Accounting & Auditing Update

FASB Issues Guidance on Down Round Features of Financial Instruments

By John M. Haslbauer, CPA, Partner

The Financial Accounting Standards Board (the FASB or the Board) issued Accounting Standards Update (ASU) 2017-11 with the intent to simplify the accounting for certain equity-linked financial instruments (or embedded conversion options) that use down round features.

A down round provides a downward adjustment of the current exercise price based on the price of future equity offerings. Down rounds are commonly used in warrants, convertible preferred shares, and convertible debt instruments issued by private companies and development-stage public companies.

Current Accounting

Current U.S. generally accepted accounting principles (GAAP) often requires issuing entities to account for these instruments or embedded features as derivatives at fair value with subsequent changes in fair value recorded through earnings. This creates measurement complexity and a reporting burden. The new guidance will reduce these costs and complexities.

The Concern

Some private companies and other stakeholders asserted concern that current accounting guidance created unnecessary cost and complexity for organizations that issue financial instruments with down round features by requiring — on an ongoing basis — fair value measurement of the entire instrument or conversion option. Thus, unnecessary income statement volatility connected to changes in the value of a company's share price may ensue.

Also, some stakeholders contended that current guidance does not reflect the economics of the down round feature which exists to protect certain investors from declines in the issuer's share price under certain circumstances.

The Fix

The new guidance allows companies to disregard the down round feature when assessing whether the instrument is indexed to its own stock for purposes of determining liability or equity classification. Accordingly, a down round feature (as defined) would no longer cause a freestanding equity-linked financial instrument (or an embedded conversion option) to be accounted for as a derivative liability at fair value with changes in fair value recognized in current earnings.

Companies that provide earnings per share (EPS) data will, upon the adoption of this guidance, adjust their basic EPS calculation for the effect of the feature when triggered (i.e., when the exercise price of the related equity-linked financial instrument is adjusted downward because of the down round feature) and also will recognize the effect of the trigger within equity.

In addition, the Board re-characterized the indefinite deferral of accounting requirements about mandatorily redeemable financial instruments of certain nonpublic entities and certain mandatorily redeemable non-controlling interests to a scope exception. The re-characterization has no accounting effect.

Effective Dates and Transition

Public business entities: For fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018.

Other organizations: For fiscal years beginning after December 15, 2019, and interim periods within fiscal years beginning after December 15, 2020.

The guidance must be applied using a full or modified retrospective approach.

Early adoption is permitted for all organizations.

Full Text

The full text of this new guidance can be accessed at: ASU 2017-11 - FASB.

Contact Us

If you have any questions about this new guidance or accounting and auditing matters in general, please contact John M. Haslbauer, CPA, Partner at jhaslbauer@pkfod.com or any member of the PKF O'Connor Davies team.

About PKF O'Connor Davies

PKF O'Connor Davies, LLP is a full-service certified public accounting and advisory firm with a long history of serving clients both domestically and internationally. With roots tracing to 1891, nine offices in New York, New Jersey, Connecticut and Maryland, and more than 700 professionals, the Firm provides a complete range of accounting, auditing, tax and management advisory services. PKF O'Connor Davies is ranked 28th on Accounting Today's 2017 "Top 100 Firms" list and is recognized as one of the "Top 10 Fastest-Growing Firms." PKF O'Connor Davies is also recognized as a "Leader in Audit and Accounting" and is ranked among the "Top Firms in the Mid-Atlantic," by Accounting Today. In 2017, PKF O'Connor Davies was named one of the 50 best accounting employers to work for in North America, by Vault.

PKF O'Connor Davies is the lead North American representative in PKF International, a global network of legally independent accounting and advisory firms located in 440 locations, in 150 countries around the world.