision, the contract may not meet the equity classification requirements in [ASC 815-40-25].

If the early termination provision is outside the entity's control but does not require the entity to net cash settle the contract (e.g., because of an override provision), the feature must still be evaluated under the indexation guidance and other equity classification conditions in ASC 815-40.

Some contracts on an entity's own equity contain provisions that could require the issuer, upon the occurrence of events outside its control, to make cash payments that do not represent a net cash settlement of the entire contract (e.g., a requirement to make a fixed cash payment if the issuer fails to file financial statements on time; see Section 5.3.5). We believe that with limited exceptions (see Section 5.2.3.7), equity classification is precluded if a contract could require the entity to make any cash payment even if the payment is not the equivalent of a net cash settlement of the entire contract. By analogy, the ASC 815-40-25 guidance on top-off or make-whole payments precludes equity classification in certain circumstances in which the issuer is required to make only partial settlement payments (see Section 5.3.6).
5.2.3 Permissible Net Cash Settlement Provisions

As an exception to the requirement to classify contracts that the entity could be forced to net cash settle as assets or liabilities, a contractual term that could require a contract to be net cash settled is permitted in the following circumstances:

- The event that would cause net cash settlement is within the entity’s control (see Section 5.2.3.1).
- The contract is required to be net cash settled only upon the final liquidation of the entity (see Section 5.2.3.2).
- The contract is required to be net cash settled only if holders of the shares underlying the contract would also receive cash in exchange for their shares (see Section 5.2.3.3), such as upon a change of control (see Section 5.2.3.4) or upon nationalization or expropriation (see Section 5.2.3.5).
- The contract is an own-share lending arrangement executed in conjunction with a convertible debt issuance, and the cash settlement provision has certain characteristics (see Section 5.2.3.6).

See Section 5.2.3.7 for further discussion of cash payment provisions that do not represent a cash settlement of the entire contract.

5.2.3.1 Net Cash Settlement Within the Entity’s Control

If a net cash settlement can be triggered only by the occurrence or nonoccurrence of an event that is solely within the entity’s control, that net cash settlement provision does not preclude the contract from being classified as equity. If the event or circumstance that can trigger a net cash settlement is not solely within the entity’s control, the contract is classified as an asset or a liability. If the event is not solely within the entity’s control but the entity cannot be forced to net cash settle the contract (e.g., the feature requires the contract to be net share settled at an adjusted settlement amount), the entity should evaluate the provision under the indexation guidance in ASC 815-40 (see Chapter 4).

The assessment of whether an event or circumstance is within the entity’s control depends on the entity’s governance structure. Normally, decisions made by management or the board of directors are considered to be within the entity’s control. On the other hand, decisions made by shareholders are considered to be outside the entity’s control (see, for example, ASC 815-40-25-19). At the 2009 AICPA Conference on Current SEC and PCAOB Developments, Professional Accounting Fellow Brian Fields made the following remarks:

I’d like to turn now to the evaluation of contracts on own stock and redeemable shares. A key question in accounting for both types of instruments is whether the company can avoid settling the instrument in cash or other assets even in contingent scenarios that may be improbable. With a few defined exceptions, a share-based derivative, such as a warrant or option on common stock, is accounted for by its issuer as an asset or liability (rather than as equity) if there is any circumstance in which the issuer could be required to settle in cash. . . .

In some cases determining whether a company can avoid paying out cash in all possible circumstances can be a difficult question, requiring a detailed analysis of both the instrument’s terms and various debt versus equity accounting requirements. One question that has come up several times recently is specifically who needs to have the power to decide how an instrument is settled to conclude that the company is in control of a settlement alternative? . . .

So who does need to have the power? In a typical corporate structure, the power to control the form of settlement might be expected to reside with the Board of Directors or executive management. However, there are a variety of governance structures in practice. For a limited partnership, the governance structure of the entity would often consist of the general partner, and one would usually expect cash versus share settlement decisions to reside with that partner in order for a decision to be within
the company’s control. In any case, in order for a settlement option to be under company control, one would generally expect that control would rest with the party or parties tasked with management or governance by the owners of the entity. [Emphasis added]

The table below lists events and circumstances that may be considered within and outside the entity’s control. Note, however, that the assessment of whether an event is within the entity’s control could differ depending on the specific facts and circumstances (e.g., whether the counterparty controls the entity’s decision to net cash settle through board representation or other rights or the issuer is firmly committed to undertaking an action that will cause the event to occur).

<table>
<thead>
<tr>
<th>Solely Within the Issuer’s Control</th>
<th>Not Solely Within the Issuer’s Control</th>
</tr>
</thead>
<tbody>
<tr>
<td>• The issuer’s decision to redeem, put, call, or convert a financial instrument</td>
<td>• The counterparty’s decision to redeem, put, call, or convert a financial instrument</td>
</tr>
<tr>
<td>• Specified corporate transactions or events (e.g., a sale of substantially all of the assets) that the issuer’s management or board of directors may decide to undertake</td>
<td>• The issuer’s failure to have a registration statement declared effective by the SEC</td>
</tr>
<tr>
<td>• A change in the issuer’s business strategy</td>
<td>• The issuer’s effective registration statement lapses</td>
</tr>
<tr>
<td>• The issuer’s declaration of an extraordinary dividend</td>
<td>• An IPO’s not being completed by a certain date (the successful completion of an IPO depends in part on factors outside the issuer’s control, such as an effective registration statement)</td>
</tr>
<tr>
<td>• The occurrence of an IPO (usually an issuer is able to prevent an IPO from occurring but is unable to control whether it can successfully complete one)</td>
<td>• The issuer’s failure to submit SEC filings on time (ASC 815-40-25-29; see Section 5.3.5)</td>
</tr>
<tr>
<td>• The issuer’s achievement of a project milestone (usually, an issuer is able to prevent a milestone from being reached but is unable to control whether it can successfully meet one)</td>
<td>• The issuer’s failure to maintain compliance with specified financial covenants</td>
</tr>
<tr>
<td>• The issuer’s future decision to issue new equity securities</td>
<td>• The issuer’s failure to achieve specified revenue or earnings targets</td>
</tr>
<tr>
<td>• Redemption upon mutual agreement by the parties</td>
<td>• The issuer’s failure to achieve a project milestone</td>
</tr>
<tr>
<td>• The issuer’s execution of an agreement for the private placement of its equity securities on terms that are commercially reasonable and customary for such agreements unless the issuer is precluded from undertaking a private placement (e.g., because a failed registration occurred within the past six months); see Section 5.3.2.1</td>
<td>• The issuer’s failure to pay specified dividends</td>
</tr>
<tr>
<td>• The attainment of a specific stock market price</td>
<td>• The delisting of the issuer’s securities</td>
</tr>
<tr>
<td>• A change in the issuer’s credit rating</td>
<td>• The instrument’s not being readily tradable on an established market</td>
</tr>
<tr>
<td>• The delisting of the issuer’s securities</td>
<td>• The issuer’s failure to deliver publicly listed shares</td>
</tr>
<tr>
<td>• The issuer’s failure to maintain compliance with specified financial covenants</td>
<td>• The absence of a public market</td>
</tr>
<tr>
<td>• The issuer’s failure to achieve a project milestone</td>
<td>• A change in control of the entity, provided that a purchaser could obtain control of the issuer without the approval of the issuer’s management or board (e.g., by purchasing shares from other investors)</td>
</tr>
<tr>
<td>• The issuer’s failure to pay specified dividends</td>
<td>• The death or disability of the holder (however, see Section 9.4.3 of Deloitte’s A Roadmap to Distinguishing Liabilities From Equity)</td>
</tr>
<tr>
<td>• The attainment of a specific stock market price</td>
<td>• The termination, resignation, or retirement of the holder (e.g., a CEO)</td>
</tr>
<tr>
<td>• A change in the issuer’s credit rating</td>
<td>• A specified change in an investor’s ownership interest (e.g., the board chairman or CEO ceases to beneficially own 20 percent of the outstanding voting stock)</td>
</tr>
<tr>
<td>• The delisting of the issuer’s securities</td>
<td>• A vote by the issuer’s shareholders (e.g., shareholder approval to increase the number of authorized shares)</td>
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</table>
(Table continued)

<table>
<thead>
<tr>
<th>Solely Within the Issuer's Control</th>
<th>Not Solely Within the Issuer's Control</th>
</tr>
</thead>
<tbody>
<tr>
<td>• A change in law</td>
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<tr>
<td>• A change in regulatory requirements</td>
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<tr>
<td>• A failed Dutch auction</td>
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<tr>
<td>• Events involving the counterparty's ability to hedge the equity price risk of the contract (e.g., a hedge disruption event, an increased cost of hedging, a loss of stock borrow, or an increased cost of stock borrow)</td>
<td></td>
</tr>
<tr>
<td>• The issuer's failure to have available a sufficient number of authorized and unissued shares to share settle a contract if the issuer does not currently have available a sufficient number of authorized and unissued shares to share settle the contract (see Chapter 5)</td>
<td></td>
</tr>
<tr>
<td>• A third party's consent (e.g., a stockholder's waiver of a redemption requirement)</td>
<td></td>
</tr>
<tr>
<td>• An unqualified audit opinion</td>
<td></td>
</tr>
</tbody>
</table>

Note that if the event that could cause a net cash settlement is within the entity's control, and the event occurs, the entity would need to reclassify the contract as an asset or a liability until it is settled (see Section 5.4).

5.2.3.2  Net Cash Settlement Upon Final Liquidation of the Entity

If net cash settlement of a contract is required only upon the entity's final liquidation, equity classification is not precluded (ASC 815-40-25-9). Note, however, that the contract cannot give the counterparty a higher claim in bankruptcy than that of holders of the contract's underlying shares (see Section 5.3.7). Further, a deemed liquidation provision that requires net cash settlement of the contract upon the redemption of one or more classes of equity securities but not all classes of equally or more subordinated equity instruments (e.g., upon a change in control) does not qualify for this exception.

5.2.3.3  Net Cash Settlement When Holders of Underlying Shares Receive Same Form of Consideration

Equity classification is not precluded if an entity can be forced to net cash settle a contract only in circumstances in which the holders of the shares underlying the contract receive, or have a right to receive, cash for their shares. For example, contracts that the entity can be forced to net cash settle upon a change in control or other deemed liquidation event might qualify as equity if the holders of the underlying shares are paid cash for their shares. Similarly, we believe that a contract that permits the counterparty to settle the contract into the kind and amount of consideration to which it would have been entitled had the contract been converted into stock does not preclude the contract from being classified as equity. If holders of the underlying shares are given a choice of the form of consideration, for example, equity classification is not precluded if the counterparty to the contract is given the same choice.

A contract could not be classified as equity if the form of consideration in settling the contract (e.g., cash, shares, property, or other assets) would be different from the form of consideration paid to holders of the underlying shares. Generally, the holders of the underlying shares should receive the same form of consideration.
Example 5-2

**Holders of Underlying Shares Receive Same Form of Consideration**

Entity A has issued warrants on shares of its common stock. If A effects a reorganization, the holders of the warrants have the right to exercise the warrants immediately before the reorganization and receive, in lieu of shares of common stock, the capital stock, securities, or other property to which the holders are entitled as owners of common shares underlying the warrants. The terms of the warrants define a reorganization as any reclassification, capital reorganization, conversion, or change to A's common stock (other than cash dividends or distributions or a subdivision or combination), any consolidation or merger involving A, or any sale of all or substantially all of A's assets. The only circumstance that would result in settlement of the warrants through the issuance of consideration other than shares of A's common stock is a reorganization. Entity A controls the actions or events that could result in delivery of consideration other than common stock for each event that constitutes a reorganization, with the exception of a consolidation, which could include a change of control that is outside A's control. Upon the occurrence of a consolidation, the holders of the warrants are not entitled to receive cash or any other form of consideration (including a choice among forms of consideration) that differs from the form of consideration that each holder of common stock is entitled to receive because, as stated above, the holders of the warrants merely have exercised those warrants before the consolidation and are able to “stand in line” with all other holders of common shares. In accordance with ASC 815-40-55-3 and 55-4 (see Section 5.2.3.4), this settlement provision would not preclude equity classification for the warrant contract.

Consider a warrant contract that specifies that the counterparty will receive the same form of consideration (in cash or shares) as the holders of the underlying shares if the value of the consideration exceeds the warrant exercise price. If the value of the consideration is less than the warrant exercise price, the counterparty will receive a cash payment equal to the fair value (i.e., time value) of the contract. We believe that such a provision does not qualify for the exception in ASC 815-40-25-8 because the warrant holder may receive consideration that is different from that received by shareholders.

### 5.2.3.4 Change-in-Control Clauses

**ASC 815-40**

55-2 An event that causes a change in control of an entity is not within the entity's control and, therefore, if a contract requires net cash settlement upon a change in control, the contract generally must be classified as an asset or a liability.

55-3 However, if a change-in-control provision requires that the counterparty receive, or permits the counterparty to deliver upon settlement, the same form of consideration (for example, cash, debt, or other assets) as holders of the shares underlying the contract, permanent equity classification would not be precluded as a result of the change-in-control provision. In that circumstance, if the holders of the shares underlying the contract were to receive cash in the transaction causing the change in control, the counterparty to the contract could also receive cash based on the value of its position under the contract.

55-4 If, instead of cash, holders of the shares underlying the contract receive other forms of consideration (for example, debt), the counterparty also must receive debt (cash in an amount equal to the fair value of the debt would not be considered the same form of consideration as debt).

55-5 Similarly, a change-in-control provision could specify that if all stockholders receive stock of an acquiring entity upon a change in control, the contract will be indexed to the shares of the purchaser (or issuer in a business combination accounted for as a pooling of interests) specified in the business combination agreement, without affecting classification of the contract.
ASC 815-40-55-2 through 55-5 illustrate that an entity must further analyze a contract that requires net cash settlement upon a change in control to determine whether that net cash settlement requirement precludes equity classification. If the change-in-control provision specifies that the contract counterparty will receive the same form of consideration as holders of the underlying shares, equity classification is not precluded.

### 5.2.3.5 Nationalization (Expropriation) Clauses

<table>
<thead>
<tr>
<th>ASC 815-40</th>
</tr>
</thead>
<tbody>
<tr>
<td>55-6: In the event of nationalization, cash compensation would be the consideration for the expropriated assets and, as a result, a counterparty to the contract could receive only cash, as is the case for a holder of the stock underlying the contract. Because the contract counterparty would receive the same form of consideration as a stockholder, a contract provision requiring net cash settlement in the event of nationalization does not preclude equity classification of the contract.</td>
</tr>
</tbody>
</table>

A contract that requires net cash settlement if the entity is nationalized does not preclude equity classification. The EITF reached this conclusion after it had received advice that the counterparty would be legally entitled to receive cash compensation for the expropriated contract in a manner similar to a holder of the underlying stock.

### 5.2.3.6 Own-Share Lending Arrangements in Connection With Convertible Debt Issuance

The terms of some share-lending arrangements executed in conjunction with a convertible debt issuance (see Section 2.9) may allow the borrower (e.g., the bank) to cash settle all or a portion of an arrangement if, after making its reasonable best effort, the borrower is unable to obtain a sufficient number of the entity’s common shares to settle the entire arrangement through physical delivery or is otherwise prohibited from settling via physical delivery in accordance with a law, rule, or regulation of a government authority. ASC 470-20-50-2A requires entities to disclose circumstances in which cash settlement would be required. Except for certain limited instances, equity classification is precluded under ASC 815-40-25 if there are any circumstances in which the issuer could be required to net cash settle a contract on its own equity. Because ASC 470-20-50-2A specifies disclosure requirements for cash settlement provisions related to equity-classified share-lending arrangements (see Section 6.1.6), a situation in which a share-lending arrangement could have a cash settlement requirement and still be classified in equity appears to be specifically contemplated in ASC 470-20, regardless of the requirements of ASC 815-40-25. However, to be classified in equity by the issuing entity, the share-lending arrangement should meet all of the other conditions for equity classification in ASC 815-40.

Therefore, we believe that a share-lending arrangement executed in conjunction with a convertible debt issuance is not precluded from classification in equity if it allows the counterparty to cash settle the arrangement upon the occurrence of certain events, but it must make its reasonable best effort to effect a physical settlement, and the situations in which cash settlement may be permitted must be limited and generally outside the control of the counterparty (e.g., delisting of the entity’s shares). In addition, the best-effort requirement must be substantive, and there should be an expectation at the inception of the arrangement that the counterparty would physically settle the arrangement. A share-lending arrangement would not be classified in equity if it unilaterally allowed the counterparty to cash settle the arrangement at its option without having made a reasonable effort to obtain shares to physically settle the arrangement.
5.2.3.7  **Cash Payments Other Than Net Cash Settlements**

As noted in Section 5.2.2, some contracts on an entity’s own equity contain provisions that could require the issuer, upon the occurrence of events outside its control, to make cash payments that do not represent a net cash settlement of the entire contract (e.g., a requirement to make a fixed cash payment if the issuer fails to file financial statements on time; see Section 5.3.5). We believe that except for the following types of provisions, equity classification is precluded if a contract could require the entity to make any cash payments:

- **Normal contractual remedies for the entity's breach of the contract** (ASC 815-40-25-31) — For example, a contract may qualify as equity even if it (1) includes an indemnification clause that holds each party harmless against damages, losses, or claims resulting from the breach of contract or gross negligence and (2) requires any such obligations to be paid in cash. This is because such payments are considered to be the result of an action that was within the entity's control.

- **Cash payment provisions within the scope of the guidance on registration payment arrangements** (see Section 3.2.4).

- **Minimal or nonsubstantive payment provisions associated with the issuance or delivery of the entity's equity shares** — We believe that equity classification of a contract that otherwise qualifies for classification within equity is not precluded if it includes a requirement to reimburse the holder for the payment of stamp duties, transfer taxes, or other governmental charges that might be imposed with respect to the issuance or delivery of the entity's equity shares upon the contract's settlement if (1) the entity's obligation is limited to costs (if any) that would be unavoidable upon the entity's issuance or delivery of equity shares; (2) the entity would be legally liable to pay such costs if the counterparty failed to pay them; (3) the obligation does not encompass expenses related to any applicable capital gains taxes, withholding taxes, or any other expenses, taxes, or charges that might be incurred by the holder and depend on holder-specific factors; and (4) the entity expects to incur no or only minimal costs associated with meeting its obligation.

- **Fractional shares** — A contract that requires fractional shares (i.e., a quantity of shares that is less than one full share) to be settled in cash is not precluded from equity classification if it does not otherwise require or permit cash settlement.

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**Example 5-2A**

**Contract With Fractional Shares Settled in Cash**

Company A has written a call option to Company B. The option permits Company B to purchase 100,000 shares of A's common stock at an exercise price of $120 per share. The contract specifies net share settlement except that any fractional share will be settled in cash. Company B exercises the option when A's stock price is $140. Accordingly, the fair value of the settlement amount is $2 million (100,000 shares × ($140 – $120)), which is equivalent to 14,285.714 shares ($2 million ÷ $140). Because the contract specifies net share settlement with cash settlement of any fractional share, A delivers 14,285 whole shares as well as $100 of cash (0.714 share × $140). This contract could qualify as equity under ASC 815-40 even though it includes a requirement to cash settle any fractional share.
5.2.4 Settlement Alternatives: General Requirements

**ASC 815-40**

**25-2** Further, an entity shall observe both of the following:

a. If the contract provides the counterparty with a choice of net cash settlement or settlement in shares, this Subtopic assumes net cash settlement.

b. If the contract provides the entity with a choice of net cash settlement or settlement in shares, this Subtopic assumes settlement in shares.

**25-4** Accordingly, unless the economic substance indicates otherwise:

a. Contracts shall be initially classified as either assets or liabilities in both of the following situations:
   1. Contracts that require net cash settlement (including a requirement to net cash settle the contract if an event occurs and if that event is outside the control of the entity)
   2. Contracts that give the counterparty a choice of net cash settlement or settlement in shares (physical settlement or net share settlement).

b. Contracts shall be initially classified as equity in both of the following situations:
   1. Contracts that require physical settlement or net share settlement
   2. Contracts that give the entity a choice of net cash settlement or settlement in its own shares (physical settlement or net share settlement), assuming that all the criteria set forth in paragraphs 815-40-25-7 through 25-35 and 815-40-55-2 through 55-6 have been met.

**35-2** Contracts that are initially classified as equity under Section 815-40-25 shall be accounted for in permanent equity as long as those contracts continue to be classified as equity. . . . Both of the following shall be reported in permanent equity:

a. Contracts that require that the entity deliver shares as part of a physical settlement or a net share settlement

b. Contracts that give the entity a choice of either of the following:
   1. Net cash settlement or settlement in shares (including net share settlement and physical settlement that requires that the entity deliver shares)
   2. Either net share settlement or physical settlement that requires that the entity deliver cash.

**35-5** Net share settlement should be assumed for contracts that are classified under Section 815-40-25 as equity instruments that provide the entity with a choice of either of the following:

a. Net share settlement

b. Physical settlement that may require that the entity deliver cash.

**35-6** Physical settlement should be assumed for contracts that are classified under Section 815-40-25 as equity instruments that provide the counterparty with a choice of either of the following:

a. Net share settlement

b. Physical settlement that may require that the entity deliver cash.
The table below describes various settlement alternatives that may be specified in a contract and the resulting classification of the contract as either equity or an asset or a liability provided that (1) any settlement alternatives have the same economic value (see Section 5.2.5 for a discussion of settlement alternatives with different economic value), (2) the settlement alternatives do not differ in gain and loss positions (see Section 5.2.6 for a discussion of settlement alternatives that differ in gain and loss positions), and (3) the contract is not otherwise precluded from equity classification (e.g., under the indexation guidance in ASC 815-40-15 or the additional equity classification conditions in ASC 815-40-25; see Chapter 4 and Section 5.3).

<table>
<thead>
<tr>
<th>Classification</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Equity Provided All Other Conditions for Equity Classification Are Met</strong></td>
</tr>
<tr>
<td>• The contract requires physical settlement.</td>
</tr>
<tr>
<td>• The contract requires net share settlement.</td>
</tr>
<tr>
<td>• The contract gives the entity a choice between net cash settlement and net share settlement.</td>
</tr>
<tr>
<td>• The contract gives the entity a choice between physical settlement and net share settlement.</td>
</tr>
<tr>
<td>• The contract gives the entity a choice between physical settlement and net cash settlement.</td>
</tr>
<tr>
<td>• The contract gives the counterparty a choice between physical settlement and net share settlement.</td>
</tr>
</tbody>
</table>

If an entity intends or expects to net cash settle a contract but cannot be forced to do so, the contract is not precluded from being classified in equity. What matters is not whether the entity expects or intends to settle in shares but whether it has the legal right to settle in shares. If the entity elects to settle net in cash, however, the entity should consider whether the contract needs to be reclassified as an asset or a liability until it is settled (e.g., if the election is binding and cannot be revoked).

5.2.4.1 Application to Convertible Securities With “Greater-of” Redemption Features

Some convertible securities give the investor a share-settled equity conversion option and a cash-settled redemption option in which the redemption amount is the greater of the fair value of the underlying shares or the face amount of the securities. In such a scenario, the “greater-of” redemption option effectively gives the security’s holder the ability to net cash settle the embedded conversion option. Accordingly, the conversion option does not qualify as equity under ASC 815-40. ASC 815-15 addresses whether an entity is required to bifurcate the option as an embedded derivative (see Section 2.2).

5.2.4.2 Application to Certain Freestanding Contracts

ASC 815-40-55-13 contains a table that illustrates the effect of different settlement methods and alternatives on the classification of a freestanding contract under which the entity sells its shares (including forward sale contracts, written call options or warrants, and purchased put options on the entity’s own equity). The table also applies to purchased call options on the entity’s own equity.
ASC 815-40

Forward Sale Contracts, Written Call Options or Warrants, and Purchased Put Options

55-13 The issuing entity (the seller) agrees to sell shares of its stock to the buyer of the contract at a specified price at some future date. The contract may be settled by physical settlement, net share settlement, or net cash settlement, or the issuing entity or counterparty may have a choice of settlement methods. The guidance in this Subtopic would be applied as follows.

<table>
<thead>
<tr>
<th>One Settlement Method</th>
<th>Entity Choice</th>
<th>Counterparty Choice</th>
</tr>
</thead>
<tbody>
<tr>
<td>Physical</td>
<td>Net Share</td>
<td>Net Cash</td>
</tr>
<tr>
<td>Physical</td>
<td>Net Share</td>
<td>Net Cash</td>
</tr>
</tbody>
</table>

(1) Initial Classification:

<table>
<thead>
<tr>
<th></th>
<th>Equity</th>
<th>Asset or Liability</th>
</tr>
</thead>
<tbody>
<tr>
<td>x</td>
<td>x</td>
<td>x</td>
</tr>
</tbody>
</table>

(2) Initial Measurement, Subsequent Classification and Measurement:

<table>
<thead>
<tr>
<th></th>
<th>Fair value, permanent equity–no changes in fair value</th>
<th>Fair value, asset or liability–adjusted for changes in fair value</th>
</tr>
</thead>
<tbody>
<tr>
<td>x</td>
<td>x</td>
<td>x</td>
</tr>
</tbody>
</table>

(a) Physical settlement of the contract requires that the entity deliver shares to the holder in exchange for cash.

(b) Equity or temporary equity classification is only appropriate if the conditions in Section 815-40-25 do not require asset or liability classification of the contract.

(c) If the contracts are ultimately settled in net cash, the amount of cash paid or received should be reported as a reduction of, or an addition to, contributed capital.

(d) Subsequent changes in fair value should be reported in earnings and disclosed in the financial statements.

(e) If the contracts are ultimately settled in shares, any gains or losses on those contracts should continue to be included in earnings.

Note: In all cases above, the contracts must be reassessed at each reporting period to determine whether the contract must be reclassified.

Purchased Call Options

55-14 The entity (the buyer) purchases call options that provide it with the right, but not the obligation, to buy from the seller, shares of the entity’s stock at a specified price. If the options are exercised, the contract may be settled by physical settlement, net share settlement, or net cash settlement, or the issuing entity or the counterparty may have a choice of settlement methods. The entity should follow the preceding table in accounting for purchased call options.
5.2.4.3 Application to Certain Embedded Features

ASC 815-40-55-11 includes a table that illustrates the application of its classification guidance to embedded written put options (i.e., embedded features that give the counterparty a right, but not an obligation, to put (sell) the entity's shares to the entity) and to embedded forward purchase contracts (i.e., embedded features that require the entity to purchase its shares). This guidance is relevant in the evaluation of whether a redemption (put) option or a mandatory redemption requirement embedded in an equity security issued by the entity (such as redeemable preferred stock) is required to be bifurcated as an embedded derivative under ASC 815-15 or is exempted from such accounting under the scope exception for certain contracts on the entity's own equity in ASC 815-10-15-74(a).

In the evaluation of whether the scope exception for own equity is met, temporary equity is considered equity (ASC 815-10-15-76). For example, if an SEC registrant issues equity shares that contain an embedded written put option that permits the holder to put the shares back to the registrant in exchange for a cash payment, the registrant may be required to classify the shares in temporary equity under ASC 480-10-59-3A (for a comprehensive discussion of the application of this guidance, see Chapter 9 of Deloitte's A Roadmap to Distinguishing Liabilities From Equity). In evaluating whether the embedded put option qualifies for the scope exception in ASC 815-10-15-74(a) under the equity classification guidance in ASC 815-40 (e.g., in assessing whether the contract permits the issuer to settle in shares), the entity would consider the equity shares to be equity even though they are presented outside of permanent equity.

The table in ASC 815-40-55-11 does not apply to freestanding written put options or freestanding forward purchase contracts that are required to be accounted for as liabilities under ASC 480 (see Section 2.3 and Deloitte's A Roadmap to Distinguishing Liabilities From Equity).

While the table contains information about the initial and subsequent measurement of an embedded feature, we believe that an entity should not rely on these aspects of the table in determining the appropriate accounting for the feature. ASC 815-40 does not apply to the measurement of an embedded feature and does not address whether such a feature should be separated from its host contract. Instead, the entity should refer to other guidance, in particular the guidance in ASC 815-15 on separating embedded derivatives.

<table>
<thead>
<tr>
<th>ASC 815-40</th>
</tr>
</thead>
<tbody>
<tr>
<td>Embedded Written Put Options and Forward Purchase Contracts</td>
</tr>
<tr>
<td>55-8 Paragraph 815-40-15-3(e) explains that financial instruments that are within the scope of Topic 480 are not subject to any of the provisions of this Subtopic. See paragraph 480-10-55-63 for a table for freestanding written put options and forward purchase contracts that are accounted for under Topic 480. The guidance that follows applies to embedded derivatives analyzed under paragraph 815-15-25-1(c).</td>
</tr>
<tr>
<td>55-9 The entity (the buyer) agrees to buy from the seller shares at a specified price at some future date. The contract may be settled by physical settlement, net share settlement, or net cash settlement, or the issuing entity or the counterparty may have a choice of settlement methods. Application of this Subtopic to purchased call options is discussed in paragraph 815-40-55-14.</td>
</tr>
<tr>
<td>55-10 The guidance in the following table includes shareholder rights (sometimes referred to as SHARP rights) issued by the entity to shareholders that give the shareholders the right to put a specified number of common shares to the entity for cash.</td>
</tr>
</tbody>
</table>
### ASC 815-40 (continued)

#### 55-11 The guidance in this Subtopic would be applied as follows.

<table>
<thead>
<tr>
<th>Physical</th>
<th>Net Share</th>
<th>Net Cash</th>
<th>Net Share or Physical</th>
<th>Net Share or Net Cash</th>
<th>Net Cash or Physical</th>
<th>Net Share or Net Cash</th>
<th>Net Cash or Physical</th>
</tr>
</thead>
<tbody>
<tr>
<td>One Settlement Method</td>
<td>Entity Choice</td>
<td>Counterparty Choice</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

(1) **Initial Classification:**

<table>
<thead>
<tr>
<th>Equity</th>
<th>Asset or Liability</th>
</tr>
</thead>
<tbody>
<tr>
<td>X</td>
<td>X</td>
</tr>
</tbody>
</table>

(2) **Initial Measurement, Subsequent Classification and Measurement:**

- **Fair value, permanent equity—no changes in fair value:**
  | X | X(2) | X(2) |

- **Fair value, transfer to temporary equity an amount equal to cash redemption amount:**
  | X | X(3) | X(3) |

- **Fair value, asset or liability—adjusted for changed in fair value:**
  | X | X(4) | X(4) |

(a) Physical settlement of the contract requires that the entity deliver cash to the holder in exchange for the shares.

(b) Equity or temporary equity classification is only appropriate if the conditions in Section 815-40-25 do not require asset or liability classification of the contract.

(c) If the contracts are ultimately physically settled by the entity, requiring that the entity deliver cash, or are ultimately settled in net cash, the amount of cash paid or received should be reported as a reduction of, or as an addition to, contributed capital.

(d) Classification and measurement guidance within temporary equity applies only to public entities.

(e) If the contracts are ultimately settled in net cash or net shares, the amount reported in temporary equity should be transferred and reported as an addition to permanent equity.

(f) Subsequent changes in fair value should be reported in earnings and disclosed in the financial statements.

(g) If the contracts are ultimately settled in shares, any gains or losses on those contracts should continue to be included in earnings.

**Note:** In all cases above, the contracts must be reassessed at each reporting period in order to determine whether or not the contract must be reclassified.

#### 55-12 See paragraph 480-10-55-63 for a table for freestanding written put options and forward purchase contracts that are accounted for under Topic 480. This table applies to embedded derivatives analyzed under paragraph 815-15-25-1(c).
5.2.5 Settlement Alternatives With Different Economic Value

**ASC 815-40**

**25-3** Except as noted in the last sentence of this paragraph, the approach discussed in [ASC 815-40-25-1 and 25-2] does not apply if settlement alternatives do not have the same economic value attached to them or if one of the settlement alternatives is fixed or contains caps or floors. In those situations, the accounting for the instrument (or combination of instruments) shall be based on the economic substance of the transaction. For example, if a freestanding contract, issued together with another instrument, requires that the entity provide to the holder a fixed or guaranteed return such that the instruments are, in substance, debt, the entity shall account for both instruments as liabilities, regardless of the settlement terms of the freestanding contract. However, this Subtopic does apply to contracts that have settlement alternatives with different economic values if the reason for the difference is a limit on the number of shares that must be delivered by the entity pursuant to a net share settlement alternative.

**25-18** If a settlement alternative includes a penalty that would be avoided by an entity under other settlement alternatives, the uneconomic settlement alternative shall be disregarded in classifying the contract.

Special considerations apply in the determination of the appropriate classification for a contract that contains settlement alternatives (e.g., net share or net cash) that could have different economic values (i.e., the net monetary amount of consideration receivable or payable differs depending on which settlement alternative applies). For example, one settlement alternative might have an economic value that is different from other settlement alternatives because:

- It is for a fixed dollar amount.
- It specifies a cap or a floor (e.g., the entity has a right to either net cash or net share settle a contract, but the number of shares that would be delivered in a net share settlement is subject to a cap).
- It contains a penalty that would not be incurred under other settlement alternatives (e.g., the entity has a right to either net cash or net share settle a contract, but the fair value of the net cash settlement alternative is at a discount to the net share settlement alternative).

In such cases, the entity should consider the contract's substance in determining its classification. The entity should ignore any settlement alternatives that would always be uneconomic. If one of the settlement alternatives is associated with a penalty that the entity could avoid by electing a different settlement alternative, the entity would disregard the alternative with the penalty in determining the appropriate contract classification.

However, if one of the settlement alternatives involves delivery of unregistered shares, a reasonable discount from the value of registered shares is permitted if it is determined by using commercially reasonable means and reflects the difference in fair value between registered and unregistered shares (see Section 5.3.2.5).

Under some contracts, the value of shares to be delivered to the counterparty must be in excess of the amount of cash that would be delivered under a net cash settlement; however, a make-whole provision is included in the contract to ensure that the counterparty to the contract receives proceeds upon the ultimate disposition of the shares equal to the amount that would be delivered under a net cash settlement. This settlement alternative should not be viewed as including a penalty as long as the make-whole provision is symmetrical. In other words, any excess value received by the counterparty must be returned to the entity. The additional shares delivered at settlement are meant to provide a cushion to reduce the likelihood that the entity will have to deliver additional shares after the counterparty sells the shares it received upon settlement.
5.2.5.1 Certain Put Warrants

ASC 815-40

55-15 An entity issues senior subordinated notes with a detachable warrant that gives the holder both the right to purchase 6,250 shares of the entity’s stock for $75 per share and the right (that is, a put) to require that the entity repurchase all or any portion of the warrant for at least $2,010 per share at a date several months after the maturity of the notes in about 7 years. The proceeds should be allocated between the debt liability and the warrant based on their relative fair values, and the resulting discount should be amortized in accordance with Subtopic 835-30. The warrants should be considered, in substance, debt and accounted for as a liability because the settlement alternatives for the warrants do not have the same economic value attached to them and they provide the holder with a guaranteed return in cash that is significantly in excess of the value of the share-settlement alternative on the issuance date.

If a warrant was issued to give the counterparty a fixed or guaranteed return so that the instrument is in-substance debt, the contract would be classified as a liability. ASC 815-40-55-15 describes a warrant that contains a right for the counterparty to either exercise the warrant at a price of $75 per share or put the warrant to the entity for cash of at least $2,010 per share. The guidance suggests that this warrant would be classified as a liability because the settlement alternatives have different economic values and give the holder a guaranteed return that is significantly in excess of the fair value of the share settlement alternative as of the issuance date. Note, however, that the detachable stock purchase warrant in this example represents a put warrant. We believe that even if the detachable stock purchase warrant in ASC 815-40-55-15 gave the counterparty a right to put the warrant at an amount of cash that was not significantly in excess of the share settlement alternative, this type of warrant would be classified as a liability as illustrated in ASC 480-10-55-31 (see Section 5.2.4 of Deloitte’s A Roadmap to Distinguishing Liabilities From Equity). The wording of ASC 815-40-55-15 was developed before the issuance of the requirements that were later incorporated into ASC 480-10, under which all redeemable warrants on the entity’s own equity are liabilities.

5.2.6 Settlement Alternatives That Differ in Gain and Loss Positions

ASC 815-40

25-36 This guidance addresses two circumstances in which settlement alternatives differ in gain and loss positions:

a. Net cash payment required in loss position

Net Cash Payment Required in Loss Position

25-37 A contract indexed to, and potentially settled in, an entity’s own stock, with multiple settlement alternatives that require the entity to pay net cash when the contract is in a loss position but receive (a) net stock or (b) either net cash or net stock at the entity’s option when the contract is in a gain position shall be accounted for as an asset or a liability.

Net-Stock Alternative in Loss Position

25-38 A contract indexed to, and potentially settled in, an entity’s own stock, within the scope of this Subtopic and with multiple settlement alternatives that require the entity to receive net cash when the contract is in a gain position but pay (a) net stock or (b) either net cash or net stock at the entity’s option when the contract is in a loss position shall be accounted for as an equity instrument. This guidance does not apply to a contract that is predominantly a purchased option in which the amount of cash that could be received when the contract is in a gain position is significantly larger than the amount that could be paid when the contract is in a loss position because, for example, there is a small contractual limit on the amount of the loss. Those contracts shall be accounted for as assets or liabilities.
Some contracts allow different settlement methods depending on whether the contract is in a gain or a loss position from the entity's perspective. For example, a forward sale contract may require or permit net share settlement if the contract is in a loss position (i.e., the entity would deliver a net number of shares equal in value to the settlement amount if the contract is unfavorable) but require net cash settlement if the contract is in a gain position (i.e., the entity would receive cash from the counterparty equal to the settlement amount if the contract is favorable). If the contract permits the entity to net share settle when the contract is in a loss position, a net cash settlement requirement that applies when the contract is in a gain position would not necessarily preclude the contract from being classified as equity.

Note that this guidance cannot be used to justify equity classification for purchased option contracts that require or permit the counterparty to settle the contract net in cash even though the contract would never require the entity to deliver cash. The guidance also does not apply to a contract that is predominantly a purchased option (e.g., because there is a small contractual limit on the amount of loss). Such a contract would be classified as an asset or a liability even if the entity has the right to net share settle the contract in a loss position.

### 5.2.7 Settlement in Shares Issued by Another Entity Within a Consolidated Group

Some contracts indexed to an entity's own equity require or permit settlement in a variable number of equity shares issued by another entity within a consolidated group (e.g., a contract issued by a parent that the holder is permitted to settle either in a fixed number of equity shares issued by the parent or a variable number of equity shares issued by its subsidiary that have an aggregate fair value at settlement equal to that of a fixed number of parent shares). We believe that if (1) the equity indexation and classification conditions in ASC 815-40 are met and (2) the contract is not required to be classified as an asset or a liability under ASC 480-10 (see Deloitte's *A Roadmap to Distinguishing Liabilities From Equity*), such a contract is not precluded from being classified in equity in consolidated financial statements that include both entities since the shares that will be delivered qualify as equity in the consolidated financial statements. However, such a contract would not qualify as equity in financial statements that do not include consolidated information of both entities since the contract would be indexed to, or involve delivery of shares that do not qualify as, equity in the reporting entity's financial statements. See Section 2.6 for further discussion about the analysis under ASC 815-40 of contracts indexed to, or settled in, the shares of an affiliated entity.
5.3 Additional Equity Classification Conditions

5.3.1 Overview

**ASC 815-40**

25-10 Because any contract provision that could require net cash settlement precludes accounting for a contract as equity of the entity (except for those circumstances in which the holders of the underlying shares would receive cash, as discussed in the preceding two paragraphs and paragraphs 815-40-55-2 through 55-6), all of the following conditions must be met for a contract to be classified as equity:

- **a.** Settlement permitted in unregistered shares. The contract permits the entity to settle in unregistered shares.
- **b.** Entity has sufficient authorized and unissued shares. The entity has sufficient authorized and unissued shares available to settle the contract after considering all other commitments that may require the issuance of stock during the maximum period the derivative instrument could remain outstanding.
- **c.** Contract contains an explicit share limit. The contract contains an explicit limit on the number of shares to be delivered in a share settlement.
- **d.** No required cash payment if entity fails to timely file. There are no required cash payments to the counterparty in the event the entity fails to make timely filings with the Securities and Exchanges Commission (SEC).
- **e.** No cash-settled top-off or make-whole provisions. There are no cash settled top-off or make-whole provisions.
- **f.** No counterparty rights rank higher than shareholder rights. There are no provisions in the contract that indicate that the counterparty has rights that rank higher than those of a shareholder of the stock underlying the contract.
- **g.** No collateral required. There is no requirement in the contract to post collateral at any point or for any reason.

Paragraphs 815-40-25-39 through 25-42 explain the application of these criteria to conventional convertible debt and other hybrid instruments.

The fact that a contract specifies that it will be settled in shares or permits the entity to settle in shares does not necessarily justify a conclusion that the entity could not be forced to net cash settle the contract. With limited exceptions, if there are any circumstances under which the entity could be required to net cash settle the contract, the contract cannot be accounted for as equity (see Section 5.2). For an entity to conclude that it cannot be required to net cash settle a contract, the entity must ensure that the seven conditions in ASC 815-40-25-10(a) through (g) are met. These conditions address whether there are any circumstances under which the issuer could be forced to net cash settle the contract given the contract’s terms and the regulatory and legal framework.

The seven conditions apply even if the contract stipulates either physical settlement or net share settlement. That is, an entity cannot assume that it can physically settle or net share settle a contract unless all the conditions are met irrespective of whether the contract specifies that it will be share settled.

The conditions are assessed without regard to the likelihood that an event could force the entity to net cash settle the contract. Accordingly, if there are circumstances under which the entity could be forced to net cash settle the contract during its term, the contract is classified as an asset or a liability even if the likelihood is remote that the circumstances will occur.
In addition, the seven conditions are evaluated on an ongoing basis (see Section 5.4). A contract that initially meets the conditions and qualifies as equity might need to be reclassified out of equity if one or more of the conditions is no longer met. Conversely, a contract that does not initially qualify for equity classification is reclassified into equity if it later meets all conditions for equity classification.

The seven conditions do not apply to a conversion option embedded in a contract that is considered conventional convertible debt. In a conventional convertible debt instrument, the investor can realize the value of the conversion option only by exercising it and receiving the entire proceeds in a fixed number of shares or the equivalent amount of cash at the issuer’s discretion (see Section 5.5).

Before the FASB’s codification of U.S. GAAP, EITF Issue 00-19 identified an eighth equity classification condition; namely, that a “contract requires net-cash settlement only in specific circumstances in which holders of shares underlying the contract also would receive cash in exchange for their shares.” Under ASC 815-40, this condition still applies but it is not one of the seven conditions described in ASC 815-40-25-10 (see Sections 5.2.2 and 5.2.3).

If the issuer cannot be required to deliver any shares to settle the instrument, conditions 1 through 3 (related to the entity’s ability to settle in shares) do not apply. Depending on the contract terms, therefore, scenarios in which those conditions may not apply include the following:

- A net-share-settled put or call option held by the entity. (If the entity elects to exercise the option, it will receive, not deliver, shares.)
- A physically settled call option held by the entity. (If the entity elects to exercise the option, it will receive, not deliver, shares.)
- A physically settled written put option embedded in own stock. (If the counterparty elects to exercise the embedded put option, the entity will receive, not deliver, shares.)
- A contingent physically settled forward contract to repurchase own stock that is embedded in an outstanding share. (If the contingency is met, the entity will receive, not deliver, shares.)

Conditions 1 through 3 do apply, however, to a physically settled put option held by the entity, since the entity would deliver shares upon exercise. This is the case even though the decision to exercise the option is within the entity’s control (ASC 815-40-25-11).

5.3.2 Condition 1: Settlement Permitted in Unregistered Shares

<table>
<thead>
<tr>
<th>ASC 815-40</th>
</tr>
</thead>
</table>

25-11 The events or actions necessary to deliver registered shares are not controlled by an entity and, therefore, except under the circumstances described in paragraph 815-40-25-16, if the contract permits the entity to net share or physically settle the contract only by delivering registered shares, it is assumed that the entity will be required to net cash settle the contract. As a result, the contract shall be classified as an asset or a liability.

25-12 Delivery of unregistered shares in a private placement to the counterparty is within the control of an entity, as long as a failed registration statement (that is, a registration statement that was filed with the SEC and subsequently withdrawn) has not occurred within six months before the classification assessment date. If a failed registration statement has occurred within six months of the classification assessment date, whether an entity can deliver unregistered shares to the counterparty in a net share or physical settlement is a legal determination.
| Condition 1 focuses on whether the entity is legally able to deliver shares in settling the contract. To meet this condition, it is not sufficient that the contract states that the issuer is required or permitted to settle by delivering shares. Under the Securities Act of 1933, offers and sales of securities must be registered with the SEC unless a specific exemption from the registration requirements applies. Accordingly, depending on the facts and circumstances, an entity may not be able to deliver shares in settling a contract unless those shares have been registered with the SEC. As an issuer of shares, however, an entity cannot control whether the SEC will approve or refuse to approve the registration of its shares, and even if it has an effective registration statement, the SEC may suspend the registration before the contract is settled. Further, the entity cannot control whether its auditor will provide it with an audit opinion or any consents required for share registration. Consequently, if it is unable to deliver registered shares because of such circumstances, the entity may be forced to net cash settle the contract unless it is legally able to settle the contract by delivering unregistered shares.

For a contract to meet condition 1, one or more of the following circumstances must be present:

- The entity has a legally enforceable right to settle the contract in unregistered shares and there was no failed registration statement within the past six months (ASC 815-40-25-12). Further, the contract cannot contain an economic penalty associated with the delivery of unregistered shares; see Sections 5.3.2.1 and 5.3.2.5.
- The contract involves the delivery of shares at settlement that were registered at contract inception and there are no further timely filing or registration requirements (ASC 815-40-25-16; see Section 5.3.2.2).
- The contract clearly states that the issuer has no obligation to net cash settle the contract if it is unable to deliver registered shares (see Section 5.3.2.3).
- The entity will never be required to deliver any shares under the contract (see Section 5.3.2.4).
5.3.2.1 **Right to Settle in Unregistered Shares**

If the entity has a legally enforceable right to settle the contract in unregistered shares in a private placement and there was no failed registration statement (i.e., the entity filed and later withdrew the registration statement) within the past six months, equity classification is not precluded as long as the contract does not contain an economic penalty associated with the delivery of unregistered shares (see Section 5.3.2.5).

If the contract is silent on whether settlement in unregistered shares is permitted, the issuer cannot assume that it has the right to such settlement; accordingly, it may need to perform a legal analysis to make this determination. In a speech at the 2006 AICPA Conference on Current SEC and PCAOB Developments, Stephanie Hunsaker, then-associate chief accountant in the SEC’s Division of Corporation Finance, said:

[The] staff believes that if the warrant agreement requires delivery of registered shares, does not specify how the contract would be settled in the event the company is unable to deliver registered shares, and does not specify any circumstances under which net cash settlement would be permitted or required, net cash settlement must be assumed since it is unlikely that noncompliance is an acceptable alternative.

Likewise, an entity cannot assume that it has a right to settle in unregistered shares even if the contract specifies that the entity has such a right. If no specific exemption from the SEC’s registration requirements is available, U.S. securities laws may require settlement in registered shares even if the contract says otherwise or is silent. Thus, if the contract specifies that the entity has a right to settle in unregistered shares but settlement in unregistered shares would violate U.S. securities laws, the entity will not be able to legally assert that it can settle the contract by delivering unregistered shares. This is a legal determination. Ms. Hunsaker said in her speech:

[We] have seen numerous situations where registrants have tried to assert that the contract permits settlement in unregistered shares. This assertion appears to stem from the fact that oftentimes the contract itself does not specifically state that the company must settle in registered shares. However, U.S. Securities Laws may implicitly require settlement in registered shares because the company will not be able to find an exemption from registration and therefore settling in unregistered (or restricted) shares would be a violation of U.S. Securities laws. . . .

[If] the warrants were sold in a registered offering, there will likely not be an exemption available to the company for the sale of the shares underlying the warrants. If there is not a current prospectus, the company will not be able to deliver registered shares upon exercise of the warrants.

If the entity has had a failed registration statement within the past six months, the entity cannot assume that it will be able to deliver unregistered shares even if the contract ostensibly allows it because delivery of unregistered shares may not be legally permitted. This is a legal determination. Issue Summary 1 of EITF Issue 00-19 (prepared July 6, 2000) states, in part:

The staff of the SEC has taken the view that the filing of a registration statement for a specific securities offering (other than a shelf registration statement) constitutes a general solicitation for that offering. Thus, if an issuer wishes to follow a withdrawn registration statement with a private offering, there may be, depending on the facts, some legal risk that a private offering exemption would be unavailable.

5.3.2.2 **No Further Timely Filing or Registration Requirements**

An entity is not precluded from classifying a contract as equity if the shares to be delivered were registered at contract inception and there are no further timely filing or registration requirements related to the shares. This is an exception to the requirement that the contract permit settlement in unregistered shares. Issue Summary 1, Supplement 2, of EITF Issue 00-19 (prepared October 23, 2000) explains the reason for this exception:
If a legal determination is made that delivery of shares at settlement of the contract will not require registration . . ., then delivery of shares is within the control of the issuer and equity classification is appropriate if the other conditions . . . are met.

In practice, however, it is sometimes difficult for an entity to meet the criteria for this exception. If securities laws (e.g., the Exchange Act) require the entity to periodically file (e.g., Form 10-K or 10-Q) and deliver a current, updated prospectus to maintain the shares’ registration, this exception is not available. An entity may need to consult legal counsel to determine whether the exception is available.

Ms. Hunsaker suggested in her 2006 speech that the legal analysis of whether there are further timely filing or registration requirements may depend on whether the counterparty will make an investment decision upon the contract’s exercise or settlement. For a warrant, for example, the counterparty may need to make an investment decision regarding whether to exercise the warrant (whereas for a forward contract, the investment decision would be made at contract inception). She said:

During the term of the warrants, the issuer will have to deliver a ‘current prospectus’ to the warrant holders in connection with any exercises by them. **These further registration requirements stem from the fact that the holder of the warrant has to make a separate investment decision at the time of the exercise of the warrant** and therefore a current prospectus must be delivered to the holder. Initially the issuer will be able to use the prospectus that was declared effective with respect to the unit offering when it sells shares to exercising warrant holders. However, as time passes, the prospectus will be required to be updated to disclose additional information or provide updated financial information. . . .

**[A] forward contract requires the holder to purchase shares of common stock on a preset date in the future. . . .**

**The conclusion that there are not further timely filing or registration requirements stems from the fact that the investment decision (to purchase common stock in the future under the stock purchase contract) has been made** at inception and there is no further investment decision to be made. In effect, there really is just a delayed delivery of the shares underlying the stock purchase contract. [Emphasis added]

In evaluating whether further timely filing or registration requirements exist, an entity should consider whether any specific exemption from the SEC’s registration requirements applies. Ms. Hunsaker emphasized in her 2006 speech that an exemption may be available under Section 3(a)(9) of the Securities Act of 1933 if one class of securities of an issuer is exchanged for a different class of securities of the same issuer as long as no consideration or commissions are being paid. She said:

Let’s take [an] example related to either registered convertible debentures or registered convertible preferred stock that could be immediately converted into shares of common stock of the registrant. In this case, the issuer would register the convertible debt or convertible preferred stock, plus the common shares underlying the convertible debt or convertible preferred stock, since the issuer is really transacting a sale of both the convertible security and an offer of the underlying common shares. There will typically be an exemption available to the company for the issuance of common shares upon conversion. This exemption is under Section 3(a)(9) of the Securities Act, and pertains to the exchange of one class of securities of an issuer for a different class of securities of the same issuer, in which no consideration or commissions are being paid. This is important, and different from my earlier general statement that once you start an offering publicly, you must complete it publicly. In this case, the Section 3(a)(9) exemption is typically available even if the offering of the convertible security takes place in a registered format. In general, the conditions of Section 3(a)(9) will be met at the time of conversion of the publicly held debt or convertible preferred stock. . . . [A]ssuming Section 3(a)(9) is available, which is generally the case, the offering of securities that underlie the convertible debentures that commenced in the registration process can be completed without the availability of a current prospectus. The shares delivered by the company will be freely tradeable since the transaction and the shares underlying the conversion option were registered upfront. As a result, even if the convertible debt or convertible preferred stock offering was conducted publicly, the registrant would not be required to conclude the embedded conversion option fails equity classification under [ASC 815-40-25-11 through 25-18]. Of course, this assumes that the settlement alternatives are equivalent and that the remaining criteria for equity classification must also be met before the final analysis is completed.
Further, Ms. Hunsaker stressed that registrants may need to consult with legal counsel:

However, registrants should ensure they have discussed with their legal counsel the availability of the Section 3(a)(9) exemption to their fact pattern, particularly in unusual circumstances such as when it is uncertain if the securities are convertible into those of the same issuer, arrangements which may involve the payment of remuneration for soliciting the exchange, or arrangements where the convertible securities are not potentially immediately convertible into shares of common stock of the registrant and the issuer has not registered all of the shares which could be issued upon conversion at inception along with the convertible debt.

5.3.2.3 No Obligation to Net Cash Settle the Contract

If the entity is not required to perform because of its inability to deliver registered shares, condition 1 (i.e., ability to settle the contract in unregistered shares) does not apply. As noted in ASC 815-40-25-14, “net cash settlement is assumed if the entity is unable to deliver registered shares (because it is unlikely that nonperformance would be an acceptable alternative).” Thus, if nonperformance is an acceptable alternative, net cash settlement would not be assumed.

The SEC staff has indicated that if there are no circumstances in which the entity would be required to net cash settle the contract, the staff would not object to the conclusion that the contract qualifies for equity classification even if the entity does not have an effective registration statement. Ms. Hunsaker said in her 2006 speech:

[T]he staff has seen circumstances . . . whereby [a] warrant agreement clearly indicates, in either the original agreement or by clarifying amendment, that in the event the company does not have an effective registration statement, there is no circumstance that would require the registrant to net cash settle the warrants. In such a case, the staff would not object to the company’s conclusion that the warrants would not be required to be classified as liabilities.

For example, a contract that requires settlement in registered shares might state:

The warrants may be exercised if and only if . . . a registration statement on an applicable form under the Securities Act, covering the issuance by the Company of all the Warrant Shares, shall have been declared effective by the Commission and shall continue to be effective as of the time of exercise of the Warrants.

Alternatively, a contract might specify that the entity will use its best efforts to maintain a current prospectus and, if the entity nevertheless is unable to deliver registered shares, the contract cannot be exercised.

5.3.2.4 No Obligation to Deliver Shares

If there are no circumstances in which the contract would require the entity to deliver shares, the condition that the entity is able to settle the contract by delivering unregistered shares does not apply. Thus, depending on the contract terms, the condition may not apply to, for example, a purchased call option on the entity’s own equity in which the entity would receive, not deliver, shares upon exercise (see Section 5.3.1).
5.3.2.5  **Discount on the Value of Unregistered Shares**

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<th>ASC 815-40</th>
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**25-17** A contract may specify that the value of the unregistered shares to be privately placed under share settlement is to be determined by the counterparty using commercially reasonable means. That valuation is used to determine the number of unregistered shares that must be delivered to the counterparty. The term *commercially reasonable* means is sufficiently objective from a legal perspective to prevent a counterparty from producing an unrealistic value that would then compel an entity to net cash settle the contract. Similarly, a contractual requirement to determine the fair value of unregistered shares by obtaining market quotations is sufficiently objective and would not suggest that the settlement alternatives have different economic values.

**Uneconomic Settlement Alternatives**

**25-18** If a settlement alternative includes a penalty that would be avoided by an entity under other settlement alternatives, the uneconomic settlement alternative shall be disregarded in classifying the contract. In the case of delivery of unregistered shares, a discount from the fair value of the corresponding registered shares that is a reasonable estimate of the difference in fair values between registered and unregistered shares (that is, the discount reflects the fair value of the restricted shares determined using commercially reasonable means) is not considered a penalty.

Investors usually will prefer to receive registered shares so they can sell those shares more easily. If an entity has the right to settle in unregistered shares but there is an economic penalty in the contract associated with the delivery of unregistered shares, the entity must presume net cash settlement, and the contract cannot be classified as equity. However, a discount from the fair value of the corresponding registered shares is permitted if it is a reasonable estimate of the difference in fair value between registered and unregistered shares that is determined by using commercially reasonable means. For example, a contract may specify that the entity has the right to settle the contract in either unregistered or registered shares. If the entity delivers unregistered shares, the number of unregistered shares required to settle the contract will be adjusted by a calculation agent to reflect an appropriate liquidity discount based on the fair value difference between a freely tradeable and an unregistered share (i.e., the entity would be required to deliver additional shares to reflect the discount).

Consider a freestanding warrant contract on an entity’s stock that specifies that the entity has the right to settle in either registered or unregistered shares. If the entity elects to deliver unregistered shares, it must give the counterparty a greater number of shares than if it were to settle by delivering registered shares. If the value of the incremental shares the entity has to deliver in case it elects to settle in unregistered shares reflects a commercially reasonable estimate of the difference in value between registered and unregistered shares as a result of illiquidity, settlement in unregistered shares is not considered uneconomic. If the value of the incremental shares exceeds such an estimate, however, the entity’s right to settle in unregistered shares is considered uneconomic and is disregarded in the classification of the contract (see Section 5.2.5). The warrant therefore does not meet condition 1 (i.e., ability to settle the contract in unregistered shares) and does not qualify as equity. (As discussed in Section 5.5, the condition that the contract permit settlement in unregistered shares does not apply to features embedded in conventional convertible debt.)

Under some contracts, the number of shares to be delivered to the counterparty if the entity elects to settle in unregistered shares must be in excess of the number of shares required to be delivered if the entity elects to settle in registered shares; however, a make-whole provision is included in the contract to ensure that the counterparty to the contract would receive proceeds upon the ultimate disposition of the unregistered shares equal to the value of the shares that would have been delivered under a settlement in registered shares. This settlement alternative should not be viewed as including a penalty as long as the make-whole provision is symmetrical. In other words, any excess value received by the
counterparty must be returned to the entity. The additional shares delivered at settlement are meant to provide a cushion to reduce the likelihood that the entity will have to deliver additional shares after the counterparty sells the shares it received upon settlement.

5.3.2.6 Interaction With the Guidance on Registration Payment Arrangements

Sometimes a contract requires the entity to pay cash penalties if it is unable to register the shares underlying the contract or is unable to maintain an effective registration statement. In this case, the entity should consider whether that penalty provision meets the definition of a registration payment arrangement under ASC 825-20 (see Section 3.2.4). Under ASC 825-20-25-1, a registration payment arrangement that has the characteristics described in ASC 825-20-15-3 is recognized as a unit of account that is separate from the contract subject to the agreement. Thus, a contract on the entity's own equity that is subject to a registration payment arrangement within the scope of ASC 825-20 is evaluated under ASC 815-40 without regard to the contingent obligation to transfer consideration under the registration payment agreement (ASC 825-20-25-2). In other words, a contract on an entity's own equity is not necessarily precluded from equity classification because it specifies cash penalties if the entity is unable to register the shares underlying the contract, as long as the entity is not required to net cash settle the contract.

We believe that if a contract permits the entity to settle by delivering unregistered shares, the contract can qualify as equity even if it requires the entity to use commercially reasonable best efforts to register any unregistered shares delivered. This is analogous to ASC 815-40-25-28, which states, in part:

Use of the entity's best efforts to obtain sufficient authorized shares to settle the contract is within the entity's control.

5.3.3 Condition 2: Entity Has Sufficient Authorized and Unissued Shares

<table>
<thead>
<tr>
<th><strong>ASC 815-40</strong></th>
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<tbody>
<tr>
<td><strong>25-19</strong> If an entity could be required to obtain shareholder approval to increase the entity's authorized shares to net share or physically settle a contract, share settlement is not controlled by the entity.</td>
</tr>
<tr>
<td><strong>25-20</strong> Accordingly, an entity shall evaluate whether a sufficient number of authorized and unissued shares exists at the classification assessment date to control settlement by delivering shares. In that evaluation, an entity shall compare both of the following amounts:</td>
</tr>
<tr>
<td>a. The number of currently authorized but unissued shares, less the maximum number of shares that could be required to be delivered during the contract period under existing commitments, including any of the following:</td>
</tr>
<tr>
<td>1. Outstanding convertible debt that is convertible during the contract period</td>
</tr>
<tr>
<td>2. Outstanding stock options that are or will become exercisable during the contract period</td>
</tr>
<tr>
<td>3. Other derivative financial instruments indexed to, and potentially settled in, an entity's own stock.</td>
</tr>
<tr>
<td>b. The maximum number of shares that could be required to be delivered under share settlement (either net share or physical) of the contract.</td>
</tr>
<tr>
<td><strong>25-21</strong> When evaluating whether there are sufficient authorized and unissued shares available to settle a contract, an entity shall consider the maximum number of shares that could be required to be delivered under a registration payment arrangement to be an existing share commitment, regardless of whether the instrument being evaluated is subject to that registration payment arrangement.</td>
</tr>
</tbody>
</table>
25-22 If the amount in paragraph 815-40-25-20(a) exceeds the amount in paragraph 815-40-25-20(b) and the other conditions in this Subtopic are met, share settlement is within the control of the entity and the contract shall be classified as a permanent equity instrument. Otherwise, share settlement is not within the control of the entity and asset or liability classification is required.

25-23 For purposes of this calculation, if a contract permits both (a) net share and (b) physical settlement by delivery of shares at the entity’s option (both alternatives permit equity classification if the other conditions in this Section are met), the alternative that results in the lesser number of maximum shares shall be included in this calculation.

25-24 If a contract is classified as either an asset or a liability because the counterparty has the option to require settlement of the contract in cash, then the maximum number of shares that the counterparty could require to be delivered upon settlement of the contract (whether physical or net share) shall be assumed for purposes of this calculation.

Under condition 2, a contract cannot be classified as equity unless either of the following criteria is met:

- The entity currently has a sufficient number of authorized and unissued shares available to share settle the contract.
- The entity is able, without shareholder approval, to increase the number of authorized shares to make a sufficient amount of authorized and unissued shares available to share settle the contract.

Whether shareholder approval would be required for an increase in the number of authorized shares is a legal determination (e.g., it may differ across jurisdictions). If shareholder approval is required for such an increase (e.g., under corporate law), the contract cannot be classified as equity unless the entity currently has a sufficient number of authorized and unissued shares available to share settle the contract. Issue Summary 1 of EITF Issue 00-19 (prepared July 6, 2000) explains the reason for this guidance:

[B]ecause the company cannot be assured that the shareholders will vote for the increase in the number of authorized shares, net share settlement is not within the control of the company.

If shareholder approval is obtained for an increase in the number of authorized shares, the entity should consider whether contracts that previously were classified as assets or liabilities (because the number of authorized shares was insufficient) will need to be reclassified as equity (see Section 5.4).

In assessing whether it has a sufficient number of authorized and unissued shares, an entity does not take into account only the number of its currently authorized and unissued shares. It must also consider how many shares it might be required to deliver under any other commitment to deliver shares during the maximum period in which the contract being evaluated might remain outstanding, including any top-off or make-whole commitments (see Section 5.3.6). Such commitments include not only contracts within the scope of ASC 815-40 but also contracts within the scope of other accounting guidance such as ASC 480 or ASC 718. Examples include warrants, options, forwards, employee stock options, convertible debt, convertible preferred stock, share-settled contingent consideration in a business combination, and share-settled registration payment arrangements.

The entity deducts the maximum number of shares it could be required to deliver during the contract period under such commitments from the number of currently authorized but unissued shares. Equity classification for the contract being assessed is precluded unless the number of authorized and unissued shares that remains after deduction of all the shares the entity might have to deliver under
other commitments exceeds the maximum number of shares that the entity could be required to deliver under the contract. In determining this number, the entity does not consider the likelihood that it might have to deliver shares under other commitments.

If an entity anticipates issuing shares but is not committed to doing so, it would not consider those shares in the calculation, but it would consider them in its periodic reassessment of the classification of contracts when the issuances actually occur. This practice is consistent with the minutes of the EITF's November 15–16, 2000, meeting, which state, in part:

It is not necessary to subtract anticipated voluntary share issuances from the number of authorized but unissued shares because such issuances are, by definition, within the control of the company. However, such voluntary issuances (when they actually occur) would be considered in the periodic reassessment of classification.

**Example 5-3**

**Application of Condition 2**

An entity has issued a warrant that expires in one year. If the holder exercises the warrant, the contractual terms of the warrant require the entity to deliver 20,000 shares of the entity's stock in exchange for a cash payment of $5 million. Further, the entity determines that (1) it currently has 100,000 authorized shares, of which 40,000 are in issuance, and (2) the maximum number of shares that it could be required to deliver during the warrant's one-year term because of other commitments (e.g., outstanding convertible debt, employee stock options) is 35,000.

The entity would calculate the number of shares available to share settle the warrant being evaluated as follows:

<table>
<thead>
<tr>
<th>Calculation and Comparison</th>
<th>Number of Shares</th>
</tr>
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<tbody>
<tr>
<td>Currently authorized shares</td>
<td>100,000</td>
</tr>
<tr>
<td><strong>Less:</strong> Issued shares</td>
<td>(40,000)</td>
</tr>
<tr>
<td><strong>Less:</strong> Maximum number of shares the entity could be forced to deliver during the contract term under other commitments</td>
<td>(35,000)</td>
</tr>
<tr>
<td><strong>Equals:</strong> Shares available to share settle the contract</td>
<td>25,000</td>
</tr>
<tr>
<td><strong>Compare:</strong> Maximum number of shares that the entity could be forced to deliver under the contract being evaluated</td>
<td>20,000</td>
</tr>
</tbody>
</table>

The warrant being evaluated is not precluded from equity classification because the entity has a sufficient number of authorized and unissued shares available to share settle the contract. That is, the contract being evaluated would never require delivery of more than 20,000 shares, and the entity has 25,000 shares available to share settle the contract.

In calculating the maximum number of shares that might have to be delivered under a contract that (1) could require the entity to deliver shares and (2) includes a choice of settlement method (e.g., physical settlement, net shares, or net cash), the entity considers which party controls the manner of settlement. If the entity has the option to elect either net share or physical settlement, the entity reflects the alternative with the lesser number of shares in the calculation (i.e., net share settlement), since the entity cannot be forced to deliver the greater number of shares that would be delivered in a physical settlement. If the counterparty can elect the settlement method, the entity reflects the alternative that will require delivery of the greater number of shares in the calculation. If this is the case, the entity incorporates the greater number of shares in the calculation even if the contract is classified as an asset or a liability (e.g., because the counterparty has the right to elect net cash settlement).
Note that the classification requirements in ASC 815-40 apply to each contract as a whole unless the contract permits partial net share settlement. If a contract does not permit partial net share settlement, the whole contract is classified as an asset or a liability if the entity does not have sufficient shares to share settle the entire contract. If a contract permits partial net share settlement and the entity has sufficient authorized and unissued shares to settle some, but not all, of the contract in shares, that portion of the contract for which the issuer has sufficient authorized and unissued shares is classified within equity as long as it meets the other conditions for equity classification. That is, a single contract can be classified as part equity or part asset or liability only if it permits partial net share settlement (ASC 815-40-35-11).

If the issuer cannot be required to deliver any shares to settle the contract, condition 2 (i.e., the entity has sufficient authorized and unissued shares to settle the contract) does not apply. Depending on the contract terms, therefore, the condition may not apply to, for example, a purchased call option on the entity’s own equity, in which the entity will receive, not deliver, shares upon exercise (see Section 5.3.1).

### 5.3.3.1 Sequencing Considerations

If an entity concludes that it does not have sufficient authorized and unissued shares to satisfy all its commitments to deliver shares, it should apply a sequencing policy to determine how to allocate any authorized and unissued shares among those commitments. In establishing a sequencing policy, an entity should consider the guidance on reclassification methods in ASC 815-40-35-11 through 35-13 (see Section 5.4). While that guidance addresses “reclassifications,” we believe that it is also helpful in the determination of the initial classification of contracts. Depending on how authorized and unissued shares are allocated under an entity’s sequencing policy, the entity may conclude that it has a sufficient number of authorized and unissued shares available to share settle the contract being evaluated.

### 5.3.4 Condition 3: Contract Contains an Explicit Share Limit

<table>
<thead>
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<th>ASC 815-40</th>
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<tbody>
<tr>
<td>25-26 For certain contracts, the number of shares that could be required to be delivered upon net share settlement is essentially indeterminate. If the number of shares that could be required to be delivered to net share settle the contract is indeterminate, an entity will be unable to conclude that it has sufficient available authorized and unissued shares and, therefore, net share settlement is not within the control of the entity.</td>
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In accordance with condition 3, for equity classification to be appropriate, the number of shares the entity might be required to deliver under the contract must be limited (capped). If determining the maximum number of such shares is not possible, then equity classification is not permitted because it would be impossible to establish whether the entity has a sufficient number of authorized and unissued shares available to settle the instrument in shares. That is, a contract that could require the entity to deliver an unlimited number of shares would not qualify as equity. The number of shares that it expects to deliver is not relevant to this determination, nor is whether there is only a remote likelihood that the entity will deliver more than some specific number of shares.
The SEC’s *Current Accounting and Disclosure Issues in the Division of Corporation Finance* (as updated November 30, 2006) notes that one of the most common causes of improper accounting for a conversion feature embedded in convertible debt or convertible preferred stock is that:

> [T]he number of shares issuable upon conversion of the convertible instrument is variable, and there is no cap on the number of shares which could be issued. [Since] there is no explicit limit on the number of shares that are to be delivered upon exercise of the conversion feature, the registrant is not able to assert that it will have sufficient authorized and unissued shares to settle the conversion option. As a result, the conversion feature would be accounted for as a derivative liability, with changes in fair value recorded in earnings each period. Additionally, registrants should note that a variable share settled instrument that results in liability classification may impact the classification of previously issued instruments, as well as instruments issued in the future.

The contract’s terms do not necessarily need to use the words “explicit share limit” to qualify under condition 3. It may be possible for an entity to infer an explicit share limit from the terms. Consider a convertible bond with a par value of 1,000, a fixed conversion price of $20, and no adjustment provisions that could increase the number of shares that would be delivered. Dividing the par value of 1,000 by the conversion price of $20 implies that the entity would never deliver more than 50 shares. Thus, 50 shares is the explicit share limit. If the issuer writes a freestanding call option on its own outstanding shares, the terms of the option contract may similarly establish an explicit share limit. For example, if the written call option has a fixed notional amount of 100 shares and no adjustment provisions, the entity will never deliver more than 100 shares irrespective of whether the contract provides for physical settlement or net share settlement.

Many contracts require adjustments to the number of shares to be delivered upon the occurrence or nonoccurrence of a specified event (e.g., an antidilution adjustment that specifies that the number of shares will be increased in case of a stock split). A contractual provision that increases the number of shares to be delivered upon the occurrence or nonoccurrence of an event does not violate condition 3 if the event that triggers the adjustment is within the entity’s control (see Section 5.2.3.1). If the triggering event is outside the entity’s control (e.g., a merger or a consolidation), the contract may still meet condition 3 if the event causes the contract to be settled and holders of the underlying shares receive the same form of consideration (see Section 5.2).

If the issuer cannot be required to deliver any shares to settle the instrument, the condition that the contract contains an explicit share limit does not apply. (Alternatively, the contract could be analyzed as having a share limit of zero since the entity could not be required to deliver any shares.) Depending on the contract terms, therefore, the condition may not apply to, for example, a purchased call option on the entity’s own equity in situations in which the entity would receive, not deliver, shares upon exercise (see Section 5.3.1).

A contract may contain a clause that limits the holder’s ability to exercise and beneficially own more than a specified percentage of the issuer’s outstanding shares (e.g., the counterparty cannot exercise the contract if it owns or would obtain more than 4.99 percent of outstanding shares). Such a cap does not qualify as an explicit share limit since the counterparty can sell the shares it holds before exercise and any shares it receives upon exercise.

We believe that if the entity is able, without shareholder approval, to increase the number of authorized shares to make a sufficient number of authorized and unissued shares available to share settle the contract, the requirement that the contract must contain an explicit share limit does not apply because the entity could not be forced to cash settle the contract (see Section 5.3.3).

The existence of an explicit share limit in a contract’s terms solely to meet condition 3 would not preclude a conclusion that the contract is a fixed-for-fixed forward or an option on the entity’s equity shares (see Section 4.3.2).
5.3.4.1 Interaction Between Condition 2 (Sufficient Shares) and Condition 3 (Share Limit)

ASC 815-40

25-27 If a contract limits or caps the number of shares to be delivered upon expiration of the contract to a fixed number, that fixed maximum number can be compared to the available authorized and unissued shares (the available number after considering the maximum number of shares that could be required to be delivered during the contract period under existing commitments as addressed in paragraph 815-40-25-20 and including top-off or make-whole provisions as discussed in paragraph 815-40-25-30) to determine if net share settlement is within the control of the entity. A contract termination trigger alone (for example, a provision that requires that the contract will be terminated and settled if the stock price falls below a specified price) does not satisfy this requirement because, in that circumstance, the maximum number of shares deliverable under the contract is not known with certainty unless there is a stated maximum number of shares.

If an entity determines that a contract contains a share limit (i.e., it satisfies condition 3), the entity can then compare that share limit with the number of available shares. If there is a share limit but it exceeds the number of available shares, the contract fails to meet condition 2 (i.e., sufficient shares available to share settle the contract). In this case, the entity classifies the contract as an asset or a liability either in whole or in part depending on whether the contract permits partial net share settlement (ASC 815-40-35-11) and meets the other conditions for equity classification. On the other hand, if there is a share limit and the number of available shares exceeds that limit, the contract potentially qualifies for equity classification if the other conditions for equity classification are met.

5.3.4.2 Contract With Share Limit and Best-Efforts Arrangement

ASC 815-40

25-28 This paragraph addresses a contract structure that caps the number of shares that must be delivered upon net share settlement but would also provide that any contract valued in excess of that capped amount may be delivered to the counterparty in cash or by delivery of shares (at the entity's option) when authorized, unissued shares become available. The structure requires the entity to use its best efforts to authorize sufficient shares to satisfy the obligation. Under the structure, the number of shares specified in the cap is less than the entity's authorized, unissued shares less the number of shares that are part of other commitments (see paragraph 815-40-25-20). Use of the entity's best efforts to obtain sufficient authorized shares to settle the contract is within the entity's control. If the contract provides that the number of shares required to settle the excess obligation is fixed on the date that net share settlement of the contract occurs, the excess shares need not be considered when determining whether the entity has sufficient, authorized, unissued shares to net share settle the contract pursuant to paragraph 815-40-25-20. However, the contract may provide that the number of shares that must be delivered to settle the excess obligation is equal to a dollar amount that is fixed on the date of net share settlement (which may or may not increase based on a stated interest rate on the obligation) and that the number of shares to be delivered will be based on the market value of the stock at the date the excess amount is settled. In that case, the excess obligation represents stock-settled debt and shall preclude equity classification of the contract (or, if partial net share settlement is permitted under the contract pursuant to paragraph 815-40-35-11, precludes equity classification of the portion represented by the excess obligation).

The counterparty to a contract on the entity's own equity may be reluctant to accept an explicit share limit that caps the gain it could make on the contract. In this case, the entity may agree to (1) deliver the shares that are in excess of the limit (the number of which becomes fixed as of the contract's settlement date) only once authorized, unissued shares become available, and (2) use its best efforts to obtain such shares. In this situation, the entity does not need to consider the excess shares in determining whether it has sufficient authorized and unissued shares to net share settle the contract because it cannot be forced to deliver those shares.
Note, however, that if the contract specifies that the entity will deliver a variable number of shares equal in value to that of the excess shares determined as of the settlement date, the excess obligation is considered stock-settled debt. In this case, the contract must be classified as a liability either for the part that exceeds the explicit share limit (if the contract permits partial net share settlement) or in its entirety (if it cannot be partially net share settled or otherwise does not meet the conditions for equity classification). Once the monetary amount of the stock-settled debt becomes fixed as of the contract’s original settlement date, that obligation is outside the scope of ASC 815-40 under ASC 815-40-15-3(e) and is instead accounted for as a liability under ASC 480-10 (see Section 2.3 and Chapter 6 of Deloitte’s A Roadmap to Distinguishing Liabilities From Equity).

5.3.5 Condition 4: No Required Cash Payment if Entity Fails to Timely File

If a contract must be net cash settled in the event that the entity does not file reports with the SEC on time, the contract cannot be accounted for as equity. In the evaluation of whether this condition is met, the likelihood of the entity's being unable to file on time is irrelevant.

The reason for this requirement is that the ability to file reports with the SEC on time is not solely within the entity's control. For example, an entity cannot control whether its auditor will provide it with an audit opinion that is required in filing the entity's annual financial statements. Some filings may require the consent of the entity's auditor or third-party experts.

If a contract requires the entity to make a cash payment for failing to timely file financial statements with the SEC or other body (e.g., an amount in cash equal to 2 percent of the contract's exercise price on the day of a failure to file and on every 30th day thereafter until the date such failure is cured), and that payment is not part of an arrangement that meets the definition of a registration payment arrangement (see Section 3.2.4), the related contract cannot be classified in equity. The fact that the payment may not be considered the equivalent of a net cash settlement of the entire contract is not relevant to the classification assessment; rather, the cash payment precludes equity classification because an entity does not control the ability to make timely filings with the SEC or other body. By analogy, the guidance in ASC 815-40-25 on top-off or make-whole payments precludes equity classification in certain circumstances in which the issuer is required to make only partial settlement payments.

A requirement that the entity use its best efforts to make timely filings is within its control and would not preclude equity classification.

Some hybrid contracts specify that the entity will pay cash penalties or additional interest if the entity does not file on time. For example, a convertible debt instrument may indicate that additional interest is payable if the entity fails to file timely reports. We believe that such a feature may be attributed to the hybrid contract and evaluated separately as an embedded derivative provided that the penalty paid does not vary on the basis of the value of the conversion option. Accordingly, it would not disqualify the conversion option from being classified as equity.
5.3.6 **Condition 5: No Cash-Settled Top-Off or Make-Whole Provision**

### ASC 815-40

**25-30** A top-off or make-whole provision would not preclude equity classification if both of the following conditions exist:

a. The provision can be net share settled.
b. The maximum number of shares that could be required to be delivered under the contract (including any top-off or make-whole provisions) is both:
   1. Fixed
   2. Less than the number of available authorized shares (authorized and unissued shares less the maximum number of shares that could be required to be delivered during the contract period under existing commitments as discussed in paragraph 815-40-25-20).

If those conditions are not met, equity classification is precluded.

### ASC 815-40-20 — Glossary

**Make-Whole Provision**

A cash payment to a counterparty if the shares initially delivered upon settlement are subsequently sold by the counterparty and the sales proceeds are insufficient to provide the counterparty with full return of the amount due. While the exact terms of such provisions vary, they generally are intended to reimburse the counterparty for any losses it incurs or to transfer to the entity any gains the counterparty recognizes on the difference between the following:

a. The settlement date value
b. The value received by the counterparty in subsequent sales of the securities within a specified time after the settlement date.

**Top-Off Provision**

See Make-Whole Provision.

Some contracts contain make-whole or top-off provisions that reimburse the counterparty if it incurs a loss on the sale of the shares it will receive upon settlement of the contract. The counterparty to a contract on the entity's equity (e.g., a warrant, a written call option, or a convertible instrument) may seek to include such a provision to ensure that it does not stand to lose from declines in the stock price following its exercise of the contract.

The existence of a top-off or a make-whole provision precludes equity classification for the entire contract unless both of the following conditions are met:

- The entity has the right to net share settle the make-whole or top-off obligation.
- The maximum number of shares that is required to settle the instrument (including the top-off or make-whole provision) is both:
  - Fixed (i.e., condition 3 is met).
  - Less than the number of available authorized and unissued shares after deduction of the maximum number of shares that could be required to be delivered during the contract period under other commitments (i.e., condition 2 is met).
Example 5-4

Top-Off Provision

An entity writes a net-share-settled call option on 1,000 of the entity's common shares. The entity has the right to settle the contract by delivering unregistered shares. On a per-share basis, the option's settlement amount equals the difference between the quoted stock price on the settlement date and $46. The option contract contains a top-off provision that specifies that if the holder sells the shares it receives upon settlement of the option contract and such sale occurs within 10 days of option settlement, the holder will receive a variable number of shares equal in value to the excess, if any, of (1) the stock price used in settling the option contract divided by (2) the price at which the holder subsequently sells the shares. The entity has the right to settle the top-off provision in unregistered shares. The contract also specifies that under no circumstances will the entity deliver more than 1,000 shares to satisfy both the option settlement and the top-off provision. The entity has 2,000 authorized and unissued shares available.

On the option's settlement date, the quoted stock price is $50. Because the contract is net share settled, the holder receives a variable number of the entity's shares equal in value to $4,000 (1,000 × [50 – 46]); that is, 80 shares ($4,000 ÷ 50). Ten days later, the holder sells the shares in the market for $40 per share and incurs an aggregate loss of $800 (80 × [50 – 40]). Under the top-off provision, therefore, the entity delivers an additional number of shares to the counterparty equal in value to $800. At a stock price of $40, the entity delivers an additional 20 shares ($800 ÷ 40) to the counterparty to satisfy the top-off provision.

Even though this option contract contains a top-off provision, the contract is not precluded from equity classification since the entity has the right to net share settle the top-off provision, and the maximum number of shares it might be required to deliver is both fixed and less than the available authorized and unissued shares. If the entity can be forced to net cash settle the top-off provision, however, the entire contract is classified as a liability.

5.3.7 Condition 6: No Counterparty Rights Rank Higher Than Shareholder Rights

ASC 815-40

25-31 To be classified as equity, a contract cannot give the counterparty any of the rights of a creditor in the event of the entity's bankruptcy. Because a breach of the contract by the entity is within its control, the fact that the counterparty would have normal contract remedies in the event of such a breach does not preclude equity classification. As a result, a contract cannot be classified as equity if the counterparty's claim in bankruptcy would receive higher priority than the claims of the holders of the stock underlying the contract.

25-32 Generally, based on existing law, a net share settled derivative instrument that an entity has a right to settle in shares even upon termination could be net share settled in bankruptcy. If the derivative instrument is not net share settled, the claim of the counterparty would not have priority over those of the holders of the underlying stock, even if the contract specified cash settlement in the event of bankruptcy. In federal bankruptcy proceedings, a debtor cannot be compelled to affirm an existing contract that would require it to pay cash to acquire its shares (which could be the case, for example, with a physically settled forward purchase or written put). As a result, even if the contract requires that the entity (debtor) pay cash to settle the contract, the entity could not be required to do so in bankruptcy. Because of the complexity of federal bankruptcy law and related case law, and because of the differences in state laws affecting derivative instruments, it is not possible to address all of the legal issues associated with the status of the contract and the claims of the counterparty in the event of bankruptcy.

25-33 A contract provision requiring net cash settlement in the event of bankruptcy does not preclude equity classification if it can be demonstrated that, notwithstanding the contract provisions, the counterparty's claims in bankruptcy proceedings in respect of the entity could be net share settled or would rank no higher than the claims of the holders of the stock underlying the contract.

25-34 Determination of the status of a claim in bankruptcy is a legal determination.
If the contract gives the counterparty creditor rights if the entity becomes bankrupt, equity classification is prohibited. Evaluating whether a contract gives the counterparty creditor rights in bankruptcy can be complex. Even though the contractual provisions may suggest that the counterparty has creditor rights in bankruptcy, such provisions would not necessarily be enforceable under the law. Equity classification is precluded only if the provisions are enforceable. This is a legal determination that may require involvement of legal counsel.

Contractual provisions that specify normal contractual remedies for a breach do not violate this condition.

In the context of convertible debt, note that any creditor rights associated with the debt do not need to be assessed under this condition. The entity needs to assess only whether senior rights are attached to the conversion option.

If the contract is subject to a netting provision (e.g., under standard ISDA terms), the entity should consider whether the netting provision gives the counterparty the rights of a creditor in bankruptcy. If the netting provision could result in the netting of the contract with contracts not classified as equity, the counterparty would have a right that would rank higher than that of a holder of the underlying shares, in which case equity classification would be precluded. To avoid this outcome, the entity may seek to include terms in the contract that specify that the contract cannot be netted or can be netted only against other equity-classified contracts. For example, the parties may include a provision such as the following:

Obligations under this Transaction shall not be set off against any other obligations of the parties, whether arising under the Agreement, this Confirmation, under any other agreement between the parties hereto, by operation of law or otherwise, and no other obligations of the parties shall be set off against obligations under this Transaction, whether arising under the Agreement, this Confirmation, under any other agreement between the parties hereto, by operation of law or otherwise, and each party hereby waives any such right of setoff.

Whether such a term is enforceable is a legal determination that may require involvement of legal counsel.

Some forward sale contracts require the entity to settle the contract upon the entity’s insolvency filing. For example, a forward sale contract may give the counterparty the right to accelerate settlement of the contract upon the entity’s filing for insolvency. We believe that such a provision does not have the effect of giving the counterparty a right senior to that of a holder of the underlying shares. This type of insolvency filing provision is commonly included in forward sale contracts and exists to ensure that the counterparty could not find itself in a situation in which it had to pay for the shares but could not receive them on the date it paid for them (a situation that could occur in bankruptcy in the absence of this provision).
5.3.8 Condition 7: No Collateral Required

ASC 815-40

25-35 A requirement to post collateral of any kind (other than the entity's shares underlying the contract, but limited to the maximum number of shares that could be delivered under the contract) under any circumstances is inconsistent with the concept of equity and, therefore, precludes equity classification of the contract.

Some contracts require the entity to post collateral (e.g., if the stock price falls below a specified price). If a contract requires or could require the entity to post collateral in a form other than the shares underlying the contract (such as cash or other assets), the contract cannot be classified as equity. Further, if the underlying shares serve as collateral, their number must be limited to the maximum number of shares that the entity might be required to deliver under the contract.

We believe that an entity does not need to consider whether the counterparty might be required to post collateral under the contract in evaluating this condition. The related EITF meeting materials (Issue Summary 1 of EITF 00-19, prepared July 6, 2000) suggest that the circumstance that the EITF had in mind when it introduced this condition was one in which the reporting entity could be required to post collateral to the counterparty because of events outside its control.

In addition, we believe that in an entity's evaluation of whether an equity conversion option embedded in convertible debt meets this condition, it is irrelevant whether the debt is backed by collateral. The entity assesses only whether it has to post collateral to back the settlement of the conversion option.

5.4 Ongoing Reassessment of a Contract's Classification

ASC 815-40

35-8 The classification of a contract shall be reassessed at each balance sheet date. If the classification required under this Subtopic changes as a result of events during the period (if, for example, as a result of voluntary issuances of stock the number of authorized but unissued shares is insufficient to satisfy the maximum number of shares that could be required to net share settle the contract [see discussion in paragraph 815-40-25-20]), the contract shall be reclassified as of the date of the event that caused the reclassification. There is no limit on the number of times a contract may be reclassified.

35-11 If a contract permits partial net share settlement and the total notional amount of the contract no longer can be classified as permanent equity, any portion of the contract that could be net share settled as of that balance sheet date shall remain classified in permanent equity. That is, a portion of the contract shall be classified as permanent equity and a portion of the contract shall be classified as an asset, a liability, or temporary equity, as appropriate.

35-12 If an entity has more than one contract subject to this Subtopic, and partial reclassification is required, there may be different methods that could be used to determine which contracts, or portions of contracts, shall be reclassified. Methods that would comply with this Section could include any of the following:

a. Partial reclassification of all contracts on a proportionate basis
b. Reclassification of contracts with the earliest inception date first
c. Reclassification of contracts with the earliest maturity date first
d. Reclassification of contracts with the latest inception or maturity date first
e. Reclassification of contracts with the latest maturity date first.

35-13 The method of reclassification shall be systematic, rational, and consistently applied.
5.4.1 Overview

An entity is required to reassess its classification of both freestanding contracts and embedded features as of each reporting date. Reclassification is required if a contract either begins or ceases to meet all the conditions for equity classification. If reclassification is required, the entity reclassifies the contract as of the date of the event that caused the reclassification at its then-current fair value, and the new classification is applied prospectively. For this reason, the entity may need to determine the fair value of the contract as of the date that reclassification is required, even if that date is not a reporting date. Prior fair value gains and losses recognized in earnings are not reversed.

Any of the following could affect an entity's conclusion about whether a contract qualifies as equity:

- The counterparty exercises an option or warrant in such a way that the settlement amount becomes fixed for fixed (e.g., if a strike-price adjustment feature ceases to apply upon exercise of the contract).
- A modification of one of the contract's terms or conditions (e.g., the parties amend the terms of the contract to specify that the entity is not required to net cash settle the contract in case it does not have an effective registration statement).
- A lapse in one of the contract's terms or conditions (e.g., immediately after an IPO if the terms provide for an adjustment to the settlement terms upon an IPO).
- A change in the reporting entity's functional currency.
- A change in securities law that affects whether the entity is able to deliver registered shares without any further timely filing or registration requirements.
- A change in securities law that affects whether the entity is able to deliver unregistered shares.
- The number of authorized shares increases or decreases as a result of a vote by shareholders.
- The entity issues previously authorized equity shares.
- The entity enters into commitments that could require it to deliver equity shares (e.g., warrants, options, forwards, share-based payment awards, or convertible instruments).
- The entity has an option to settle the contract either in shares or net in cash and elects to settle the contract net in cash.
- An event that is within the entity's control occurs and triggers a requirement to net cash settle the contract.

Example 5-5

Reassessment

Entity X issues a warrant on its own common stock. The warrant meets all conditions for equity classification in ASC 815-40 except for the requirement that the entity has sufficient authorized and unissued shares to settle the contract in shares (see Section 5.3.3). Accordingly, the warrant is classified as a liability and accounted for at fair value with changes in fair value recognized in earnings.

Subsequently, X's shareholders vote to approve an amendment to its certificate of incorporation to increase the number of authorized shares of common stock. Entity X files a certificate of amendment with its state of incorporation. As a result, X reassesses its prior conclusion and determines that it now has sufficient authorized and unissued shares to cover all its outstanding commitments to issue shares. Entity X should therefore determine the fair value of the warrant as of the date that the number of authorized and unissued shares increased and recognize through earnings any change in the fair value of the contract that had not been previously recognized up to that date. The updated fair value carrying amount would be reclassified from liabilities to equity.
A reassessment is required irrespective of whether the event that causes an equity classification condition to be met or no longer met is within the entity's control (i.e., a reassessment is required once such an event occurs).

At the 2005 AICPA Conference on Current SEC and PCAOB Developments, the SEC staff reiterated the requirement to continually reassess the classification of contracts. The staff presented an example in which the issuance of a contract that requires settlement in a variable number of shares and in which the number of shares to be delivered upon settlement is not limited. The staff concluded that a company could not classify this uncapped contract within equity and that the issuance of the uncapped contract could cause other contracts to fail the criteria to be classified within equity.

Example 5-6
Continual Reassessment

Reporting Entity X issues freestanding warrants that allow the holder to purchase 1,000 shares of X's common stock for $10 per share. The warrants have a 10-year term and are exercisable at any time. However, the terms of the warrants specify that if X sells shares of its common stock for less than $10 per share at any time during the 18-month period after the warrants' issuance date, the exercise price of the warrants is reduced to equal the issuance price of the shares.

In accordance with Example 9 in ASC 815-40-55 (see Section 4.3.7.2), the warrants are not considered indexed to X's stock because the “occurrence of a sale of common stock by the entity at market is not an input” used in the pricing (fair value measurement) of a fixed-for-fixed option on equity shares. However, when the provision that may result in an adjustment to the exercise price lapses (i.e., 18 months after the issuance date), X should reconsider, as of that date, whether the warrants should be treated as indexed to its own stock.

The reclassification requirements apply to each contract as a whole unless the contract permits partial net share settlement. If the contract does not permit partial net share settlement, the contract is reclassified in its entirety.

5.4.2 Sequencing Policy

One of the conditions for equity classification is that the entity have sufficient authorized and unissued shares available after considering all other commitments that may require it to deliver shares during the maximum period the contract could remain outstanding (see Section 5.3.3). Therefore, the entity may need to reassess its classification of existing contracts if it issues shares, enters into new commitments to deliver shares, or reduces the number of authorized shares. To determine whether the entity has sufficient authorized and unissued shares available to share settle contracts being evaluated under ASC 815-40-25, the entity should adopt a “sequencing policy” (also known as “reclassification policy” or “contract ordering policy”) as an accounting policy election and disclose such policy under ASC 235. The sequencing policy should be systematic and rational (i.e., understandable and reasonable) as well as consistently applied (i.e., the entity must use the same sequencing policy for all contracts within the scope of the guidance).

We believe that one acceptable sequencing policy would be for an entity to perform the following two steps to evaluate whether contracts, or portions of contracts, should be initially classified as equity or later reclassified from equity to an asset or a liability:

- **Step 1** — Determine whether outstanding contracts have overlapping settlement opportunities with respect to their exercise periods or settlement dates.

In step 1, the entity determines whether the outstanding commitments to deliver shares have overlapping settlement opportunities with respect to their exercise periods or settlement dates. (For commitments with early settlement date provisions, the entity should consider the earliest
possible settlement date.) If the settlement opportunities in the commitments do not overlap, the contract with the earlier exercise date or settlement date would be considered first with regard to the availability of shares for settlement. If an entity determines in step 1 that two or more commitments have overlapping exercise periods or settlement dates, the entity should proceed to step 2.

- **Step 2** — Apply a sequencing policy to determine which contracts, or portions of contracts, if any, qualify as equity.

In step 2, the entity applies a sequencing policy under ASC 815-40-35-11 through 35-13 to determine which contracts, or portions of contracts, qualify as equity.

ASC 815-40-35-12 lists several permissible methods of reclassification:

- Partial reclassification of all contracts on a proportionate basis.
- Reclassification of contracts with the earliest inception date first (i.e., first in, first out).
- Reclassification of contracts with the earliest maturity date first.
- Reclassification of contracts with the latest inception or maturity date first.
- Reclassification of contracts with the latest maturity date first.

An entity should also consider any legal priority specified in the contracts’ terms. If an instrument has dedicated shares under a legally enforceable share reservation clause, the instrument may be exempt from the sequencing exercise if the dedicated shares would have highest priority, thereby ensuring share settlement of the contract. In this case, the entity should subtract shares related to the reservation clause from shares available for equity-settled contracts before assessing share sufficiency for all remaining contracts. Because this is a legal, rather than an accounting, consideration, it may require the involvement of a legal specialist.

### 5.4.3 Commitments to Deliver a Potentially Unlimited Number of Shares

Some commitments may not explicitly limit the potential number of shares an entity could be required to deliver. In this case, the commitment could result in an obligation to deliver a potentially unlimited number of equity shares upon settlement. Examples of such commitments, which may fall outside the scope of ASC 815-40, include:

- A net-share-settled written put option or forward repurchase contract on an entity’s own stock (see ASC 480).
- An obligation to issue a variable number of shares worth a fixed monetary amount (see ASC 480).
- An obligation to issue a variable number of shares indexed to something other than the entity’s own stock (e.g., the price of gold) (see ASC 480 and ASC 815-40-15-7F).
- Share-settled interest deferral features in certain hybrid debt securities.

When an entity enters into a commitment that may require it to deliver a potentially unlimited number of shares, it is possible that other contracts no longer meet the condition that the entity has sufficient authorized and unissued shares to share settle the contract. Nevertheless, an entity is not necessarily precluded from classifying any or all of its other contracts as equity. To determine whether share settlement is within the entity’s control for contracts other than the unlimited contract, the entity should apply its sequencing policy. Such a policy may indicate that sufficient authorized and unissued shares are available to share settle some or all of the contracts other than the contract that does not limit the number of shares.
If the entity issues an uncapped contract, it would need to reevaluate the classification of all its other outstanding contracts classified within equity. To do so, the entity may apply the two-step approach described in Section 5.4.2 to evaluate whether those other contracts, or portions of contracts, should be reclassified from equity to an asset or a liability. (Note that this Roadmap does not take a view on whether an entity is permitted to use an approach other than this two-step approach when it has issued one or more uncapped contracts.)

Under the two-step approach, if a commitment that might require delivery of a potentially unlimited number of shares has an earlier exercise period or settlement date than the contract being evaluated, then the contract being evaluated does not qualify as equity until the contract with the potentially unlimited number of shares has been settled. If several contracts are currently exercisable and the entity could not be forced to settle the uncapped contract first, the entity should apply its sequencing policy to determine which contracts, or portions of contracts, qualify as equity.

However, equity classification of other contracts may be appropriate under the two-step approach if the other contracts will be settled before the earliest possible date that the uncapped contract can be settled (provided that these contracts meet all the criteria for equity classification), or upon expiration of the uncapped contract. For example, if an entity has an accounting policy of reclassifying contracts with the latest inception or maturity date first, contracts with an inception or maturity date earlier than the unlimited contract would remain classified in permanent equity as long as the entity has a sufficient number of authorized and unissued shares available to allow delivery under those contracts.

**Example 5-7**

**Two-Step Approach: Latest Maturity Date First**

Entity A has adopted a two-step sequencing policy that reclassifies contracts (from equity to assets or liabilities) with the latest maturity date first. Thus, any available shares are allocated first to contracts with the earliest maturity date. Entity A has two million shares of common stock authorized, with 200,000 shares unissued and a stock price of $25.

On January 1, 20X7, A acquires assets from Entity B and, as consideration, enters into a contract to provide a variable number of common shares of its stock to B in the amount of $2.5 million on December 31, 20X7.

On April 1, 20X7, A enters into a written call option contract to sell 150,000 shares of its stock to Entity C at a strike price of $35. The contract may be settled by physical settlement, net share settlement, or net cash settlement, as determined by A. The call option expires on June 30, 20X7.

While the contract with B could require a potentially unlimited number of shares to be delivered by A, if A applies its sequencing policy only to contracts with overlapping settlement opportunities with respect to their exercise periods or settlement dates (as discussed Section 5.4.2), it does not need to consider the contract with B in determining whether the call option qualifies for equity classification because the contract with B can be settled only after the entire term of the call option.

Under a sequencing policy that reclassifies contracts with the latest maturity date first, available shares are allocated to contracts in order of increasing maturity dates. That is, the 200,000 available shares are first compared with the potential share delivery requirement of 150,000 under the written call option contract that matures on June 30, 20X7, since that contract has the earliest maturity date. Given the greater number of available shares compared with the share delivery requirement (200,000 vs. 150,000), A would be able to conclude that there are sufficient shares available to share settle the written call option contract and that it has 50,000 remaining shares available to share settle other contracts with a later maturity date. Because of the unlimited contract with B that matures on December 31, 20X7, however, A would be unable under this sequencing policy to assert that it has any shares available to share settle contracts with a maturity date after December 31, 20X7. The contract with B is not eligible for equity classification because of the unlimited share exposure; nor is it eligible for partial classification in equity.
**Example 5-8**

**Two-Step Approach: Earliest Maturity Date First**

Entity A has adopted a two-step sequencing policy that reclassifies contracts (from equity to assets or liabilities) with the earliest maturity date first. Thus, any available shares are allocated first to contracts with the latest maturity date. Entity A has two million shares of common stock authorized with 200,000 shares unissued and a stock price of $25.

On January 1, 20X4, A enters into a six-month written call option contract to sell 150,000 shares of its stock to Entity B at a strike price of $35. The contract may be settled by physical settlement, net share settlement, or net cash settlement as determined by A. The call option can be exercised at any time and expires on June 30, 20X4.

On April 1, 20X4, A issues a hybrid convertible debt instrument to Entity C with interest payments due quarterly. Entity A has the option to defer its scheduled interest payment, but such a deferral triggers an obligation to share settle all deferred interest after five years unless previously paid. Since any deferred interest will result in a fixed-dollar payable settled in a variable number of shares, this feature has the potential to result in the issuance of an unlimited number of shares.

Because the exercise period of the written call option (January 1, 20X4, to June 30, 20X4) does not overlap with the earliest possible settlement date of the share-settled interest payment (April 1, 20X9), the 200,000 available shares would first be allocated to the written call option before consideration of the potentially unlimited number of shares associated with the hybrid convertible debt instrument. Entity A would apply its sequencing policy only if the exercise periods or settlement dates overlap.

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**5.5 Conventional Convertible Debt**

**ASC 815-40**

- **25-39** For purposes of evaluating under paragraph 815-15-25-1 whether an embedded derivative indexed to an entity’s own stock would be classified in stockholders’ equity if freestanding, the requirements of paragraphs 815-40-25-7 through 25-35 and 815-40-55-2 through 55-6 do not apply if the hybrid contract is a conventional convertible debt instrument in which the holder may only realize the value of the conversion option by exercising the option and receiving the entire proceeds in a fixed number of shares or the equivalent amount of cash (at the discretion of the issuer).

- **25-40** However, the requirements of paragraphs 815-40-25-7 through 25-35 and 815-40-55-2 through 55-6 do apply if an issuer is evaluating whether any other embedded derivative is an equity instrument and thereby excluded from the scope of Subtopic 815-10.

- **25-41** Instruments that provide the holder with an option to convert into a fixed number of shares (or equivalent amount of cash at the discretion of the issuer) for which the ability to exercise the option is based on the passage of time or a contingent event shall be considered conventional for purposes of applying this Subtopic. **Standard antidilution provisions** contained in an instrument do not preclude a conclusion that the instrument is convertible into a fixed number of shares.

- **25-42** Convertible **preferred stock** with a mandatory redemption date may qualify for the exception included in paragraph 815-40-25-39 if the economic characteristics indicate that the instrument is more akin to debt than equity. An entity shall consider the guidance in paragraph 815-15-25-17 in assessing whether the instrument is more akin to debt or equity. That paragraph explains that, if the preferred stock is more akin to equity than debt, an equity conversion feature would be clearly and closely related to that host instrument.
Chapter 5 — Classification Guidance

ASC 815-40-20 — Glossary

**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.

**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.

The seven conditions in ASC 815-40-25-10 (see Section 5.3) do not apply to an embedded conversion option within “conventional convertible debt.” Thus, a conversion option in such a convertible debt instrument may fail to meet one or more of those conditions and still qualify for the own-equity scope exception from derivative accounting in ASC 815-10. Convertible preferred stock may also qualify under the exception for conventional convertible debt if it has a mandatory redemption date and its economic characteristics indicate that the instrument is more akin to debt than equity (ASC 815-40-25-42). Because of the requirement related to a mandatory redemption date, convertible preferred securities that are redeemable only at the option of the holder do not qualify.

As explained in ASC 815-40-25-39, conventional convertible debt represents an “instrument in which the holder may only realize the value of the conversion option by exercising the option and receiving the entire proceeds in a fixed number of shares or the equivalent amount of cash (at the discretion of the issuer).” Thus, for an instrument to be considered conventional convertible debt, the issuer must have the ability to settle it gross by delivering a fixed number of shares, although the issuer might alternatively elect to settle the instrument in an equivalent amount of cash. The holder’s ability to exercise the conversion option may be “based on the passage of time or a contingent event” (ASC 815-40-25-41).

The following are examples of convertible debt instruments that do not qualify as conventional because the number of shares to be delivered upon conversion is not fixed:

- A convertible debt instrument that contains a down-round provision that reduces the conversion price if the issuer offers new shares to the market at an issuance price lower than the conversion price in the convertible debt (see Section 4.3.7.2).
- A convertible debt instrument that contains a make-whole provision (other than a standard antidilution provision) that adjusts the conversion rate so that the issuer is required to deliver additional shares if it fails to meet specified debt covenants.

There is one exception to the rule requiring that the number of shares be fixed. Adjustments to the number of shares are permitted if they are considered to be “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 (ASC 815-40-20). An equity restructuring transaction is a nonreciprocal transaction between an entity and its shareholders that causes the per-share fair value of the shares underlying a contract to change.
### Examples of Adjustment to the Conversion Price

<table>
<thead>
<tr>
<th>Type of Antidilution Provision</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Subdivision (stock split, stock dividend)</strong></td>
</tr>
<tr>
<td><strong>Combination (reverse stock split) of outstanding common shares</strong></td>
</tr>
<tr>
<td><strong>Issuance of common shares at a lower price than the conversion price in effect immediately before such issuance</strong></td>
</tr>
<tr>
<td><strong>Recurring quarterly cash dividend to all common shareholders</strong></td>
</tr>
<tr>
<td><strong>Recapitalization through a large nonrecurring cash dividend</strong></td>
</tr>
</tbody>
</table>

We believe that in assessing whether a convertible instrument qualifies as conventional, an entity does not need to evaluate whether the circumstances that are identified in ASC 815-40-25-7 through 25-35 or ASC 815-40-55-2 through 55-6 could cause the issuer to net cash settle the conversion option. This is because the purpose of the exception for conventional convertible debt is to exempt entities from the requirement to evaluate whether the conditions in those paragraphs are met. In other words, even if the conditions specified in one of those paragraphs could result in a cash settlement outside the issuer’s control, the convertible debt might still qualify as conventional. Accordingly, contractual terms that require cash settlement in the following situations do not preclude a convertible instrument from being considered conventional:

- The contract requires settlement in registered shares. If registered shares are unavailable, then the contract is settled in cash.
- The contract requires the issuer to make cash payments to the counterparty in the event the issuer fails to make timely filings with the SEC.
- The contract includes cash-settled top-off or make-whole provisions that require the issuer to make cash payments to the counterparty if the shares initially delivered upon settlement are subsequently sold by the counterparty and the sales proceeds are insufficient to provide the counterparty with full return of the amount due.
- The contract requires the issuer to cash settle the contract upon a change in control.
- The contract requires the issuer to cash settle the contract upon bankruptcy.

Although the seven equity classification conditions in ASC 815-40-25-10 do not apply to conventional convertible debt, an entity still needs to be satisfied that the other conditions for equity classification are met before it can conclude that the embedded conversion option qualifies as equity. For example, conventional convertible debt is not exempted from the guidance on indexation in ASC 815-40-15 (see Chapter 4). If the entity could be forced to net cash settle the embedded conversion option upon (1) the occurrence of an event not discussed in ASC 815-40-25-7 through 25-35 or ASC 815-40-55-2 through 55-6 or (2) only the passage of time, the convertible debt does not qualify as conventional, and the conversion option does not qualify as equity (see Section 5.2). If the embedded conversion option does not qualify as equity, the entity should determine whether the conversion option is required to be separated as an embedded derivative under ASC 815-15 (see Section 2.2).
Chapter 6 — Initial and Subsequent Accounting

This chapter discusses the initial and subsequent accounting for contracts on an entity's own equity, including:

- Freestanding equity-classified contracts (see Section 6.1), including:
  - Initial and subsequent measurement (see Section 6.1.1).
  - Reclassifications (see Section 6.1.2).
  - Settlements (see Section 6.1.3).
  - Modifications (see Section 6.1.4).
  - Down-round features (see Section 6.1.5).
  - Own-share lending arrangements entered into on an entity's own equity in connection with a convertible debt issuance (see Section 6.1.6).

- Freestanding contracts indexed to own equity and classified as assets or liabilities (see Section 6.2), including:
  - Initial and subsequent measurement (see Section 6.2.1).
  - Reclassifications (see Section 6.2.2).
  - Settlements (see Section 6.2.3).
  - Modifications (see Section 6.2.4).

- Freestanding contracts not indexed to own equity (see Section 6.3).
- Embedded features (see Section 6.4).
- Fair value measurements (see Section 6.5).
6.1 Freestanding Equity-Classified Contracts

6.1.1 Initial and Subsequent Measurement

**ASC 815-40**

30-1 All contracts within the scope of this Subtopic shall be initially measured at fair value.

35-1 All contracts shall be subsequently accounted for based on the current classification and the assumed or required settlement method in Section 815-40-25 as follows.

**Equity Instruments — Permanent Equity**

35-2 Contracts that are initially classified as equity under Section 815-40-25 shall be accounted for in permanent equity as long as those contracts continue to be classified as equity. Subsequent changes in fair value shall not be recognized as long as the contracts continue to be classified as equity.

If an entity concludes that a freestanding contract qualifies as equity under the guidance on indexation and equity classification in ASC 815-40, the entity recognizes the contract by recording an entry to additional paid-in capital (APIC) in stockholders’ equity in its balance sheet. Such a contract would be initially measured at its fair value.

If the contract is issued as part of a larger transaction (i.e., one involving multiple units of account), allocation of the transaction proceeds may be necessary. ASC 470-20 requires allocation of proceeds on a relative fair value basis when a debt instrument is issued with equity-classified detachable stock purchase warrants. ASC 470-20-25-2 states:

Proceeds from the sale of a debt instrument with stock purchase warrants (detachable call options) shall be allocated to the two elements based on the relative fair values of the debt instrument without the warrants and of the warrants themselves at time of issuance. The portion of the proceeds so allocated to the warrants shall be accounted for as paid-in capital. The remainder of the proceeds shall be allocated to the debt instrument portion of the transaction. This usually results in a discount (or, occasionally, a reduced premium), which shall be accounted for under Topic 835.

**Example 6-1**

**Initial and Subsequent Measurement**

Entity A issues a debt security with a detachable equity-classified warrant for total proceeds of $19.5 million. Entity A does not elect to account for the debt at fair value under the fair value option in ASC 825-10. At the time of issuance, a third-party valuation specialist estimates the fair value of the debt to be $18 million and the fair value of the warrant to be $2 million. In this case, A allocates $17.55 million of the proceeds to the debt and $1.95 million of the proceeds to the warrant. Accordingly, the initial carrying amount of the debt is $17.55 million and the initial carrying amount of the warrant is $1.95 million.

We believe that a relative fair value allocation approach is also appropriate for other types of freestanding equity-classified contracts on an entity’s own equity that are issued together with debt or stock that is not accounted for at fair value on a recurring basis (e.g., a detachable warrant issued with preferred stock). If the debt or stock contains an embedded derivative that is required to be separated under ASC 815-15 (e.g., certain embedded put or call options), the allocation of proceeds between the contract on the entity's own equity and the debt is performed on a relative fair value basis before the allocation of proceeds between the debt host contract and the embedded derivative.
If an entity issues a freestanding equity-classified contract together with debt and elects to account for the debt under the fair value option in ASC 825-10, however, we believe that it is appropriate for the entity to allocate (1) an amount of the proceeds equal to the debt's fair value to the debt (since the debt is required to be accounted for at fair value with changes in fair value recognized in earnings on a recurring basis under ASC 825-10) and (2) the remaining amount to the contract on the entity's own equity. The initial carrying amount assigned to the equity-classified contract would then be the difference between the total proceeds received and the fair value of the debt. This method of allocating proceeds, sometimes referred to as a "with-and-without" method on the basis of the fair value of the debt, avoids the recognition of a gain or a loss caused solely by the allocation model. It is similar to the method of allocating the basis of a hybrid instrument between a host contract and an embedded derivative under ASC 815 (see ASC 815-15-30-2). The working draft of a 2006 AICPA technical practice aid, “Convertible Debt, Convertible Preferred Shares, Warrants, and Other Equity-Related Financial Instruments,” provides support for this method, stating:

In practice, for financing transactions that include debt or equity instruments and other freestanding financial instruments that are recorded at fair value each period with changes in fair value recorded in earnings, practitioners generally record the freestanding "mark-to-fair value" instrument at its initial fair value, and allocate the residual proceeds to the debt or equity instrument.

The initial carrying amount of an equity-classified contract is not subsequently adjusted to fair value unless, in subsequent periods, the instrument no longer qualifies for equity classification (e.g., the issuing entity no longer has sufficient authorized and unissued shares) and so must be reclassified as an asset or a liability. After an entity's adoption of ASU 2017-11, special recognition and measurement requirements apply when a down-round feature has been triggered in an equity-classified contract (see Section 6.1.5).

### 6.1.2 Reclassifications

<table>
<thead>
<tr>
<th>ASC 815-40</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>35-9</strong> If a contract is reclassified from permanent or temporary equity to an asset or a liability, the change in fair value of the contract during the period the contract was classified as equity shall be accounted for as an adjustment to stockholders' equity. The contract subsequently shall be marked to fair value through earnings.</td>
</tr>
</tbody>
</table>

An entity is required to reassess its classification of each contract as of each reporting date (see Section 5.4). Reclassification of an equity-classified contract is required if the contract ceases to meet all the criteria for equity classification. If reclassification is required, the instrument is reclassified as of the date of the event or change in circumstance that caused the reclassification at its then-current fair value. If an instrument is no longer eligible for equity classification, the entity recognizes the adjustment to its current fair value as a deemed dividend within stockholders’ equity before the reclassification. Subsequent adjustments to fair value while the contract is an asset or a liability are recognized in the income statement.

### 6.1.3 Settlements

<table>
<thead>
<tr>
<th>ASC 815-40</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>40-1</strong> If contracts classified as permanent equity are ultimately settled in a manner that requires that the entity deliver cash, the amount of cash paid or received shall be reported as a reduction of, or an addition to, contributed capital.</td>
</tr>
</tbody>
</table>
If an entity settles a freestanding equity-classified contract by delivering or receiving shares in accordance with its original terms, the entity recognizes the shares issued or received within equity in a manner similar to other transactions in its own stock (see ASC 505-10 and ASC 505-30).

Sometimes an entity settles an equity-classified contract net in cash. For example, a written call option on the entity’s own equity may give the entity the right to settle the contract either net in shares or net in cash (see Section 5.2.4). If an entity settles an equity-classified contract in accordance with its original terms through a net cash settlement by delivering cash, the amount of cash paid is deducted from APIC. If an entity settles the contract by receiving cash, the amount is added to APIC.

If an entity repurchases an equity-classified contract, the repurchase price is generally equal to its fair value. However, if the entity pays an amount significantly in excess of the contract’s fair value, the excess consideration must be associated with something other than the repurchase. If no other element is identified for which accounting is required under GAAP, the excess consideration is recognized either as a dividend paid to the holder or as an expense. In determining how to recognize the excess consideration, an entity must use judgment and consider the facts and circumstances associated with the repurchase (such as the purpose of the excess payment) and the relationship between the entity and the holder. If an entity is in doubt about how to treat the excess amount, accounting for it as an expense is generally appropriate. For further discussion, see Sections 3.2.4.3 and 3.2.5.2 of Deloitte’s A Roadmap to the Presentation and Disclosure of Earnings per Share.

If an entity settles an equity-classified contract under an inducement offer, it should treat as a dividend or expense the additional value provided as a result of the inducement offer, which is calculated as the fair value of all securities and other consideration transferred in the transaction over the fair value of the stock issuable according to the original terms of the contract. For further discussion, see Section 3.2.5.2 of Deloitte’s A Roadmap to the Presentation and Disclosure of Earnings per Share and Section 4.6.3.3 of Deloitte’s A Roadmap to the Issuer’s Accounting for Convertible Debt.

Special considerations are necessary in the accounting for redemptions of equity-classified contracts indexed to an entity’s preferred stock, including warrants that contain a beneficial conversion feature. For further discussion, see Section 3.2.5.2.2 of Deloitte’s A Roadmap to the Presentation and Disclosure of Earnings per Share and Section 7.3.4 of Deloitte’s A Roadmap to the Issuer’s Accounting for Convertible Debt.

6.1.4 Modifications

ASC 815-40 does not address how an entity should account for a modification to a freestanding equity-classified contract on the entity’s own equity that continues to qualify for equity classification. We believe that in the absence of directly applicable guidance, one reasonable approach is for an entity to analogize to the guidance on the modification of share-based payment arrangements in ASC 718-20-35-3 to determine whether it is necessary to record an entry upon modification. Under that guidance, an entity calculates the difference between (1) the fair value of the contract immediately before the modification and (2) the fair value of the contract immediately after the modification. If the fair value immediately after the modification exceeds the fair value immediately before the modification, the entity allocates the incremental fair value to the carrying amount of the equity-classified contract.

If no other element is identified for which accounting is required under GAAP, the increase in fair value is recognized either as a deemed dividend paid to the holder or as an expense. In determining how to recognize the increase in fair value, an entity must use judgment and consider the facts and circumstances associated with the modification (such as its purpose) and the relationship between the entity and the holder. For further discussion, see Section 3.2.6.4 of Deloitte’s A Roadmap to the Presentation and Disclosure of Earnings per Share.
Special considerations are necessary in the accounting for modifications and exchanges of equity-classified contracts indexed to an entity's preferred stock. For more information, see Section 3.2.6.4 of Deloitte’s *A Roadmap to the Presentation and Disclosure of Earnings per Share*.

### 6.1.5 Down-Round Features

**ASC Master Glossary**

<table>
<thead>
<tr>
<th>Pending Content (Transition Guidance: ASC 260-10-65-4)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Down Round Feature</strong></td>
</tr>
<tr>
<td>A feature in a financial instrument that reduces the strike price of an issued financial instrument if the issuer sells shares of its stock for an amount less than the currently stated strike price of the issued financial instrument or issues an equity-linked financial instrument with a strike price below the currently stated strike price of the issued financial instrument.</td>
</tr>
<tr>
<td>A down round feature may reduce the strike price of a financial instrument to the current issuance price, or the reduction may be limited by a floor or on the basis of a formula that results in a price that is at a discount to the original exercise price but above the new issuance price of the shares, or may reduce the strike price to below the current issuance price. A standard antidilution provision is not considered a down round feature.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>ASC 260-10</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Pending Content (Transition Guidance: ASC 260-10-65-4)</strong></td>
</tr>
<tr>
<td>05-1A An entity may issue a freestanding financial instrument (for example, a warrant) with a down round feature that is classified in equity. This Subtopic provides guidance on earnings per share and recognition and measurement of the effect of a down round feature when it is triggered.</td>
</tr>
<tr>
<td>25-1 An entity that presents earnings per share (EPS) in accordance with this Topic shall recognize the value of the effect of a down round feature in an equity-classified freestanding financial instrument (that is, instruments that are not convertible instruments) when the down round feature is triggered. That effect shall be treated as a dividend and as a reduction of income available to common stockholders in basic earnings per share, in accordance with the guidance in paragraph 260-10-45-12B. See paragraphs 260-10-55-95 through 55-97 for an illustration of this guidance.</td>
</tr>
<tr>
<td>30-1 As of the date that a down round feature is triggered (that is, upon the occurrence of the triggering event that results in a reduction of the strike price) in an equity-classified freestanding financial instrument, 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:</td>
</tr>
<tr>
<td>a. The fair value of the financial instrument (without the down round feature) with a strike price corresponding to the currently stated strike price of the issued instrument (that is, before the strike price reduction)</td>
</tr>
<tr>
<td>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.</td>
</tr>
<tr>
<td>30-2 The fair values of the financial instruments in paragraph 260-10-30-1 shall be measured in accordance with the guidance in Topic 820 on fair value measurement. See paragraph 260-10-45-12B for related earnings per share guidance and paragraphs 50S-10-50-3 through 50-3A for related disclosure guidance.</td>
</tr>
</tbody>
</table>
ASC 260-10 (continued)

Pending Content (Transition Guidance: ASC 260-10-65-4)

35-1 An entity shall recognize the value of the effect of a down round feature in an equity-classified freestanding financial instrument 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 260-10-25-1 and 260-10-30-1 through 30-2. An entity shall not subsequently amortize the amount in additional paid-in capital arising from recognizing the value of the effect of the down round feature.

45-12B For a freestanding equity-classified financial instrument with a down round feature, an entity shall deduct the value of the effect of a down round feature (as recognized in accordance with paragraph 260-10-25-1 and measured in accordance with paragraphs 260-10-30-1 through 30-2) in computing income available to common stockholders when that feature has been triggered (that is, upon the occurrence of the triggering event that results in a reduction of the strike price).

After an entity’s adoption of ASU 2017-11 (see Section 4.3.7.2 for a discussion of the ASU’s effective date and transition guidance), special recognition and measurement requirements apply each time a down-round feature in a freestanding equity-classified contract is triggered (i.e., the entity sells shares of its stock for an amount less than the currently stated strike price or issues an equity-linked financial instrument with a strike price below the currently stated strike price). These requirements do not apply to convertible instruments (e.g., convertible preferred stock) for which other GAAP applies (e.g., if a convertible instrument is subject to the BCF guidance in ASC 470-20, it would apply the accounting model for contingent BCFs upon the trigger of a down-round feature). Further, issuers that do not present EPS in accordance with ASC 260 are not required to apply the guidance. If an entity that is not required to present EPS elects voluntarily to disclose EPS in its financial statements, however, the guidance applies.

When the strike price of an equity-classified contract is reduced in accordance with the terms of a down-round feature, the issuer is required to determine the amount of value that was transferred to the holder through the strike price adjustment, but the issuer does not use the change in the fair value of the entire instrument to compute that amount. Instead, the issuer calculates the amount of value transferred by comparing the fair values of two hypothetical contracts whose terms are consistent with the actual contract, except that the contracts do not contain a down-round feature. The strike price of the first hypothetical contract equals the strike price of the actual contract immediately before the strike price reduction. The strike price of the second hypothetical contract equals the strike price immediately after the down-round feature is triggered. The value transferred is the difference between the fair values of the two hypothetical contracts. The issuer determines those fair values on the basis of the conditions immediately after the down-round feature is triggered by using the fair value measurement guidance in ASC 820.

Further, the issuer recognizes the value transferred as a reduction of retained earnings and as an increase in APIC (i.e., as a deemed dividend). The transfer of value is reflected as a deduction to income available to common stockholders in the basic EPS calculation.

In addition, an entity that applies the special recognition and measurement guidance in ASC 260-10 to a down-round feature that was triggered during the reporting period must, under ASC 505-10-50-3A (added by ASU 2017-11), disclose (1) the fact that the down-round feature has been triggered and (2) the amount of value transferred.
Example 6-1A

On January 1, 2017, Entity A grants warrants to Investor X to acquire A's common shares. The warrants have an exercise price of $3.00 per share, subject to adjustment if A issues new shares of its common stock. If A issues new shares of its common stock for less than $3.00 per share, the exercise price is adjusted to that issue price. In accordance with ASC 815-40, A evaluated the warrants and concluded that they should be classified in equity since (1) they are considered indexed to the entity's own stock if the down-round provision is disregarded and (2) settleable in the issuer's shares. On July 1, 2017, A issues new shares of its common stock to Investor Y at a price of $2.50 per share. Accordingly, the exercise price of the warrants is adjusted from $3.00 to $2.50.

On July 1, 2017, A would determine the value transferred to X as the difference between the fair values of two hypothetical contracts with terms similar to those of the actual warrants, except that the contracts contain no down-round feature. The only difference between the two hypothetical contracts is that one has an exercise price of $2.50 and the other has an exercise price of $3.00. Entity A would recognize the value transferred as a reduction in retained earnings, with an offsetting increase to the carrying value of the warrants in APIC. The amount would also be reflected as a reduction to the income available to common stockholders in the basic EPS calculation.

Because the amount of the value transferred reduces income available to common stockholders in the basic EPS calculation, an entity may be required to adjust the diluted EPS calculation. In computing diluted EPS, an entity applies the treasury stock method if the option or warrant is dilutive. Under the treasury stock method, options and warrants are assumed to be exercised as of the beginning of the period. An entity therefore assumes that options or warrants are exercised before the trigger of the down-round feature. Accordingly, as noted in ASC 260-10-55-97 (added by ASU 2017-11), the amount of value transferred that has been deducted from basic EPS is added back to income available for common stockholders in the calculation of diluted EPS if the option or warrant is dilutive. ASC 260-10-45-25 notes that warrants or options have a dilutive effect under the treasury stock method if the options or warrants are in-the-money (i.e., “the average market price of the common stock during the period exceeds the exercise price of the options or warrants”).

ASC 260-10

Pending Content (Transition Guidance: ASC 260-10-65-4)

Example 16: Equity-Classified Freestanding Financial Instruments That Include a Down Round Feature

55-95 Assume Entity A issues warrants that permit the holder to buy 100 shares of its common stock for $10 per share and that Entity A presents EPS in accordance with the guidance in this Topic. 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 because they are indexed to the entity's own stock and meet the additional conditions necessary for equity classification in accordance with the guidance in Subtopic 815-40 on derivatives and hedging—contracts in entity's own equity (see paragraphs 815-40-55-33 through 55-34A for an illustration of the guidance in Subtopic 815-40 applied to a warrant with a down round feature). Because the warrants are an equity-classified freestanding financial instrument, they are within the scope of the recognition and measurement guidance in this Topic. 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-classified 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 feature are such that the strike price cannot be reduced below $8 per share. After issuing 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.
55-96 In accordance with the measurement guidance in paragraphs 260-10-30-1 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 $600 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 $750. The increase in the value of $150 is the value of the effect of the triggering of the down round feature.

55-97 The $150 increase is the value of the effect of the down round feature to be recognized in equity in accordance with paragraph 260-10-25-1, as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Retained earnings</td>
<td>$150</td>
</tr>
<tr>
<td>Additional paid-in capital</td>
<td>$150</td>
</tr>
</tbody>
</table>

Additionally, Entity A reduces income available to common stockholders in its basic EPS calculation by $150 in accordance with the guidance in paragraph 260-10-45-12B. Entity A applies the treasury stock method in accordance with paragraphs 260-10-45-23 through 45-27 to calculate diluted EPS. Accordingly, the $150 is added back to income available to common stockholders when calculating diluted EPS. However, the treasury stock method would not be applied if the effect were to be antidilutive.

6.1.6 Own-Share Lending Arrangements in Connection With Convertible Debt Issuance

ASC 470-20

25-20A At the date of issuance, a share-lending arrangement entered into on an entity's own shares in contemplation of a convertible debt offering or other financing shall be measured at fair value (in accordance with Topic 820) and recognized as an issuance cost, with an offset to additional paid-in capital in the financial statements of the entity.

30-26A At the date of issuance, a share-lending arrangement entered into on an entity's own shares in contemplation of a convertible debt offering or other financing shall be measured at fair value in accordance with Topic 820.

35-11A If it becomes probable that the counterparty to a share-lending arrangement will default, the issuer of the share-lending arrangement shall recognize an expense equal to the then fair value of the unreturned shares, net of the fair value of probable recoveries, with an offset to additional paid-in capital. The issuer of the share-lending arrangement shall remeasure the fair value of the unreturned shares each reporting period through earnings until the arrangement consideration payable by the counterparty becomes fixed. Subsequent changes in the amount of the probable recoveries should also be recognized in earnings.

Under ASC 470-20-25-20A and 30-26A, equity-classified own-share lending arrangements executed in contemplation of a convertible debt issuance (see Section 2.9) are recorded initially at fair value and recognized as a debt issuance cost with an offset to APIC in the entity's financial statements. Unless the issuer elects to account for the debt at fair value under the fair value option in ASC 825-10, it amortizes any discount (or reduced premium) on the debt created by the recognition of the own-share lending arrangement as a debt issuance cost by using the effective interest method. The amount recognized in equity is not remeasured as long as (1) the share-lending arrangement qualifies as equity under ASC 815-40 and (2) it is not probable that the counterparty to the share-lending arrangement will default in returning the loaned shares (or an equivalent amount of consideration).
ASC 470-20-35-11A states that if it becomes probable that the counterparty to a share-lending arrangement will default in returning the loaned shares (or an equivalent amount of consideration), the issuer must recognize an expense equal to the fair value of the unreturned shares adjusted for the fair value of any probable recoveries. The offsetting entry for the expense is to APIC. At its June 18, 2009, meeting, the EITF stated the following related to this issue:

Some Task Force members observed that equity-classified instruments do not generally result in expense charges. However, the Task Force concluded that an expense was appropriate in this situation because it relates to a counterparty default and not changes in the entity’s share price.

Said differently, even though a share-lending arrangement is classified in equity, it is appropriate to record an expense because the issuer is suffering a loss from the counterparty’s failure to satisfy its obligation to return the loaned shares. Under the contractual terms, the shares (or an equivalent amount of consideration) should have been returned to the issuer, but as a result of the counterparty credit risk, the issuer is instead receiving something of lesser or no value. The amount of the loss (i.e., the fair value of the unreturned shares adjusted for probable recoveries) is remeasured in each period (e.g., for changes in the fair value of the unreturned shares) until the consideration payable becomes fixed. The issuer recognizes changes in the amount of the loss in earnings with an offset to APIC.

6.2 Freestanding Contracts Indexed to an Entity’s Own Equity and Classified as Assets or Liabilities

6.2.1 Initial and Subsequent Measurement

If an entity determines that a freestanding contract does not qualify as equity under ASC 815-40, the entity would classify the contract as an asset or a liability. If a contract that does not qualify as equity is considered to be indexed to the entity's equity under ASC 815-40-15 (see Chapter 4), it would be initially measured at its fair value, and changes in the fair value of the contract would be recorded through earnings (see Section 6.3 for a discussion of the accounting for a contract on the entity's own equity that is considered not indexed to its equity).

If the contract was issued with debt or stock, the issuance proceeds received need to be allocated between the items. An entity typically allocates proceeds first to the items that will be measured at fair value on a recurring basis; it then allocates any residual proceeds to those items that will be carried at amortized cost (i.e., a with-and-without method on the basis of the fair value of the contract) to avoid the recognition of a gain or a loss caused solely by the allocation model (see Section 6.1.1).
In some circumstances, the initial fair value of the items required to be subsequently measured at fair value exceeds the proceeds received. At the 2014 AICPA Conference on Current SEC and PCAOB Developments, Professional Accounting Fellow Hillary Salo addressed the allocation of proceeds related to a reporting entity’s issuance of a hybrid instrument when the initial fair value of the financial liabilities required to be measured at fair value (such as embedded derivatives) exceeds the net proceeds received. We believe that her remarks are applicable by analogy to freestanding contracts (e.g., debt issued with detachable warrants) when one or both are measured at fair value with changes in fair value recognized in earnings and the initial fair value of items required to be remeasured at fair value exceeds the amount of the proceeds received. Ms. Salo made the following remarks:

> The staff believes that when reporting entities analyze these types of unique fact patterns, they should first, and most importantly, verify that the fair values of the financial liabilities required to be measured at fair value are appropriate under [ASC 820]. [Footnote omitted] If appropriate, then the reporting entity should evaluate whether the transaction was conducted on an arm’s length basis, including an assessment as to whether the parties involved are related parties under [ASC 850]. Lastly, if at arm’s length between unrelated parties, a reporting entity should evaluate all elements of the transaction to determine if there are any other rights or privileges received that meet the definition of an asset under other applicable guidance.

In the fact patterns analyzed by the staff, we concluded that if no other rights or privileges that require separate accounting recognition as an asset could be identified, the financial liabilities that are required to be measured at fair value (for example, embedded derivatives) should be recorded at fair value with the excess of the fair value over the net proceeds received recognized as a loss in earnings. Furthermore, given the unique nature of these transactions, we would expect reporting entities to provide clear and robust disclosure of the nature of the transaction, including reasons why the entity entered into the transaction and the benefits received.

Additionally, some people may wonder whether the staff would reach a similar conclusion if a transaction was not at arm’s length or was entered into with a related party. We believe those fact patterns require significant judgment; therefore, we would encourage consultation with OCA in those circumstances.

For a freestanding contract classified as an asset or a liability under ASC 815-40, an entity should determine whether the contract also falls within the scope of the derivative accounting requirements in ASC 815-10. If so, an entity would need to provide the disclosures required by ASC 815 for derivatives and could designate the instrument as a hedging instrument in a qualifying hedge relationship if the criteria for such designation are met.

Note that ASC 815-40 provides subsequent accounting guidance only on contracts classified as assets and liabilities that are also considered indexed to the entity’s own stock. If the contract is not considered indexed to the entity’s own equity under ASC 815-40-15, the subsequent measurement guidance in ASC 815-40 does not apply (see Section 6.3).

### 6.2.2 Reclassifications

<table>
<thead>
<tr>
<th>ASC 815-40</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>35-10</strong> if a contract is reclassified from an asset or a liability to equity, gains or losses recorded to account for the contract at fair value during the period that the contract was classified as an asset or a liability shall not be reversed.</td>
</tr>
</tbody>
</table>

An entity is required to reassess its classification of each contract as of each reporting date (see Section 5.4). Reclassification of a contract classified as an asset or a liability is required if the contract begins to meet all the criteria for equity classification (e.g., the entity’s shareholders approve an increase in the number of authorized shares; see Section 5.3.3).
If reclassification is required, the entity reclassifies the instrument as of the date of the event or change in circumstance that caused the reclassification at its then-current fair value. If a contract is reclassified from an asset or a liability to equity, gains and losses during the period the contract was classified as an asset or a liability are not reversed, and the adjustment to the contract’s current fair value is recognized in earnings before reclassification.

6.2.3 Settlements

<table>
<thead>
<tr>
<th>ASC 815-40</th>
</tr>
</thead>
<tbody>
<tr>
<td>40-2 If contracts classified as assets or liabilities are ultimately settled in shares, any gains or losses on those contracts shall continue to be included in earnings.</td>
</tr>
</tbody>
</table>

An entity should record in earnings all changes in the fair value of a contract classified as an asset or a liability. The gains and losses are not reversed upon contract settlement, even if the contract is settled in shares. When the contract is settled, the entity should measure it at its current fair value as of the settlement date and include in earnings any fair value gain or loss that has not been previously recognized. If the entity delivers or receives equity shares upon settlement of a contract classified as an asset or a liability, the contract is derecognized and its carrying amount and any cash paid or received is treated as consideration for the shares issued or received.

6.2.4 Modifications

A freestanding contract indexed to an entity’s own equity and classified as an asset or a liability is recognized at fair value, with changes in fair value recognized in earnings. A modification or exchange of such a contract is reflected in the change in fair value of the instrument that is recognized in net income.

6.3 Freestanding Contracts Not Indexed to an Entity’s Own Equity

<table>
<thead>
<tr>
<th>ASC 815-40</th>
</tr>
</thead>
<tbody>
<tr>
<td>15-8A If the instrument does not meet the criteria to be considered indexed to an entity’s own stock as described in paragraphs 815-40-15-5 through 15-8, it shall be classified as a liability or an asset.</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>ASC 815-10</th>
</tr>
</thead>
<tbody>
<tr>
<td>S99-4 The following is the text of the SEC Observer Comment: Accounting for Written Options. SEC staff’s longstanding position is that written options that do not qualify for equity classification initially should be reported at fair value and subsequently marked to fair value through earnings.</td>
</tr>
</tbody>
</table>

If a freestanding contract on an entity’s own equity does not meet the conditions for being considered indexed to the entity’s own stock under ASC 815-40-15, ASC 815-40 precludes classification of the contract as equity but does not otherwise address the accounting for the contract. Accordingly, the entity should consult other accounting literature.
If such a contract has all the characteristics of a derivative and is not excluded from the scope of ASC 815-10, then it should be accounted for both initially and subsequently at fair value, with changes in fair value recorded immediately through earnings (unless it is designated as a hedging instrument in a cash flow hedge or net investment hedge). ASC 815-10-15-83 defines a derivative as a contract that contains all three of the following characteristics:

- It contains one or more underlyings and “[o]ne or more notional amounts or payment provisions or both.”
- It “requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors.”
- It requires or permits net settlement. (Under ASC 815, net settlement also refers to (1) a market mechanism that facilitates net settlement and (2) physical settlement of the contract if the underlying asset is readily convertible to cash.)

Not all contracts that fail to meet the indexation guidance in ASC 815-40-15 have all the characteristics of a derivative in ASC 815-10. For example, a written call option contract that requires physical settlement in shares that are not readily convertible to cash may be outside the scope of ASC 815-10 because the net settlement characteristic in the definition of a derivative in ASC 815-10-15-83 is not met.

The long-standing position of the SEC staff is that if the contract is a written option (e.g., a warrant or call option) that does not qualify for equity classification, and the subsequent accounting is not specifically addressed in other U.S. GAAP (including ASC 480-10, ASC 505-50, ASC 718, ASC 805-30, and ASC 815-10), registrants should account for the contract at fair value with changes in fair value recorded in earnings in each reporting period (ASC 815-10-S99-4).

The SEC staff’s view is consistent with AICPA Issues Paper 86-2 on accounting for options, which states, in part:

Options should be carried at market price. Options not traded on exchanges should be accounted for the same as options traded on exchanges.

Further, at the 2003 AICPA Conference on Current SEC Developments, Professional Accounting Fellow Gregory Faucette stated the following:

Important to the interpretation of the historical staff position is the scope of [the AICPA Issues Paper]. The Issues Paper addressed all options traded on exchanges, all options on fungible items not traded on exchanges, and all options settled in cash only, such as options on stock indices. The scope excluded options on land or real estate, options on large blocks of stock, options issued by an enterprise on its securities, and agreements that obligated enterprises to make or acquire loans under specified conditions.

In a manner consistent with the AICPA issues paper and the above remarks, we believe that options on large blocks of an entity’s own equity shares are not subject to the SEC’s long-standing position on written options.

If the contract is a purchased call option and the subsequent accounting is not specifically addressed in other GAAP (including ASC 480-10, ASC 718, ASC 805-30, and ASC 815-10), the entity could use either of the following methods to subsequently account for it:

- **Cost method in ASC 325-20** — Under this method, the entity would not recognize changes in the fair value of the purchased call option; however, the carrying amount of the purchased call option would be subject to an other-than-temporary impairment assessment.

- **Fair value method** — Under this method, the reporting entity would recognize changes through earnings by electing the fair value option in ASC 825-10.
Entities commonly remeasure at fair value other contracts that do not qualify for equity classification and for which the subsequent accounting is not specifically addressed by U.S. GAAP. ASC 825-10-25-1 permits entities to elect, on specified election dates, to measure at fair value eligible financial instruments, such as instruments that are classified as assets or liabilities under ASC 815-40-15-8A. In support of fair value accounting, some entities also point to AICPA Issues Paper No. 86-2.

6.4 Embedded Features

While ASC 815-40 applies in the determination of whether an embedded feature qualifies as equity, it does not address the recognition, measurement, and presentation of a feature embedded in another contract (e.g., an equity conversion option embedded in a debt security or in a preferred stock instrument).

Under ASC 815-15-25-1, an entity is required to bifurcate — that is, separately account for — a feature embedded within another contract when the following three conditions are met:

- The hybrid instrument (i.e., the combination of the embedded feature and its host contract) is not being measured at fair value with changes in fair value recorded immediately through earnings.
- The embedded feature — if issued separately — would be accounted for as a derivative instrument under ASC 815-10. In evaluating whether this condition is met, the entity considers the definition of a derivative in ASC 815-10 and the scope exceptions from derivative accounting in ASC 815-10 and ASC 815-15.
- The economic characteristics and risks of the embedded feature are not clearly and closely related to those of the host contract (e.g., an embedded feature with characteristics and risks of equity would not be considered clearly and closely related to a debt host contract).

If the feature is required to be separated under ASC 815-15, the feature is recognized as a derivative asset or liability and measured at fair value with changes in fair value recognized in earnings. For example, an equity conversion feature embedded in a debt security would be separated from its host contract and accounted for as a derivative if the feature does not qualify as equity under ASC 815-40 and the shares to be delivered are readily convertible to cash.

If the embedded feature qualifies as equity under ASC 815-40, it is excluded from the scope of the derivative accounting guidance in ASC 815-10 and ASC 815-15 in accordance with ASC 815-10-15-74(a). For such a feature, the entity should consider whether other accounting guidance applies, including:

- The requirement to separate an equity component from a convertible instrument subject to the cash conversion guidance in ASC 470-20.
- The requirement to recognize certain BCFs in equity under ASC 470-20.
- The requirement to allocate an amount to equity if a convertible debt instrument is issued at a substantial premium (ASC 470-20-25-13).

If a feature that does not qualify as equity under ASC 815-40 is not required to be separated as an embedded derivative under ASC 815-15, the entity should consider whether other accounting guidance applies, including the guidance referenced above.

The determination of whether an embedded feature qualifies as equity is reassessed in each period unless reassessment is unnecessary because the feature does not meet the other criteria for bifurcation in ASC 815-15-25-1. If an embedded feature ceases to meet the conditions in ASC 815-40 for equity classification after the initial recognition of the hybrid contract (e.g., because the entity no longer has sufficient authorized
and unissued shares to share settle the feature; see Section 5.3.3), it no longer meets the scope exception for contracts on an entity’s own equity in ASC 815-10-15-74(a). Accordingly, the entity would need to evaluate whether the feature should be separated as an embedded derivative under ASC 815-15.

If separation is required after the initial recognition of the hybrid contract, the embedded derivative is bifurcated and recognized at fair value at the time it ceases to meet the conditions for classification in equity. If no amount was previously allocated to equity, a portion of the current carrying amount of the hybrid contract equal to the current fair value of the feature is allocated to the embedded derivative (in accordance with ASC 815-15-30-2). Alternatively, if an amount attributable to the equity feature was previously allocated to equity under the cash conversion guidance in ASC 470-20 the difference between the amount previously recognized in equity and the fair value of the conversion option as of the date of reclassification is accounted for as an adjustment to equity (ASC 470-20-35-19).

If an embedded feature that was bifurcated from its host contract subsequently meets the conditions for equity classification in ASC 815-40 (e.g., because the entity now has sufficient authorized and unissued shares to share settle the feature), the embedded derivative no longer meets the bifurcation criteria in ASC 815-15. Therefore, the embedded feature should no longer be classified as an asset or a liability. However, any previously recognized gains and losses should not be reversed (ASC 815-40-35-10). Instead, the carrying amount of the embedded derivative (i.e., the fair value of the feature as of the date of the reclassification) should be reclassified to shareholders’ equity. Any remaining debt discount (that arose from the original bifurcation) should continue to be amortized (ASC 815-15-35-4). The entity also should provide the disclosures required by ASC 815-15-50-3, as applicable:

An issuer shall disclose both of the following for the period in which an embedded conversion option previously accounted for as a derivative instrument under [ASC 815-15] no longer meets the separation criteria under [ASC 815-15] :

a. A description of the principal changes causing the embedded conversion option to no longer require bifurcation under this Subtopic

b. The amount of the liability for the conversion option reclassified to stockholders’ equity.

Example 6-2

**Embedded Features**

On January 1, 20X5, Company ABC issues a 10-year note that has a $1,000 par value, accrues interest at an annual rate of 4 percent, and is convertible into 100 shares of ABC’s common stock. The fair value of one share of ABC’s common stock is $8.50 on the issue date. Upon conversion, ABC must settle the accreted value of the note in cash and has the option to settle the conversion spread in either cash or common stock (commonly referred to as Instrument C). In accordance with ASC 815-40, Instrument C is not a “conventional convertible” instrument in ABC’s application of ASC 815-40 to the conversion option (i.e., ASC 815-40-25-7 through 25-35 do apply). After ABC considers its potential share requirements for other existing commitments, it concludes that it cannot assert that it has a sufficient number of authorized but unissued common shares available to share settle the conversion option; accordingly, the conversion option does not qualify for equity classification under ASC 815-40. After applying ASC 815-40 and ASC 815-15-25-1, ABC concludes that the conversion option must be bifurcated and accounted for as a separate derivative.

At inception, on January 1, 20X5, ABC records the following entry to bifurcate the embedded derivative (assume that the fair value of the conversion option on that date is $50):

**Journal Entry: January 1, 20X5**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>1,000</td>
</tr>
<tr>
<td>Discount — debt</td>
<td>50</td>
</tr>
<tr>
<td>Debt</td>
<td>1,000</td>
</tr>
<tr>
<td>Conversion option liability</td>
<td>50</td>
</tr>
</tbody>
</table>
Example 6-2 (continued)

As of each quarterly reporting date during 20X5, ABC determines that continued bifurcation of the conversion option is required. For each quarterly reporting period, the derivative (which is not designated as a hedging instrument) is marked to fair value, with the changes in fair value recognized in earnings (the conversion option has a fair value of $200 on December 31, 20X5). Company ABC also recognizes its contractual interest expense on the note, and it amortizes to interest expense the debt discount created by the bifurcation of the embedded conversion option. The following journal entries reflect the cumulative activity booked during the year ended December 31, 20X5 (each journal entry represents the sum of the quarterly journal entries):

Journal Entry: Year Ended December 31, 20X5

Interest expense
   Cash/interest payable
   To recognize contractual interest expense on the debt.
Interest expense
   Discount — debt
   To amortize the discount on the debt created by the bifurcation.
Change in fair value of conversion liability
   Conversion option liability
   To mark the conversion option derivative to fair value.

As of December 31, 20X5, the carrying amounts of the debt host contract and the conversion liability are $954 and $200, respectively.

Embedded Features

On January 1, 20X6, ABC obtains shareholder approval to increase the number of its authorized common shares to a level sufficient for it to assert that it has the ability to share settle the conversion option. On the basis of this approval, ABC concludes that the conversion option now qualifies for equity classification under ASC 815-40 and that the bifurcated derivative liability no longer needs to be accounted for as a separate derivative under ASC 815-15-25-1.

No modification of terms occurred. Rather, an event extraneous to the note (obtaining shareholder approval to increase authorized common shares) has caused the embedded conversion option to no longer meet the conditions for bifurcation.

Company ABC records the following entry on January 1, 20X6 (assume no changes in fair value from December 31, 20X5, to January 1, 20X6):

Journal Entry: January 1, 20X6

Conversion option liability
   APIC
   Note that the debt discount will continue to be amortized over the remaining term of the debt since this discount reflects the issuer's economic borrowing costs related to the convertible debt instrument.
Company ABC also is required to provide the disclosures described in ASC 815-15-50-3.
6.5 Fair Value Measurements

<table>
<thead>
<tr>
<th>ASC 815-40-20 — Glossary</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Fair Value</strong></td>
</tr>
<tr>
<td>The price that would be received to sell an asset or paid to transfer a liability in an <em>orderly transaction</em> between <em>market participants</em> at the measurement date.</td>
</tr>
</tbody>
</table>

Because ASC 815-40 requires certain fair value measurements and disclosures (e.g., contracts classified as assets or liabilities under ASC 815-40-25 are subsequently measured at fair value), ASC 815-40-20 includes definitions related to fair value. In determining fair value under ASC 815-40, an entity should apply the guidance in ASC 820. In the absence of a specific exception, ASC 820 applies whenever fair value measurement or disclosures are permitted or required under U.S. GAAP (ASC 820-10-15-1). There is no specific scope exception in ASC 820 for fair value measurements under ASC 815-40.
Chapter 7 — Presentation and Disclosure

7.1 Requirements Under U.S. GAAP

7.1.1 EPS

7.1.1.1 Basic EPS

As noted in ASC 260-10-45-10, basic EPS is calculated “by dividing income available to common stockholders (the numerator) by the weighted-average number of common shares outstanding (the denominator) during the period.” Although freestanding contracts on an entity’s own stock that are within the scope of ASC 815-40 do not represent outstanding common shares, they can affect the calculation of income available to common stockholders in the computation of basic EPS. In particular:

- The two-class method of calculating EPS applies to contracts that participate on a nondiscretionary basis in the entity’s undistributed earnings. Examples of freestanding contracts on the entity’s own stock that may trigger application of the two-class method include (1) those that entitle the holder to participate in cash dividends on the entity’s common stock and (2) forward contracts to issue common shares that include a reduction to the forward price or an increase in the number of shares when the entity declares a cash dividend. For further discussion, see Sections 5.3.3.4 and 5.3.3.5 of Deloitte’s A Roadmap to the Presentation and Disclosure of Earnings per Share.

- For freestanding equity-classified contracts that contain a down-round feature, an adjustment to income available to common stockholders is required when the down-round feature is triggered (see Section 6.1.5 of this Roadmap and Section 3.2.5.3 of Deloitte’s A Roadmap to the Presentation and Disclosure of Earnings per Share).

- Modifications, exchanges, reclassifications, and settlements of equity-classified contracts on the entity’s own equity may cause the recognition of a dividend or expense. For further discussion, see Sections 3.2.5.2, 3.2.6.4, and 3.2.6.5 of Deloitte’s A Roadmap to the Presentation and Disclosure of Earnings per Share.

7.1.1.2 Diluted EPS

Diluted EPS is a per-share performance measure under which it is assumed that (1) all dilutive potential common shares within an entity’s capital structure were outstanding during the reporting period and (2) net income was calculated by using a consistent assumption. Specifically, an entity makes various adjustments to the numerator and denominator in the calculation of basic EPS to reflect the impact of potential common shares.
Unless an exception applies (see discussion below), the treasury stock method of calculating diluted EPS applies to the following types of potential common shares if the effect is dilutive:

- Written call options (warrants) on common stock.
- Written call options (warrants) on convertible securities.
- Forward sale contracts on common stock.
- Forward sale contracts on convertible securities.

Under the treasury stock method, it is assumed that the proceeds that would be received upon settlement are used to repurchase common shares at the average market price for common stock during the period. Because the contract is assumed to be classified as equity under the treasury stock method, the entity must, in addition to adding the incremental shares to the denominator, make a numerator adjustment if the contract is classified as an asset or a liability under ASC 815-40, which would reverse the mark-to-market adjustment net of any associated income tax effects. Special considerations are necessary if the contract requires or permits net share settlement or is subject to adjustments to the number of shares or to the exercise price or forward price. For further discussion, see Section 4.2.2 of *A Roadmap to the Presentation and Disclosure of Earnings per Share*.

An entity should not apply the treasury stock method, however, if either (1) the contract must be net cash settled (i.e., no common shares or potential common shares would be issued upon settlement) or (2) the contract may be settled in cash or stock at the election of the entity, and the entity has overcome the presumption of share settlement (see Section 4.2.2.3 of *A Roadmap to the Presentation and Disclosure of Earnings per Share*). Further, if a potential common share is a participating security, an entity is required to use the more dilutive of the treasury stock method or the two-class method of calculating diluted EPS (see Section 5.5.4 of *A Roadmap to the Presentation and Disclosure of Earnings per Share*).

Contracts that give the entity the right to purchase or sell its common stock, such as purchased put options and purchased call options on the entity's own equity, are not included in the calculation of diluted EPS because they would only be exercised when they are in-the-money and the resulting effect would be antidilutive under the treasury stock method or the reverse treasury stock method. For further discussion, see Section 4.1.1.1 of *A Roadmap to the Presentation and Disclosure of Earnings per Share*.

### 7.1.2 Disclosure

**ASC 815-40**

50-1 Changes in the fair value of all contracts classified as assets or liabilities shall be disclosed in the financial statements as long as the contracts remain classified as assets or liabilities.

50-2 Some contracts that are classified as assets or liabilities meet the definition of a derivative instrument under the provisions of Subtopic 815-10. The related disclosures that are required by Sections 815-10-50, 815-25-50, 815-30-50, and 815-35-50 also are required for those contracts.

**Reclassifications and Related Accounting Policy Disclosures**

50-3 Contracts within the scope of this Subtopic may be required to be reclassified into (or out of) equity during the life of the instrument (in whole or in part) pursuant to the provisions of paragraphs 815-40-35-8 through 35-13. An issuer shall disclose contract reclassifications (including partial reclassifications), the reason for the reclassification, and the effect on the issuer's financial statements.

50-4 The determination of how to partially reclassify contracts subject to this Subtopic is an accounting policy decision that shall be disclosed pursuant to Topic 235.
Interaction with Disclosures About Capital Structure

The disclosures required by Section 505-10-50 apply to all contracts within the scope of this Subtopic as follows:

a. In the case of an option or forward contract indexed to the issuer's equity, the pertinent information to be disclosed under Section 505-10-50 about the contract includes all of the following:
   1. The forward rate
   2. The option strike price
   3. The number of issuer's shares to which the contract is indexed
   4. The settlement date or dates of the contract
   5. The issuer's accounting for the contract (that is, as an asset, liability, or equity).

b. If the terms of the contract provide settlement alternatives, those settlement alternatives shall be disclosed under Section 505-10-50, including both of the following:
   1. Who controls the settlement alternatives
   2. The maximum number of shares that could be required to be issued to net share settle a contract, if applicable. Paragraph 505-10-50-3 requires additional disclosures for actual issuances and settlements that occurred during the accounting period.

c. If a contract does not have a fixed or determinable maximum number of shares that may be required to be issued, the fact that a potentially infinite number of shares could be required to be issued to settle the contract shall be disclosed under Section 505-10-50.

d. A contract's current fair value for each settlement alternative (denominated, as relevant, in monetary amounts or quantities of shares) and how changes in the price of the issuer's equity instruments affect those settlement amounts (for example, the issuer is obligated to issue an additional X shares or pay an additional Y dollars in cash for each $1 decrease in stock price) shall be disclosed under Section 505-10-50. (For some issuers, a tabular format may provide the most concise and informative presentation of these data.)

e. The disclosures required by paragraph 505-10-50-11 shall be made for any equity instrument in the scope of this Subtopic that is (or would be if the issuer were a public entity) classified as temporary equity. (That paragraph applies to redeemable stock issued by nonpublic entities, regardless of whether the private entity chooses to classify those securities as temporary equity.)
ASC 505-10

50-3 An entity shall explain, in summary form within its financial statements, the pertinent rights and privileges of the various securities outstanding. Examples of information that shall be disclosed are dividend and liquidation preferences, participation rights, call prices and dates, conversion or exercise prices or rates and pertinent dates, sinking-fund requirements, unusual voting rights, and significant terms of contracts to issue additional shares. An entity shall disclose within its financial statements the number of shares issued upon conversion, exercise, or satisfaction of required conditions during at least the most recent annual fiscal period and any subsequent interim period presented.

Pending Content (Transition Guidance: ASC 260-10-65-4)

50-3 An entity shall explain, in summary form within its financial statements, the pertinent rights and privileges of the various securities outstanding. Examples of information that shall be disclosed are dividend and liquidation preferences, participation rights, call prices and dates, conversion or exercise prices or rates and pertinent dates, sinking-fund requirements, unusual voting rights, and significant terms of contracts to issue additional shares or terms that may change conversion or exercise prices (excluding standard antidilution provisions). An entity shall disclose within its financial statements the number of shares issued upon conversion, exercise, or satisfaction of required conditions during at least the most recent annual fiscal period and any subsequent interim period presented. An entity also shall disclose within the financial statements actual changes to conversion or exercise prices that occur during the reporting period (excluding changes due to standard antidilution provisions).

50-3A For a financial instrument with a down round feature that has been triggered during the reporting period and for which an entity has recognized the effect in accordance with paragraph 260-10-25-1, 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 that has been triggered.

ASC 815-40 requires disclosure of:
- Changes in the fair value of contracts on an entity's own equity classified as assets or liabilities.
- Information related to contracts on own equity reclassified into or out of equity (in whole or in part), such as:
  - Contract reclassifications (including partial reclassifications).
  - The reason for reclassifications.
  - The effect of reclassifications on the issuer's financial statements.
  - The entity's accounting policy for determining how to partially reclassify contracts.
- Information related to the entity's capital structure, including:
  - For options or forwards indexed to the issuer's equity, the forward rate, the option strike price, the number of underlying shares, the settlement date or dates, and the accounting for the contract (i.e., as an asset, a liability, or equity).
  - For contracts that contain settlement alternatives (e.g., physical, net share, or net cash), those settlement alternatives, which party controls the settlement alternatives (i.e., the entity or the counterparty), and the maximum number of shares that the entity could be required to deliver to net share settle the contract, if applicable.
  - If a contract could require the entity to issue a potentially infinite number of shares, that fact.
“A contract’s current fair value for each settlement alternative (denominated, as relevant, in monetary amounts or quantities of shares) and how changes in the price of the issuer’s equity instruments affect those settlement amounts.”

After adoption of ASU 2017-11, ASC 505-10-50 requires disclosure of:

- Contractual terms that might adjust conversion or exercise prices as well as actual changes to such prices that occurred during the reporting period. An entity should therefore disclose contractual adjustments that are subject to evaluation under the indexation guidance in ASC 815-40-15 (see Chapter 4). However, disclosure is not required for standard antidilution provisions (see Section 5.5 for the definition of such provisions).
- Information about financial instruments with down-round features that have been triggered during the reporting period, including the fact that the feature was triggered and the value of the feature’s effect (see Section 6.1.5 for measurement guidance). For further discussion of down-round features, measurement, and the effective date and transition guidance related to ASU 2017-11, see Sections 4.3.7.2 and 6.1.5.

An entity should also consider disclosure requirements in other Codification topics and subtopics that may be applicable to contracts on its own equity. For example, contracts on own equity that must be accounted for as derivatives under ASC 815-10 or ASC 815-15 are subject to any applicable disclosure requirements in ASC 815-10, ASC 815-15, ASC 815-25, ASC 815-30, and ASC 815-35. Further, contracts on own equity that are accounted for at fair value under ASC 815-40 are subject to disclosures about fair value measurements under ASC 820.

**ASC 470-20**

50-2A An entity that enters into a share-lending arrangement on its own shares in contemplation of a convertible debt offering or other financing shall disclose all of the following. The disclosures must be made on an annual and interim basis in any period in which a share-lending arrangement is outstanding.

a. A description of any outstanding share-lending arrangements on the entity’s own stock

b. All significant terms of the share-lending arrangement including all of the following:
   1. The number of shares
   2. The term
   3. The circumstances under which cash settlement would be required
   4. Any requirements for the counterparty to provide collateral.

c. The entity’s reason for entering into the share-lending arrangement

d. The fair value of the outstanding loaned shares as of the balance sheet date

e. The treatment of the share-lending arrangement for the purposes of calculating earnings per share

f. The unamortized amount of the issuance costs associated with the share-lending arrangement at the balance sheet date

g. The classification of the issuance costs associated with the share-lending arrangement at the balance sheet date

h. The amount of interest cost recognized relating to the amortization of the issuance cost associated with the share-lending arrangement for the reporting period

i. Any amounts of dividends paid related to the loaned shares that will not be reimbursed.
ASC 470-20 (continued)

**50-2B** An entity that enters into a share-lending arrangement on its own shares in contemplation of a convertible debt offering or other financing shall also make the disclosures required by Topic 505.

**50-2C** In the period in which an entity concludes that it is *probable* that the counterparty to its share-lending arrangement will default, the entity shall disclose the amount of expense reported in the statement of earnings related to the default. The entity shall disclose in any subsequent period any material changes in the amount of expense as a result of changes in the fair value of the entity's shares or the probable recoveries. If default is probable but has not yet occurred, the entity shall disclose the number of shares related to the share-lending arrangement that will be reflected in basic and diluted earnings per share when the counterparty defaults.

ASC 470-20-50-2A through 50-2C include incremental disclosure requirements related to own-share lending arrangements executed in contemplation of a convertible debt offering or other financing (see Section 2.9).

### 7.2 SEC Requirements

SEC registrants should consider any applicable disclosure requirements issued by the SEC. For example, Regulation S-X, Rule 4-08 (reproduced in ASC 235-10-S99-1), requires disclosure of warrants or rights outstanding as of the balance sheet date, including:

- Title of issue of securities called for by warrants or rights.
- Aggregate amount of securities called for by warrants or rights outstanding.
- Date from which warrants or rights are exercisable.
- Price at which warrants or rights are exercisable.

Further, SEC Regulation S-K, Item 303, requires disclosure within a separate section of the MD&A of information about off-balance-sheet arrangements (including equity-classified contracts on own equity). The threshold for disclosure is when those arrangements have or are reasonably likely to have a material current or future effect on the registrant’s financial condition, changes in financial condition, revenue and expenses, results of operations, liquidity, capital expenditures, or capital resources. The SEC’s *Current Accounting and Disclosure Issues in the Division of Corporation Finance* (as updated November 30, 2006) notes:

> Registrants often disclose a variety of equity-linked contracts, such as convertible debt arrangements, stock warrants and forward agreements to sell shares at pre-set terms, where the registrant has applied the . . . scope exception [in ASC 815-10 for contracts on an entity's own equity], yet the arrangements are not fully disclosed in the off-balance sheet arrangement section of MD&A. To ensure completeness of the information provided in the off-balance sheet arrangement section, registrants should carefully consider whether there are any outstanding contracts indexed to their own stock and classified as stockholders' equity that are reasonably likely to materially impact the registrant's financial condition, liquidity or capital resources.
Chapter 8 — Comparison With IFRS Standards

8.1 Background

8.1.1 Circumstances in Which an Understanding of IFRS Standards May Be Relevant

An understanding of the differences between U.S. GAAP and IFRS Standards in the accounting for contracts on an entity’s own equity may be relevant for:

- U.S. entities that consolidate subsidiaries or other foreign operations that report under IFRS Standards.
- U.S. entities that provide financial statement information to a parent entity that reports under IFRS Standards.
- U.S. entities that negotiate transaction terms for contracts on own equity with entities that report under IFRS Standards (and vice versa).
- Entities that seek to compare their financial statements with those of international competitors.
- Foreign entities that report under IFRS Standards and consolidate subsidiaries or other operations that report under U.S. GAAP.
- Foreign entities that report under IFRS Standards and provide financial statement information to a parent entity that reports under U.S. GAAP.
- Investors and other users of financial statements that seek to compare financial statements prepared under U.S. GAAP and IFRS Standards.
- Standard setters and others that consider opportunities to converge accounting requirements.
- Parties that participate in discussions on or seek to influence the development of new accounting requirements under U.S. GAAP or IFRS Standards.

8.1.2 IFRS Guidance

Under IFRS Standards, an entity evaluates contracts on its own equity (including equity features embedded in other contracts) in accordance with IAS 32 to determine whether they qualify for equity classification or must be classified as assets or liabilities.

IAS 32 has a broader scope than does ASC 815-40. For example, IAS 32 contains guidance on forward repurchase contracts and written put options on an entity’s shares. Under U.S. GAAP, freestanding forward repurchase contracts and freestanding written put options on an entity’s shares are outside the scope of ASC 815-40. The discussion of key differences below applies only to contracts within the scope
of ASC 815-40, not to freestanding forward purchase contracts or written put options on the entity’s shares that are within the scope of ASC 480-10 (both IAS 32 and ASC 480-10 require such contracts to be classified as liabilities, but the measurement guidance differs).

### 8.1.3 Key Differences

The table below summarizes key differences between U.S. GAAP and IFRS Standards in the accounting for contracts on own equity that are within the scope of ASC 815-40. The table is followed by a detailed explanation of each difference.

<table>
<thead>
<tr>
<th>U.S. GAAP</th>
<th>IFRS Standards</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Exercise contingencies</strong></td>
<td>Exercise contingencies must be evaluated to determine whether they preclude equity classification.</td>
</tr>
<tr>
<td><strong>Settlement amount</strong></td>
<td>To qualify as equity, the contract must be a fixed-for-fixed forward or option on equity shares, or the only variables that can adjust the settlement amount are inputs to a fixed-for-fixed forward or option.</td>
</tr>
<tr>
<td><strong>Strike price denominated in foreign currency</strong></td>
<td>Preclude equity classification.</td>
</tr>
<tr>
<td><strong>Net cash settlement provisions</strong></td>
<td>Do not preclude equity classification if the entity cannot be forced to net cash settle the contract. Contain detailed guidance on how to assess whether an entity is able to settle in shares (e.g., whether the entity has sufficient authorized and unissued shares available to share settle the contract).</td>
</tr>
<tr>
<td><strong>Net share settlement provisions</strong></td>
<td>Do not preclude equity classification if the entity cannot be forced to net cash settle the contract.</td>
</tr>
<tr>
<td><strong>Settlement alternatives</strong></td>
<td>Do not preclude equity classification if the entity cannot be forced to net cash settle the contract.</td>
</tr>
</tbody>
</table>
(Table continued)

<table>
<thead>
<tr>
<th></th>
<th>U.S. GAAP</th>
<th>IFRS Standards</th>
</tr>
</thead>
<tbody>
<tr>
<td>Embedded equity-linked features that do not qualify as equity</td>
<td>Not separated as embedded derivatives if they do not meet the net settlement characteristic in the definition of a derivative under ASC 815-10.</td>
<td>May be required to be separated as embedded derivatives even if they do not meet the net settlement characteristic in ASC 815-10.</td>
</tr>
<tr>
<td>Embedded equity-linked features that qualify as equity</td>
<td>Not separated from liabilities except in specified circumstances (e.g., conversion features subject to the cash conversion or BCF guidance in ASC 470-20).</td>
<td>Separated from liabilities.</td>
</tr>
<tr>
<td>Initial measurement of equity component</td>
<td>Different methods depending on the reason an amount is allocated to equity.</td>
<td>With-and-without method under which the liability component is measured first.</td>
</tr>
</tbody>
</table>

8.2 Indexation Guidance

8.2.1 Exercise Contingencies

Under U.S. GAAP, exercise contingencies preclude equity classification if they are based on an observable market other than the market for the issuer's stock or an observable index other than one calculated or measured solely by reference to the issuer's own operations (see Section 4.2). IFRS Standards do not contain requirements for exercise contingencies like those in ASC 815-40-15. Therefore, exercise contingencies that would have precluded a contract from being classified as equity under U.S. GAAP (e.g., an option contract that can be exercised only if the S&P 500 reaches a certain level) would not disqualify a contract from equity classification under IFRS Standards.

8.2.2 Fixed-for-Fixed Requirement

Under paragraph 22 of IAS 32, “[a] contract that will be settled by the entity (receiving or) delivering a fixed number of its own equity instruments in exchange for a fixed amount of cash or another financial asset is an equity instrument” unless the equity instruments to be received or delivered are equity-classified puttable instruments. Accordingly, a contract must provide for the exchange of a fixed number of equity instruments for a fixed monetary amount of cash or other assets to qualify as equity under IFRS Standards. This guidance is comparable to the requirement under ASC 815-40-15 that to qualify as equity, a contract on an entity's own equity must be a fixed-for-fixed forward or option on equity shares, or the only variables that could adjust the settlement amount must be inputs to a fixed-for-fixed forward or option (see Section 4.3). However, unlike ASC 815-40, IAS 32 does not provide detailed guidance on determining whether a contract should be considered fixed for fixed when it contains adjustments to the settlement amount (e.g., antidilution provisions). In practice, certain adjustments are viewed as acceptable under IAS 32 (e.g., when the purpose is to give the counterparty the same protection from a dilutive event as holders of the underlying shares have).

8.2.3 Foreign Currency Provisions

To meet the fixed-for-fixed requirement under IAS 32, the monetary amount must be specified in the reporting entity's functional currency; however, there is one exception. Paragraph 11 of IAS 32 states that “rights, options or warrants to acquire a fixed number of the entity's own equity instruments for a fixed amount of any currency are equity instruments if the entity offers the rights, options or warrants pro rata to all of its existing owners of the same class of its own non-derivative equity instruments.”
Under U.S. GAAP, there is no such exception. An equity-linked financial instrument (or embedded feature) is not considered indexed to the entity's own stock if the strike price is denominated in a currency other than the issuer's functional currency (see Section 4.3.8).

8.3 Classification Guidance

8.3.1 Net Cash Settlement Provisions

Like ASC 815-40, IAS 32 does not permit equity classification for contracts that the entity could be forced to net cash settle. IAS 32 precludes equity classification for any contract that permits the entity to net cash settle or could require the entity to deliver cash or another financial asset or otherwise to settle the contract in such a manner that it would be a financial liability under IAS 32 (e.g., a contract that is net share settled).

Unlike ASC 815-40-25, IFRS Standards do not provide detailed guidance on how an entity should evaluate whether it could be forced to net cash settle a contract (e.g., a contract that requires or permits physical settlement in shares when the issuer does not have sufficient authorized and unissued shares to settle the contract in shares; see Chapter 5). Therefore, it is possible that practitioners might reach different conclusions under ASC 815-40 and IAS 32 regarding whether a contract that specifies physical settlement qualifies as equity when any of the equity classification conditions in ASC 815-40-25 are not met.

8.3.2 Net Share Settlement Provisions

Unlike under ASC 815-40, contracts on own equity that require or permit the issuer to net share settle do not qualify as equity under IAS 32. Only contracts that require physical settlement could qualify for equity classification under IFRS Standards.

8.3.3 Settlement Alternatives

If a contract gives either party a choice about how the contract is settled, IAS 32 requires the contract to be classified as an asset or a liability unless all the settlement alternatives would result in its being an equity instrument. Unlike ASC 815-40, IAS 32 precludes equity classification for contracts that permit the issuer to net cash settle or net share settle, even if the issuer could not be forced to settle in such a manner.

8.4 Embedded Features

8.4.1 Separation of Embedded Derivatives

While both U.S. GAAP and IFRS Standards contain requirements about separation of embedded derivatives, they define a derivative differently. Unlike that under ASC 815-10, the definition of a derivative under IFRS Standards does not include a requirement for net settlement. Therefore, the accounting for an equity-linked feature that is embedded in a host liability and does not qualify as equity under IAS 32 and ASC 815-40 may differ depending on whether the feature meets the net settlement characteristic in the definition of a derivative under ASC 815-10. If the liability is not accounted for at fair value with changes in fair value recognized in net income, an embedded feature that neither qualifies as equity nor meets the net settlement characteristic (e.g., because it involves physical settlement in private company stock) would be separated from its host contract and accounted for as a derivative at fair value under IFRS Standards but not under U.S. GAAP.
8.4.2 Separation of Equity Components

Under IFRS Standards, if a liability contains a component that qualifies as equity in IAS 32 (e.g., an equity conversion feature embedded in a debt security), that component is always required to be separately recognized in equity by the issuer. Under U.S. GAAP, allocation of an amount to equity is precluded even if the embedded feature qualifies as equity in ASC 815-40 (ASC 470-20-25-12) unless any one of the following requirements applies:

- The requirement to separate an equity component from a convertible instrument subject to the cash conversion guidance in ASC 470-20. (Note that such an instrument may not contain any separately recognized equity component under IAS 32 since the potential for cash conversion precludes equity classification under IAS 32.)
- The requirement to recognize certain BCFs in equity under ASC 470-20.
- The requirement to allocate an amount to equity if a convertible debt instrument is issued at a substantial premium (ASC 470-20-25-13).

8.4.3 Initial Measurement of Equity Components

The initial measurement of separately recognized equity components under IAS 32 is similar, but not identical, to the initial measurement of equity components under the cash conversion guidance in ASC 470-20. Under IAS 32, the equity component is initially measured as the difference between the fair value of the entire contract and the fair value of the liability component. Under ASC 470-20, the equity component in an instrument subject to the cash conversion guidance is initially measured as the difference between the initial proceeds and the fair value of the liability component. The initial measurement of equity components under IAS 32 is different from that under the BCF guidance in ASC 470-20 (generally, intrinsic value) and for convertible debt instruments issued at a substantial premium (see ASC 470-20-25-13).
Appendix A — Overview of Examples in ASC 815-40-55

ASC 815-40-55-26 through 55-48 contain 20 examples (numbered from 2 to 21) of the application of the guidance on indexation in ASC 815-40-15. The table below gives an overview of those examples. Chapter 4 discusses related accounting considerations.

<table>
<thead>
<tr>
<th>Example Number (ASC Paragraph)</th>
<th>Contract Type</th>
<th>Step 1: Exercise Contingency?</th>
<th>Step 2: Settlement Adjustments?</th>
<th>Indexed to Own Equity?</th>
</tr>
</thead>
<tbody>
<tr>
<td>2 (ASC 815-40-55-26)</td>
<td>Warrant</td>
<td>Yes. IPO.</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>3 (ASC 815-40-55-27)</td>
<td>Warrant</td>
<td>Yes. $100 million in sales to third parties.</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>5 (ASC 815-40-55-29)</td>
<td>Warrant</td>
<td>Yes. IPO.</td>
<td>Yes. The strike price varies on the basis of the price of gold.</td>
<td>No</td>
</tr>
<tr>
<td>6 (ASC 815-40-55-30)</td>
<td>Warrant</td>
<td>No</td>
<td>Yes. Adjustment to offset effect of merger announcement.</td>
<td>Yes</td>
</tr>
<tr>
<td>7 (ASC 815-40-55-31)</td>
<td>Warrant</td>
<td>No</td>
<td>Yes. The strike price is reduced by $0.50 after any year in which revenue does not exceed $100 million.</td>
<td>No</td>
</tr>
<tr>
<td>8 (ASC 815-40-55-32)</td>
<td>Option</td>
<td>No</td>
<td>Yes. The share price is capped.</td>
<td>Yes</td>
</tr>
<tr>
<td>9 (ASC 815-40-55-33 and 55-34)</td>
<td>Warrant</td>
<td>No</td>
<td>Yes. Down-round protection.</td>
<td>Before the adoption of ASU 2017-11: No After the adoption of ASU 2017-11: Yes</td>
</tr>
<tr>
<td>Example Number (ASC Paragraph)</td>
<td>Contract Type</td>
<td>Step 1: Exercise Contingency?</td>
<td>Step 2: Settlement Adjustments?</td>
<td>Indexed to Own Equity?</td>
</tr>
<tr>
<td>--------------------------------</td>
<td>---------------</td>
<td>-------------------------------</td>
<td>--------------------------------</td>
<td>-----------------------</td>
</tr>
<tr>
<td>10 (ASC 815-40-55-35)</td>
<td>Warrant</td>
<td>No</td>
<td>Yes. Investor put option settleable in shares and for a fixed monetary amount if regulatory approval of a drug compound is not obtained.</td>
<td>No</td>
</tr>
<tr>
<td>11 (ASC 815-40-55-36)</td>
<td>Warrant</td>
<td>No</td>
<td>Yes. The strike price is denominated in a currency other than the entity's functional currency.</td>
<td>No</td>
</tr>
<tr>
<td>12 (ASC 815-40-55-37)</td>
<td>Forward</td>
<td>No</td>
<td>Yes. The strike price is adjusted if dividends differ from expectations or the cost of stock borrow increases.</td>
<td>Yes</td>
</tr>
<tr>
<td>13 (ASC 815-40-55-38)</td>
<td>Forward</td>
<td>No</td>
<td>Yes. The strike price includes interest that varies on the basis of the Federal Funds rate plus a fixed spread. The share price is specified as a 30-day weighted average.</td>
<td>Yes</td>
</tr>
<tr>
<td>14 (ASC 815-40-55-39)</td>
<td>Forward</td>
<td>No</td>
<td>Yes. The strike price includes interest that varies inversely with changes in LIBOR.</td>
<td>No</td>
</tr>
<tr>
<td>15 (ASC 815-40-55-40)</td>
<td>Forward</td>
<td>No</td>
<td>Yes. The share price is subject to both a floor and a cap.</td>
<td>Yes</td>
</tr>
<tr>
<td>16 (ASC 815-40-55-41)</td>
<td>Forward</td>
<td>No</td>
<td>Yes. The number of shares depends on the stock price.</td>
<td>Yes</td>
</tr>
</tbody>
</table>
(Table continued)

<table>
<thead>
<tr>
<th>Example Number (ASC Paragraph)</th>
<th>Contract Type</th>
<th>Step 1: Exercise Contingency?</th>
<th>Step 2: Settlement Adjustments?</th>
<th>Indexed to Own Equity?</th>
</tr>
</thead>
<tbody>
<tr>
<td>17 (ASC 815-40-55-42 and 55-43)</td>
<td>Forward</td>
<td>No</td>
<td>Yes. The strike price is subject to antidilution adjustments (related to stock dividend, ordinary cash dividend, stock split, spinoff, rights offering, recapitalization through a large nonrecurring cash dividend, below-market price issue of shares, or above-market price repurchase of shares).</td>
<td>Yes</td>
</tr>
<tr>
<td>18 (ASC 815-40-55-44)</td>
<td>Forward</td>
<td>No</td>
<td>Yes. The strike price is denominated in a currency other than the entity's functional currency.</td>
<td>No</td>
</tr>
<tr>
<td>19 (ASC 815-40-55-45 and 55-46)</td>
<td>Convertible debt</td>
<td>Yes. The debt is convertible contingent on the entity's stock price (market price trigger), the debt's trading price (parity provision), or a merger announcement.</td>
<td>Yes. Additional make-whole shares may be delivered on the basis of a table with axes of stock price and time (see Section 4.3.7.10).</td>
<td>Yes</td>
</tr>
<tr>
<td>20 (ASC 815-40-55-47)</td>
<td>Convertible debt</td>
<td>No</td>
<td>No. The debt is denominated in the entity's functional currency. (The shares trade only on an exchange in which trades are denominated in a foreign currency.)</td>
<td>Yes</td>
</tr>
<tr>
<td>21 (ASC 815-40-55-48)</td>
<td>Stock option valuation instrument</td>
<td>Maybe</td>
<td>Yes. Payments vary on the basis of stock option exercise behavior.</td>
<td>No</td>
</tr>
</tbody>
</table>
Appendix B — Checklists for Determining Whether Contracts or Features Qualify as Equity

The three checklists in this appendix are intended to help a practitioner determine whether the following types of contracts or features qualify as equity under ASC 815-40:

- Freestanding contracts.
- Features embedded in hybrid contracts other than conventional convertible debt.
- Features embedded in conventional convertible debt.

See Section 5.5 for a discussion of how a practitioner can determine whether a hybrid contract represents conventional convertible debt.

### B.1 Freestanding Contracts

A freestanding contract is classified as equity under ASC 815-40 only if it meets all the requirements outlined in the table below. In determining whether those requirements are met, an entity:

- Does not consider the contingent obligation to transfer consideration under a registration payment arrangement even if it is embedded in the contract (see Section 3.2.4).
- Disregards any uneconomic settlement alternatives (see Section 5.2.5).

<table>
<thead>
<tr>
<th>✓ If Met</th>
<th>Requirement</th>
<th>Roadmap Discussion</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Within the Scope of ASC 815-40</td>
<td></td>
</tr>
<tr>
<td></td>
<td>The contract is not required to be classified as a liability under ASC 480.</td>
<td>Section 2.3</td>
</tr>
<tr>
<td></td>
<td>If the contract was originally issued to compensate employees, it was modified so that it is now within the scope of ASC 815-40.</td>
<td>Section 2.4.1</td>
</tr>
<tr>
<td></td>
<td>If the contract was issued to acquire goods or services from nonemployees:</td>
<td></td>
</tr>
<tr>
<td></td>
<td>- Before the adoption of ASU 2018-07 — Performance has occurred or the contract is not within the scope of ASC 505-50.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>- After the adoption of ASU 2018-07 — The contract was modified so that it is now within the scope of ASC 815-40.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>The contract is not a lock-up option.</td>
<td>Section 2.5.2</td>
</tr>
</tbody>
</table>
(Table continued)

<table>
<thead>
<tr>
<th>✓ If Met Requirement</th>
<th>Roadmap Discussion</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Within the Scope of ASC 815-40</strong></td>
<td></td>
</tr>
<tr>
<td>If the contract is on the equity shares of a subsidiary, the subsidiary is a</td>
<td>Section 2.6.1</td>
</tr>
<tr>
<td>consolidated, substantive entity.</td>
<td></td>
</tr>
<tr>
<td>The contract does not represent the combination of a written put option and a</td>
<td>Section 2.6.4</td>
</tr>
<tr>
<td>purchased call option embedded in the shares of a noncontrolling interest.</td>
<td></td>
</tr>
<tr>
<td><strong>Indexed to the Entity's Own Equity</strong></td>
<td></td>
</tr>
<tr>
<td>If the contract contains an exercise contingency that is based on an observable</td>
<td>Section 4.2</td>
</tr>
<tr>
<td>market, it is the market for the issuer's stock.</td>
<td></td>
</tr>
<tr>
<td>If the contract contains an exercise contingency that is based on an observable</td>
<td>Section 4.2</td>
</tr>
<tr>
<td>index, it is an index calculated or measured solely by reference to the entity's</td>
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<tr>
<td>own operations (e.g., sales revenue, EBITDA, net income, or total equity).</td>
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<tr>
<td>If the settlement amount is adjusted in response to changes in an explicit input,</td>
<td>Section 4.3</td>
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<tr>
<td>that input is not extraneous but rather an input in the pricing of a fixed-for-fixed</td>
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<tr>
<td>forward or option on the entity's equity shares.</td>
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<tr>
<td>If the settlement amount is adjusted in response to changes in an explicit input</td>
<td>Section 4.3</td>
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<tr>
<td>(other than the entity's stock price), the adjustment is not inconsistent with how</td>
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<tr>
<td>a change in the input would affect the pricing of a fixed-for-fixed forward or</td>
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<tr>
<td>option on the entity's equity shares (e.g., it is not leveraged).</td>
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<tr>
<td>If the settlement amount is adjusted in response to changes in an explicit input</td>
<td>Section 4.3</td>
</tr>
<tr>
<td>(other than the entity's stock price), the change in the input cannot result in a</td>
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<tr>
<td>settlement at a fixed monetary amount.</td>
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<tr>
<td>If the settlement amount is adjusted in response to the occurrence or nonoccurrence</td>
<td>Section 4.3</td>
</tr>
<tr>
<td>of a specified event, the event invalidates an implicit assumption used in the</td>
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<tr>
<td>pricing of a fixed-for-fixed forward or option on the entity's equity shares (e.g.,</td>
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<tr>
<td>no dilutive event) or, after the adoption of ASU 2017-11, the adjustment is</td>
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<tr>
<td>triggered by a down-round feature.</td>
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<tr>
<td>If the settlement amount is adjusted in response to an implicit input, the</td>
<td>Section 4.3</td>
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<tr>
<td>adjustment is consistent with the effect that the occurrence or nonoccurrence of</td>
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<tr>
<td>the event had on the fair value of the instrument.</td>
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</tr>
<tr>
<td>The contract otherwise is a fixed-for-fixed forward or option on the entity's</td>
<td>Section 4.3</td>
</tr>
<tr>
<td>equity shares.</td>
<td></td>
</tr>
<tr>
<td><strong>Potentially Settled in the Entity's Own Stock</strong></td>
<td></td>
</tr>
<tr>
<td>The only circumstance (if any) in which the entity could be forced to net cash</td>
<td>Section 5.2.3</td>
</tr>
<tr>
<td>settle the contract is:</td>
<td></td>
</tr>
<tr>
<td>• An event that is solely within the entity's control or</td>
<td></td>
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<tr>
<td>• The final liquidation of the entity or</td>
<td></td>
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<tr>
<td>• An event that would cause the holders of the underlying shares to receive the</td>
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<tr>
<td>same form of consideration.</td>
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</tbody>
</table>
Appendix B — Checklists for Determining Whether Contracts or Features Qualify as Equity

(Table continued)

<table>
<thead>
<tr>
<th>√ If Met</th>
<th>Requirement</th>
<th>Roadmap Discussion</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Potentially Settled in the Entity’s Own Stock</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>The economic substance of the contract is not that of an asset or a liability because:</td>
<td>Section 5.2.5</td>
</tr>
<tr>
<td></td>
<td>• The settlement alternatives have different economic values or</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• One of the settlement alternatives is fixed or contains caps or floors.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>(Note that this requirement does not apply if the reason for the difference is to limit the number of shares that must be delivered in a net share settlement.)</td>
<td></td>
</tr>
<tr>
<td></td>
<td>If the settlement alternatives differ in gain and loss positions, the contract:</td>
<td>Section 5.2.6</td>
</tr>
<tr>
<td></td>
<td>• Permits the entity to net share settle in a loss position and</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Is not predominantly a purchased option.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>The contract:</td>
<td>Section 5.3.2</td>
</tr>
<tr>
<td></td>
<td>• Permits settlement in unregistered shares and there was no failed registration statement within the past six months or</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Permits settlement in shares that were registered at inception and there are no further timely filing or registration requirements or</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Clearly states that the issuer has no obligation to net cash settle the contract even if it is unable to deliver unregistered shares or</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Does not require the issuer to deliver shares.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>If the entity does not have sufficient authorized and unissued shares available to share settle the contract and all other contracts that may require share settlement during the contract period, the entity has the ability to increase the number of authorized shares without shareholder approval.</td>
<td>Section 5.3.3</td>
</tr>
<tr>
<td></td>
<td>The contract contains an explicit share limit.</td>
<td>Section 5.3.4</td>
</tr>
<tr>
<td></td>
<td>The contract does not require net cash settlement if the entity fails to timely file.</td>
<td>Section 5.3.5</td>
</tr>
<tr>
<td></td>
<td>If the contract includes a top-off or make-whole provision, it:</td>
<td>Section 5.3.6</td>
</tr>
<tr>
<td></td>
<td>• Can be net share settled and</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Is subject to a fixed share limit that is less than the number of available authorized and unissued shares.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>The counterparty has no rights that are more highly ranked than the rights of the holders of the underlying shares in bankruptcy.</td>
<td>Section 5.3.7</td>
</tr>
<tr>
<td></td>
<td>If the contract requires the entity to post collateral, the collateral is the shares underlying the contract and is limited to the maximum number of shares that could be delivered under the contract.</td>
<td>Section 5.3.8</td>
</tr>
</tbody>
</table>
### B.2 Features Embedded in Hybrid Contracts Other Than Conventional Convertible Debt

An embedded feature other than one embedded in conventional convertible debt (see Section 5.5) qualifies as equity under ASC 815-40 only if it meets all the requirements outlined in the table below. In determining whether those requirements are met, an entity:

- Does not consider the contingent obligation to transfer consideration under a registration payment arrangement even if it is embedded in the contract (see Section 3.2.4).
- Disregards any uneconomic settlement alternatives (see Section 5.2.5).

<table>
<thead>
<tr>
<th>✓ If Met</th>
<th>Requirement</th>
<th>Roadmap Discussion</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td><strong>Within the Scope of ASC 815-40</strong></td>
<td></td>
</tr>
<tr>
<td></td>
<td>If the contract was originally issued to compensate employees, it has been modified so that it is now within the scope of ASC 815-40.</td>
<td>Section 2.4.1</td>
</tr>
<tr>
<td></td>
<td>• <em>Before the adoption of ASU 2018-07</em> — Performance has occurred or the contract is not within the scope of ASC 505-50.</td>
<td>Section 2.4.2</td>
</tr>
<tr>
<td></td>
<td>• <em>After the adoption of ASU 2018-07</em> — The contract was modified so that it is now within the scope of ASC 815-40.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>The feature is not a lock-up option.</td>
<td>Section 2.5.2</td>
</tr>
<tr>
<td></td>
<td>If the feature is on the equity shares of a subsidiary, the subsidiary is a consolidated, substantive entity.</td>
<td>Section 2.6.1</td>
</tr>
<tr>
<td></td>
<td>The feature does not involve the combination of a written put option and a purchased call option embedded in the shares of a noncontrolling interest.</td>
<td>Section 2.6.4</td>
</tr>
<tr>
<td></td>
<td><strong>Indexed to the Entity's Own Equity</strong></td>
<td></td>
</tr>
<tr>
<td></td>
<td>If the feature contains an exercise contingency that is based on an observable market, it is the market for the issuer's stock.</td>
<td>Section 4.2</td>
</tr>
<tr>
<td></td>
<td>If the feature contains an exercise contingency that is based on an observable index, it is an index calculated or measured solely by reference to the entity's own operations (e.g., sales revenue, EBITDA, net income, or total equity).</td>
<td>Section 4.2</td>
</tr>
<tr>
<td></td>
<td>If the settlement amount is adjusted in response to changes in an explicit input, that input is not extraneous but rather an input in the pricing of a fixed-for-fixed forward or option on the entity's equity shares.</td>
<td>Section 4.3</td>
</tr>
<tr>
<td></td>
<td>If the settlement amount is adjusted in response to changes in an explicit input (other than the entity's stock price), the adjustment is not inconsistent with how a change in the input would affect the pricing of a fixed-for-fixed forward or option on the entity's equity shares (e.g., it is not leveraged).</td>
<td>Section 4.3</td>
</tr>
<tr>
<td></td>
<td>If the settlement amount is adjusted in response to changes in an explicit or an implicit input (other than the entity's stock price), the change in the input cannot result in a settlement at a fixed monetary amount.</td>
<td>Section 4.3</td>
</tr>
<tr>
<td></td>
<td>If the settlement amount is adjusted in response to the occurrence or nonoccurrence of a specified event, the event invalidates an implicit assumption used in the pricing of a fixed-for-fixed forward or option on the entity's equity shares (e.g., no dilutive event) or, after the adoption of ASU 2017-11, the adjustment is triggered by a down-round feature.</td>
<td>Section 4.3</td>
</tr>
</tbody>
</table>
## Indexed to the Entity’s Own Equity

<table>
<thead>
<tr>
<th>√ If Met</th>
<th>Requirement</th>
<th>Roadmap Discussion</th>
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<tr>
<td></td>
<td>If the settlement amount is adjusted in response to an implicit input, the adjustment is consistent with the impact that the occurrence or nonoccurrence of the event had on the fair value of the instrument.</td>
<td>Section 4.3</td>
</tr>
<tr>
<td></td>
<td>The feature otherwise is a fixed-for-fixed forward or option on the entity's equity shares.</td>
<td>Section 4.3</td>
</tr>
</tbody>
</table>

## Potentially Settled in the Entity’s Own Stock

<table>
<thead>
<tr>
<th>√ If Met</th>
<th>Requirement</th>
<th>Roadmap Discussion</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>The only circumstance (if any) in which the entity could be forced to net cash settle the feature is:</td>
<td>Section 5.2.3</td>
</tr>
<tr>
<td></td>
<td>• An event that is solely within the entity’s control or</td>
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<td></td>
<td>• The final liquidation of the entity or</td>
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<tr>
<td></td>
<td>• An event that would cause the holders of the underlying shares to receive the same form of consideration.</td>
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</tr>
<tr>
<td></td>
<td>The economic substance of the feature is not that of an asset or a liability because:</td>
<td>Section 5.2.5</td>
</tr>
<tr>
<td></td>
<td>• The settlement alternatives have different economic values or</td>
<td></td>
</tr>
<tr>
<td></td>
<td>• One of the settlement alternatives is fixed or contains caps or floors.</td>
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<tr>
<td></td>
<td>(Note that this requirement does not apply if the reason for the difference is to limit the number of shares that must be delivered in a net share settlement.)</td>
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<tr>
<td></td>
<td>If the settlement alternatives differ in gain and loss positions, the feature:</td>
<td>Section 5.2.6</td>
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<tr>
<td></td>
<td>• Permits the entity to net share settle in a loss position and</td>
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<tr>
<td></td>
<td>• Is not predominantly a purchased option.</td>
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</tr>
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<td>The feature:</td>
<td>Section 5.3.2</td>
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<td>• Permits settlement in unregistered shares and there was no failed registration statement within the past six months or</td>
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<td>• Clearly states that the issuer has no obligation to net cash settle the contract even if it is unable to deliver unregistered shares or</td>
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<td>If the entity does not have sufficient authorized and unissued shares available to share settle the contract and all other contracts that may require share settlement during the contract period, the entity has the ability to increase the number of authorized shares without shareholder approval.</td>
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<tr>
<td></td>
<td>The feature contains an explicit share limit.</td>
<td>Section 5.3.4</td>
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</tbody>
</table>
### B.3 Features Embedded in Conventional Convertible Debt

A feature embedded in conventional convertible debt (see Section 5.5) qualifies as equity under ASC 815-40 only if it meets all the requirements specified in the table below. In determining whether those requirements are met, an entity:

- Does not consider the contingent obligation to transfer consideration under a registration payment arrangement even if it is embedded in the contract (see Section 3.2.4).
- Disregards any uneconomic settlement alternatives (see Section 5.2.5).

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<td><strong>Within the Scope of ASC 815-40</strong></td>
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<td>If the contract was originally issued to compensate employees, it has been modified so that it is now within the scope of ASC 815-40.</td>
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| - Before the adoption of ASU 2018-07 — Performance has occurred or the contract is not within the scope of ASC 505-50.  
- After the adoption of ASU 2018-07 — The contract was modified so that it is now within the scope of ASC 815-40. | | Section 2.4.2 |
<p>| The feature is not a lock-up option. | | Section 2.5.2 |
| If the feature is on the equity shares of a subsidiary, the subsidiary is a consolidated, substantive entity. | | Section 2.6.1 |
| The feature does not involve the combination of a written put option and a purchased call option embedded in the shares of a noncontrolling interest. | | Section 2.6.4 |
| <strong>Indexed to the Entity's Own Equity</strong> | | |
| If the feature contains an exercise contingency that is based on an observable market, it is the market for the issuer's stock. | | Section 4.2 |
| If the feature contains an exercise contingency that is based on an observable index, it is an index calculated or measured solely by reference to the entity's own operations (e.g., sales revenue, EBITDA, net income, or total equity). | | Section 4.2 |</p>
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<td>Section 4.3</td>
</tr>
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<td>The only circumstance (if any) in which the entity could be forced to net cash settle the feature is:</td>
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</tr>
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<td>• An event that is solely within the entity's control or</td>
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<td>• The final liquidation of the entity or</td>
<td></td>
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<tr>
<td>• An event that would cause the holders of the underlying shares to receive the same form of consideration or</td>
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</tr>
<tr>
<td>• A change in control.</td>
<td></td>
</tr>
<tr>
<td>The economic substance of the feature is not that of an asset or a liability because:</td>
<td>Section 5.2.5</td>
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<td>• The settlement alternatives have different economic values or</td>
<td></td>
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<td>• One of the settlement alternatives is fixed or contains caps or floors.</td>
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<td>(Note that this requirement does not apply if the reason for the difference is to limit the number of shares that must be delivered in a net share settlement.)</td>
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<td>• Permits the entity to net share settle in a loss position and</td>
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</tr>
<tr>
<td>• Is not predominantly a purchased option.</td>
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</tbody>
</table>
Appendix C — Selected ASC Glossary Terms

The glossary terms in ASC 815-40-20 are reprinted below along with selected terms from the ASC master glossary.

<table>
<thead>
<tr>
<th><strong>ASC 815-40-20 and ASC Master Glossary</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Antidilution</strong></td>
</tr>
<tr>
<td>An increase in earnings per share amounts or a decrease in loss per share amounts.</td>
</tr>
</tbody>
</table>

| **Cashless Exercise**                   |
| See Net Share Settlement.              |

| **Common Stock**                       |
| A stock that is subordinate to all other stock of the issuer. Also called common shares. |

| **Consolidated Financial Statements**   |
| The financial statements of a consolidated group of entities that include a parent and all its subsidiaries presented as those of a single economic entity. |

| **Consolidated Group**                  |
| A parent and all its subsidiaries.     |

| **Consolidation**                      |
| The presentation of a single set of amounts for an entire reporting entity. Consolidation requires elimination of intra-entity transactions and balances. |

| **Contingent Consideration**           |
| Usually an obligation of the acquirer to transfer additional assets or equity interests to the former owners of an acquiree as part of the exchange for control of the acquiree if specified future events occur or conditions are met. However, contingent consideration also may give the acquirer the right to the return of previously transferred consideration if specified conditions are met. |

| **Contract**                           |
| **Note:** The following definition is Pending Content; see Transition Guidance in 606-10-65-1. |
| An agreement between two or more parties that creates enforceable rights and obligations. |
### ASC 815-40-20 and ASC Master Glossary (continued)

**Conversion Rate**
The ratio of the number of common shares issuable upon conversion to a unit of a convertible security. For example, $100 face value of debt convertible into 5 shares of common stock would have a conversion ratio of 5:1. Also called conversion ratio.

**Convertible Security**
A security that is convertible into another security based on a conversion rate. For example, convertible preferred stock that is convertible into common stock on a two-for-one basis (two shares of common for each share of preferred).

**Derivative Instrument**
Paragraphs 815-10-15-83 through 15-139 define the term *derivative instrument*.

**Dilution**
A reduction in EPS resulting from the assumption that convertible securities were converted, that options or warrants were exercised, or that other shares were issued upon the satisfaction of certain conditions.

**Down Round Feature**
*Note:* The following definition is Pending Content; see Transition Guidance in 260-10-65-4.
A feature in a financial instrument that reduces the strike price of an issued financial instrument if the issuer sells shares of its stock for an amount less than the currently stated strike price of the issued financial instrument or issues an equity-linked financial instrument with a strike price below the currently stated strike price of the issued financial instrument.
A down round feature may reduce the strike price of a financial instrument to the current issuance price, or the reduction may be limited by a floor or on the basis of a formula that results in a price that is at a discount to the original exercise price but above the new issuance price of the shares, or may reduce the strike price to below the current issuance price. A standard antidilution provision is not considered a down round feature.

**Earnings per Share**
The amount of earnings attributable to each share of common stock. For convenience, the term is used to refer to either earnings or loss per share.

**Embedded Derivative**
Implicit or explicit terms that affect some or all of the cash flows or the value of other exchanges required by a contract in a manner similar to a derivative instrument.

**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.

**Equity Shares**
Equity shares refers only to shares that are accounted for as equity.
ASC 815-40-20 and ASC Master Glossary (continued)

**Exercise Contingency**
A provision that entitles the entity (or the counterparty) to exercise an equity-linked financial instrument (or embedded feature) based on changes in an underlying, including the occurrence (or nonoccurrence) of a specified event. Provisions that accelerate the timing of the entity's (or the counterparty's) ability to exercise an instrument and provisions that extend the length of time that an instrument is exercisable are examples of exercise contingencies.

**Fair Value**
The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

**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.

**Firm Commitment**
An agreement with an unrelated party, binding on both parties and usually legally enforceable, with the following characteristics:

a. The agreement specifies all significant terms, including the quantity to be exchanged, the fixed price, and the timing of the transaction. The fixed price may be expressed as a specified amount of an entity's functional currency or of a foreign currency. It may also be expressed as a specified interest rate or specified effective yield. The binding provisions of an agreement are regarded to include those legal rights and obligations codified in the laws to which such an agreement is subject. A price that varies with the market price of the item that is the subject of the firm commitment cannot qualify as a fixed price. For example, a price that is specified in terms of ounces of gold would not be a fixed price if the market price of the item to be purchased or sold under the firm commitment varied with the price of gold.

b. The agreement includes a disincentive for nonperformance that is sufficiently large to make performance probable. In the legal jurisdiction that governs the agreement, the existence of statutory rights to pursue remedies for default equivalent to the damages suffered by the nondefaulting party, in and of itself, represents a sufficiently large disincentive for nonperformance to make performance probable for purposes of applying the definition of a firm commitment.
Foreign Currency
A currency other than the functional currency of the entity being referred to (for example, the dollar could be a foreign currency for a foreign entity). Composites of currencies, such as the Special Drawing Rights, used to set prices or denominate amounts of loans, and so forth, have the characteristics of foreign currency.

Freestanding Contract
A freestanding contract is entered into either:
- a. Separate and apart from any of the entity's other financial instruments or equity transactions
- b. In conjunction with some other transaction and is legally detachable and separately exercisable.

Functional Currency
An entity's functional currency is the currency of the primary economic environment in which the entity operates; normally, that is the currency of the environment in which an entity primarily generates and expends cash. (See paragraphs 830-10-45-2 through 830-10-45-6 and 830-10-55-3 through 830-10-55-7.)

Hybrid Instrument
A contract that embodies both an embedded derivative and a host contract.

Liquidation
The process by which an entity converts its assets to cash or other assets and settles its obligations with creditors in anticipation of the entity ceasing all activities. Upon cessation of the entity's activities, any remaining cash or other assets are distributed to the entity's investors or other claimants (albeit sometimes indirectly). Liquidation may be compulsory or voluntary. Dissolution of an entity as a result of that entity being acquired by another entity or merged into another entity in its entirety and with the expectation of continuing its business does not qualify as liquidation.

Lock-Up Options
Contingently exercisable options to purchase equity securities of another party to a business combination, at favorable prices, to encourage successful completion of that combination. If the merger is consummated as proposed, the options expire unexercised. If, however, a specified event occurs that interferes with the planned business combination, the options become exercisable.

Make-Whole Provision
A cash payment to a counterparty if the shares initially delivered upon settlement are subsequently sold by the counterparty and the sales proceeds are insufficient to provide the counterparty with full return of the amount due. While the exact terms of such provisions vary, they generally are intended to reimburse the counterparty for any losses it incurs or to transfer to the entity any gains the counterparty recognizes on the difference between the following:
- a. The settlement date value
- b. The value received by the counterparty in subsequent sales of the securities within a specified time after the settlement date.

Management
Persons who are responsible for achieving the objectives of the entity and who have the authority to establish policies and make decisions by which those objectives are to be pursued. Management normally includes members of the board of directors, the chief executive officer, chief operating officer, vice presidents in charge of principal business functions (such as sales, administration, or finance), and other persons who perform similar policy making functions. Persons without formal titles also may be members of management.
ASC 815-40-20 and ASC Master Glossary (continued)

**Market Participants**

Buyers and sellers in the principal (or most advantageous) market for the asset or liability that have all of the following characteristics:

- They are independent of each other, that is, they are not related parties, although the price in a related-party transaction may be used as an input to a fair value measurement if the reporting entity has evidence that the transaction was entered into at market terms.
- They are knowledgeable, having a reasonable understanding about the asset or liability and the transaction using all available information, including information that might be obtained through due diligence efforts that are usual and customary.
- They are able to enter into a transaction for the asset or liability.
- They are willing to enter into a transaction for the asset or liability, that is, they are motivated but not forced or otherwise compelled to do so.

**Net Cash Settlement**

The party with a loss delivers to the party with a gain a cash payment equal to the gain, and no shares are exchanged.

**Net Share Settlement**

The party with a loss delivers to the party with a gain shares with a current fair value equal to the gain.

**Noncontrolling Interest**

The portion of equity (net assets) in a subsidiary not attributable, directly or indirectly, to a parent. A noncontrolling interest is sometimes called a minority interest.

**Notional Amount**

A number of currency units, shares, bushels, pounds, or other units specified in a derivative instrument. Sometimes other names are used. For example, the notional amount is called a face amount in some contracts.

**Orderly Transaction**

A transaction that assumes exposure to the market for a period before the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets or liabilities; it is not a forced transaction (for example, a forced liquidation or distress sale).

**Parent**

An entity that has a controlling financial interest in one or more subsidiaries. (Also, an entity that is the primary beneficiary of a variable interest entity.)

**Physical Settlement**

The party designated in the contract as the buyer delivers the full stated amount of cash to the seller, and the seller delivers the full stated number of shares to the buyer.
**Preferred Stock**
A security that has preferential rights compared to common stock.

**Probable**
*Note:* The following definition is Pending Content; see Transition Guidance in 842-10-65-1.
The future event or events are likely to occur.

**Registration Payment Arrangement**
An arrangement with both of the following characteristics:

a. It specifies that the issuer will endeavor to do either of the following:
   1. File a registration statement for the resale of specified financial instruments and/or for the resale of equity shares that are issuable upon exercise or conversion of specified financial instruments and for that registration statement to be declared effective by the U.S. Securities and Exchange Commission (SEC) (or other applicable securities regulator if the registration statement will be filed in a foreign jurisdiction) within a specified grace period.
   2. Maintain the effectiveness of the registration statement for a specified period of time (or in perpetuity).

b. It requires the issuer to transfer consideration to the counterparty if the registration statement for the resale of the financial instrument or instruments subject to the arrangement is not declared effective or if effectiveness of the registration statement is not maintained. That consideration may be payable in a lump sum or it may be payable periodically, and the form of the consideration may vary. For example, the consideration may be in the form of cash, equity instruments, or adjustments to the terms of the financial instrument or instruments that are subject to the registration payment arrangement (such as an increased interest rate on a debt instrument).

**Related Parties**
Related parties include:

a. Affiliates of the entity
b. Entities for which investments in their equity securities would be required, absent the election of the fair value option under the Fair Value Option Subsection of Section 825-10-15, to be accounted for by the equity method by the investing entity
c. Trusts for the benefit of employees, such as pension and profit-sharing trusts that are managed by or under the trusteeship of management
d. Principal owners of the entity and members of their immediate families
e. Management of the entity and members of their immediate families
f. Other parties with which the entity may deal if one party controls or can significantly influence the management or operating policies of the other to an extent that one of the transacting parties might be prevented from fully pursuing its own separate interests
g. Other parties that can significantly influence the management or operating policies of the transacting parties or that have an ownership interest in one of the transacting parties and can significantly influence the other to an extent that one or more of the transacting parties might be prevented from fully pursuing its own separate interests.
Share-Based Payment Arrangements
An arrangement under which either of the following conditions is met:

a. One or more suppliers of goods or services (including employees) receive awards of equity shares, equity share options, or other equity instruments.

b. The entity incurs liabilities to suppliers that meet either of the following conditions:
   1. The amounts are based, at least in part, on the price of the entity's shares or other equity instruments. (The phrase at least in part is used because an award may be indexed to both the price of the entity's shares and something other than either the price of the entity's shares or a market, performance, or service condition.)
   2. The awards require or may require settlement by issuance of the entity's shares.

The term shares includes various forms of ownership interest that may not take the legal form of securities (for example, partnership interests), as well as other interests, including those that are liabilities in substance but not in form. Equity shares refers only to shares that are accounted for as equity.

Also called share-based compensation arrangements.

Shares
Shares includes various forms of ownership that may not take the legal form of securities (for example, partnership interests), as well as other interests, including those that are liabilities in substance but not in form. (Business entities have interest holders that are commonly known by specialized names, such as stockholders, partners, and proprietors, and by more general names, such as investors, but all are encompassed by the descriptive term owners. Equity of business entities is, thus, commonly known by several names, such as owners' equity, stockholders' equity, ownership, equity capital, partners' capital, and proprietorship. Some entities [for example, mutual organizations] do not have stockholders, partners, or proprietors in the usual sense of those terms but do have participants whose interests are essentially ownership interests, residual interests, or both.)

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.

Stock Dividend
An issuance by a corporation of its own common shares to its common shareholders without consideration and under conditions indicating that such action is prompted mainly by a desire to give the recipient shareholders some ostensibly separate evidence of a part of their respective interests in accumulated corporate earnings without distribution of cash or other property that the board of directors deems necessary or desirable to retain in the business. A stock dividend takes nothing from the property of the corporation and adds nothing to the interests of the stockholders; that is, the corporation's property is not diminished and the interests of the stockholders are not increased. The proportional interest of each shareholder remains the same.

Stock Split
An issuance by a corporation of its own common shares to its common shareholders without consideration and under conditions indicating that such action is prompted mainly by a desire to increase the number of outstanding shares for the purpose of effecting a reduction in their unit market price and, thereby, of obtaining wider distribution and improved marketability of the shares. Sometimes called a stock split-up.
| **Subsidiary** | An entity, including an unincorporated entity such as a partnership or trust, in which another entity, known as its parent, holds a controlling financial interest. (Also, a variable interest entity that is consolidated by a primary beneficiary.) |
| **Top-Off Provision** | See Make-Whole Provision. |
| **Transaction** | An external event involving transfer of something of value (future economic benefit) between two (or more) entities. (See FASB Concepts Statement No. 6, Elements of Financial Statements.) |
| **Underlying** | A specified interest rate, security price, commodity price, foreign exchange rate, index of prices or rates, or other variable (including the occurrence or nonoccurrence of a specified event such as a scheduled payment under a contract). An underlying may be a price or rate of an asset or liability but is not the asset or liability itself. An underlying is a variable that, along with either a notional amount or a payment provision, determines the settlement of a derivative instrument. |
| **Volatility** | A measure of the amount by which a financial variable such as a share price has fluctuated (historical volatility) or is expected to fluctuate (expected volatility) during a period. Volatility also may be defined as a probability-weighted measure of the dispersion of returns about the mean. The volatility of a share price is the standard deviation of the continuously compounded rates of return on the share over a specified period. That is the same as the standard deviation of the differences in the natural logarithms of the stock prices plus dividends, if any, over the period. The higher the volatility, the more the returns on the shares can be expected to vary — up or down. Volatility is typically expressed in annualized terms. |
| **Warrant** | A security that gives the holder the right to purchase shares of common stock in accordance with the terms of the instrument, usually upon payment of a specified amount. |
Appendix D — Titles of Standards and Other Literature

The following are the titles of standards and other literature mentioned in this publication:

**AICPA Literature**
Issues Paper, “Accounting for Options”

**FASB Literature**

**ASC Topics**
ASC 105, *Generally Accepted Accounting Principles*
ASC 235, *Notes to Financial Statements*
ASC 250, *Accounting Changes and Error Corrections*
ASC 260, *Earnings per Share*
ASC 325, *Investments — Other*
ASC 460, *Guarantees*
ASC 470, *Debt*
ASC 480, *Distinguishing Liabilities From Equity*
ASC 505, *Equity*
ASC 606, *Revenue From Contracts With Customers*
ASC 718, *Compensation — Stock Compensation*
ASC 805, *Business Combinations*
ASC 810, *Consolidation*
ASC 815, *Derivatives and Hedging*
ASC 820, *Fair Value Measurement*
ASC 825, *Financial Instruments*
ASC 830, *Foreign Currency Matters*
ASC 850, *Related Party Disclosures*
ASUs
ASU 2012-04, Technical Corrections and Improvements
ASU 2016-19, Technical Corrections and Improvements
ASU 2017-11, Earnings Per Share (Topic 260); Distinguishing Liabilities From Equity (Topic 480); Derivatives and Hedging (Topic 815); (Part I) Accounting for Certain Financial Instruments With Down Round Features, (Part II) Replacement of the Indefinite Deferral for Mandatorily Redeemable Financial Instruments of Certain Nonpublic Entities and Certain Mandatorily Redeemable Noncontrolling Interests With a Scope Exception
ASU 2018-07, Compensation — Stock Compensation (Topic 718): Improvements to Nonemployee Share-Based Payment Accounting
ASU 2018-09, Codification Improvements

Proposed ASU
2019-730, Debt — Debt With Conversion and Other Options (Subtopic 470-20) and Derivatives and Hedging — Contracts in Entity’s Own Equity (Subtopic 815-40) — Accounting for Convertible Instruments and Contracts in an Entity’s Own Equity

Concepts Statement
No. 6, Elements of Financial Statements

International Literature
International Standard
IAS 32, Financial Instruments: Presentation

ISDA Literature
2002 ISDA Master Agreement
2002 ISDA Equity Derivatives Definitions

SEC Literature
Regulation S-K
Item 303, “Management’s Discussion and Analysis of Financial Condition and Results of Operations”

Regulation S-X
Rule 4-08, “General Notes to Financial Statements”

Superseded Literature
Derivatives Implementation Group Issue
F6, “Fair Value Hedges: Concurrent Offsetting Matching Swaps and Use of One as Hedging Instrument”

EITF Issues
No. 94-7, “Accounting for Financial Instruments Indexed to, and Potentially Settled in, a Company’s Own Stock”
No. 96-13, “Accounting for Derivative Instruments Indexed to, and Potentially Settled in, a Company’s Own Stock”

No. 97-9, “Effect on Pooling-of-Interests Accounting of Certain Contingently Exercisable Options or Other Equity Instruments”

No. 00-4, “Majority Owner’s Accounting for a Transaction in the Shares of a Consolidated Subsidiary and a Derivative Indexed to the Noncontrolling Interest in That Subsidiary”

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

No. 01-6, “The Meaning of ‘Indexed to a Company’s Own Stock’ ”

No. 02-2, “When Certain Contracts That Meet the Definition of Financial Instruments Should Be Combined for Accounting Purposes”

No. 07-5, “Determining Whether an Instrument (or Embedded Feature) Is Indexed to an Entity’s Own Stock”

No. 08-8, “Accounting for an Instrument (or an Embedded Feature) With a Settlement Amount That Is Based on the Stock of an Entity’s Consolidated Subsidiary”

No. 08-10, “Selected Statement 160 Implementation Questions”

**FASB Staff Position**

APB 14-1, “Accounting for Convertible Debt Instruments That May Be Settled in Cash Upon Conversion (Including Partial Cash Settlement)”

**FASB Statement**

No. 150, *Accounting for Certain Financial Instruments With Characteristics of Both Liabilities and Equity*
## Appendix E — Abbreviations

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Description</th>
</tr>
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<tbody>
<tr>
<td>AICPA</td>
<td>American Institute of Certified Public Accountants</td>
</tr>
<tr>
<td>APB</td>
<td>Accounting Principles Board</td>
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<tr>
<td>APIC</td>
<td>additional paid-in capital</td>
</tr>
<tr>
<td>ASC</td>
<td>FASB Accounting Standards Codification</td>
</tr>
<tr>
<td>ASR</td>
<td>accelerated share repurchase</td>
</tr>
<tr>
<td>ASU</td>
<td>FASB Accounting Standards Update</td>
</tr>
<tr>
<td>BCF</td>
<td>beneficial conversion feature</td>
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<tr>
<td>BRRD</td>
<td>Bank Recovery and Resolution Directive</td>
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<tr>
<td>CAD</td>
<td>Canadian dollars</td>
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<tr>
<td>CNY</td>
<td>Chinese yuan</td>
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<tr>
<td>CPI</td>
<td>consumer price index</td>
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<tr>
<td>EBITDA</td>
<td>earnings before interest, taxes, depreciation, and amortization</td>
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<td>EITF</td>
<td>Emerging Issues Task Force</td>
</tr>
<tr>
<td>EPS</td>
<td>earnings per share</td>
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<td>EU</td>
<td>European Union</td>
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<td>FASB</td>
<td>Financial Accounting Standards Board</td>
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<td>FDA</td>
<td>Food &amp; Drug Administration</td>
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<td>FSP</td>
<td>FASB Staff Position</td>
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<tr>
<td>GAAP</td>
<td>generally accepted accounting principles</td>
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<tr>
<td>IAS</td>
<td>International Accounting Standard</td>
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<tr>
<td>IFRS</td>
<td>International Financial Reporting Standard</td>
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<tr>
<td>IPO</td>
<td>initial public offering</td>
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<tr>
<td>ISDA</td>
<td>International Swaps and Derivatives Association Inc.</td>
</tr>
<tr>
<td>LIBOR</td>
<td>London Interbank Offered Rate</td>
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<tr>
<td>MD&amp;A</td>
<td>Management’s Discussion and Analysis</td>
</tr>
<tr>
<td>OCA</td>
<td>SEC Office of the Chief Accountant</td>
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<tr>
<td>OCI</td>
<td>other comprehensive income</td>
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<tr>
<td>PCAOB</td>
<td>Public Company Accounting Oversight Board</td>
</tr>
<tr>
<td>SEC</td>
<td>Securities and Exchange Commission</td>
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<tr>
<td>Securities Act</td>
<td>Securities Act of 1933</td>
</tr>
<tr>
<td>S&amp;P 500 Index</td>
<td>Standard and Poor’s 500 stock market index</td>
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<tr>
<td>USD</td>
<td>U.S. dollars</td>
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<tr>
<td>VWAP</td>
<td>volume-weighted average daily market price</td>
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Appendix F — Changes Made in the 2019 Edition of This Publication

The tables below summarize the substantive changes made since the 2018 edition of this Roadmap as a result of FASB standard-setting activities, discussions regarding implementation matters with the FASB and SEC staffs, and other practice developments.

New Content
The following table describes the content that was added to the Roadmap:

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<thead>
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<th>Section</th>
<th>Topic</th>
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<tr>
<td>6.2.4</td>
<td>Modifications of freestanding contracts that are accounted for at fair value, with changes in fair value recognized in earnings</td>
<td>Discusses the accounting for modifications of such contracts</td>
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<tr>
<td>7.1.1</td>
<td>EPS</td>
<td>Discusses the computation of EPS for contracts on an entity’s own equity</td>
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Amended Content
The following table describes the content that was amended in the Roadmap:

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</thead>
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<tr>
<td>2.8</td>
<td>Contingently issuable contracts</td>
<td>Added two examples and expanded and revised the discussion of the applicability of ASC 815-40 to contingently issuable contracts</td>
</tr>
<tr>
<td>3.2.1</td>
<td>Concept of a “freestanding contract”</td>
<td>Amended discussion related to whether items are considered “legally detachable”</td>
</tr>
<tr>
<td>3.2.2</td>
<td>Combination guidance</td>
<td>Expanded discussion of whether items should be combined</td>
</tr>
<tr>
<td>3.2.3.1</td>
<td>Examples of the application of the unit of account guidance</td>
<td>Added an example to illustrate the identification of units of account in a tranche preferred stock agreement</td>
</tr>
<tr>
<td>4.3.5.7</td>
<td>Adjustments based on a percentage of equity</td>
<td>Expanded discussion and added two examples of the evaluation under ASC 815-40-15 of adjustments based on a percentage of equity</td>
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(Table continued)

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<th>Section</th>
<th>Topic</th>
<th>Description</th>
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<td>4.3.7.1</td>
<td>Antidilution adjustments</td>
<td>Added examples of antidilution adjustments</td>
</tr>
<tr>
<td>5.2.3.1</td>
<td>Net cash settlement within the entity's control</td>
<td>Added examples of events that would or would not be considered within the issuer's control under ASC 815-40-25</td>
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<tr>
<td>5.2.3.7</td>
<td>Cash payments other than net cash settlements</td>
<td>Added discussion and an example of contracts with fractional shares settled in cash</td>
</tr>
<tr>
<td>5.3.4</td>
<td>Contract contains explicit share limit</td>
<td>Clarified that this equity classification condition does not apply if the entity is able to increase the number of authorized shares without shareholder approval</td>
</tr>
<tr>
<td>6.1.2</td>
<td>Reclassifications of freestanding equity-classified contracts</td>
<td>Clarified that an adjustment upon a reclassification is recognized as a deemed dividend</td>
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<tr>
<td>6.1.3</td>
<td>Settlements of freestanding equity-classified contracts</td>
<td>Expanded discussion of repurchases at other than fair value</td>
</tr>
<tr>
<td>6.1.4</td>
<td>Modifications of freestanding equity-classified contracts</td>
<td>Expanded discussion of the accounting for modifications</td>
</tr>
<tr>
<td>7, 7.1.2</td>
<td>Presentation and disclosure</td>
<td>Renamed the chapter and renumbered Section 7.1 as Section 7.1.2 to reflect the addition of Section 7.1.1 on EPS</td>
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