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On the Radar

Contracts on an Entity's Own Equity

Entities raising capital must apply the highly complex, rules-based guidance in U.S. GAAP to determine whether (1) freestanding contracts such as warrants, options, and forwards to sell equity shares are classified as liabilities or equity instruments and (2) convertible instruments contain embedded equity features that require separate accounting as derivative liabilities. To reach the proper accounting conclusion, they must consider the following key questions:

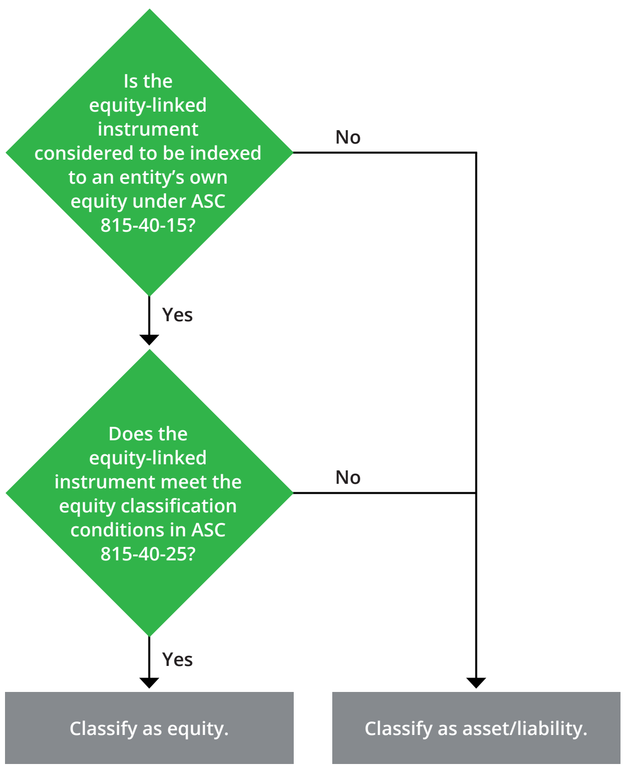
What is the appropriate unit of account? → **Is a freestanding or embedded instrument indexed to the entity's stock?** → **Are the conditions for equity classification met?**

All entities are capitalized with debt or equity. The nature and mix of debt and equity securities that comprise an entity's capital structure, and an entity's decision about the type of security to issue when raising capital, may depend on the stage of the entity's life cycle, the cost of capital, the need to comply with regulatory capital requirements or debt covenants (e.g., capital or leverage ratios), and the financial reporting implications. For example, early-stage and smaller-growth companies are often financed with preferred stock and warrants with complex and unusual features, whereas larger, more mature entities often have a mix of debt and equity securities with more plain-vanilla common stock capitalization.

ASC 815-40 provides guidance on the reporting entity's accounting for contracts that are potentially indexed to, and potentially settled in, an entity's own equity (also known as equity-linked financial instruments). The following are examples of the types of instruments that are within the scope of ASC 815-40:

Freestanding Equity-Linked Financial Instruments	Embedded Equity-Linked Financial Instruments
• Share-settleable contingent consideration arrangements in business combinations. • Call options and warrants to purchase common stock or preferred stock. • Forward contracts to purchase or sell common stock or preferred stock. • Put options to sell common stock or preferred stock.	• Embedded conversion options in convertible debt. • Embedded conversion options in convertible preferred stock. • Prepaid forward contracts to purchase or sell common stock or preferred stock. • Prepaid options to purchase or sell common stock or preferred stock.

An equity-linked financial instrument can be classified in equity only if it (1) is indexed to the entity's own stock and (2) meets all other conditions for equity classification. If an equity-linked financial instrument either is not indexed to the entity's own stock or does not meet the other conditions for equity classification, it is classified as an asset or a liability. Under the indexation and equity classification guidance, all terms of a contract must be analyzed regardless of their significance or likelihood of becoming applicable. Seemingly inconsequential features in a contract can cause it to fail to qualify for equity classification.



An equity-linked financial instrument's classification on the balance sheet will affect how returns on the instrument are reflected in an entity's income statement. Returns on asset- and liability-classified instruments are reflected in net income because they are subsequently measured at fair value, with changes in fair value reported in earnings, whereas returns on equity-classified instruments are generally reflected in equity, without affecting net income.

In addition to the effect on net income and earnings per share, entities often seek to avoid classifying freestanding or embedded equity-linked financial instruments as liabilities for other reasons, including:

- The effect of the classification on the entity's credit rating and stock price.
- Regulatory capital requirements.
- Debt covenant requirements (e.g., leverage or capital ratios).

The SEC staff closely scrutinizes the appropriate balance sheet classification of freestanding and embedded equity-linked financial instruments. This is evident in comment letters on registrants' filings and the number of restatements arising from inappropriate classification.

Balance Sheet Classification

What is the appropriate unit of account?

ASC 815-40 applies to each freestanding equity-linked financial instrument regardless of whether it meets the ASC 815 definition of a derivative instrument. In addition, ASC 815-40 applies to embedded equity-linked financial instruments in hybrid financial instruments such as convertible debt and convertible preferred stock unless (1) the embedded feature is clearly and closely related to the host contract; (2) the hybrid financial instrument is measured at fair value, with changes in fair value reported in earnings; or (3) the equity-linked financial instrument does not, on a stand-alone basis, meet the definition of a derivative instrument.

In some cases, equity-linked contracts are issued on a stand-alone basis and it is readily apparent that there is only one unit of account. In other financing transactions, there are two or more components that individually represent separate units of account (e.g., preferred stock is issued with detachable warrants). When an entity enters into a financing transaction that includes equity-linked items that can be legally detached and exercised separately, those items are separate freestanding financial instruments and ASC 815-40 must be applied to them individually.

Equity-linked features may be embedded in hybrid financial instruments. If so, an entity often needs to use judgment to determine the unit of account for the embedded feature that must be evaluated under ASC 815-40.

Is a freestanding or embedded instrument indexed to the entity's stock?

Unless a freestanding or embedded equity-linked financial instrument is considered indexed to the entity's stock, it must be classified as an asset or a liability. To be considered indexed to the entity's stock, the instrument's exercise and settlement provisions must meet certain conditions. While contingent exercise provisions often do not disqualify an instrument from being indexed to an entity's stock, the instrument's settlement terms may contain adjustments to the exercise price or settlement amount that can result in the arrangement's failure to be considered indexed to the entity's stock. Any input that could potentially affect an instrument's exercise price or settlement amount (i.e., number of shares) that is not an input into the pricing of a fixed-for-fixed forward or option on equity shares will result in the instrument's failure to be considered indexed to the entity's stock.

Are the conditions for equity classification met?

A number of equity classification conditions must be met for freestanding or embedded equity-linked financial instruments that are indexed to the entity's stock to be classified as equity instruments. The general principle is that if net cash settlement could be required for any event that is not within the entity's control, the contract should be classified as an asset or a liability rather than as equity.

Earnings per Share

ASC 260 addresses the EPS accounting for contracts within the scope of ASC 815-40. Special considerations are necessary for contracts that may be settled in stock or cash.

Under ASC 260, an entity may not overcome the presumption of share settlement for a contract that may be settled in stock or cash. Therefore, the shares potentially issuable under such a contract must be included in the denominator of diluted EPS.

Deloitte's Roadmap *Contracts on an Entity's Own Equity* provides a comprehensive discussion of the classification, initial and subsequent measurement, and presentation and disclosure of equity-linked financial instruments. Entities should also consider Deloitte's Roadmap *Distinguishing Liabilities From Equity* for guidance on equity-linked financial instruments as well as Deloitte's Roadmap *Earnings per Share* for guidance on basic and diluted EPS.

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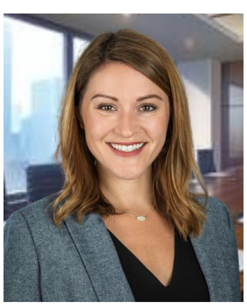

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