FINANCIAL ACCOUNTING SERIES

ACCOUNTING STANDARDS UPDATE

No. 2021-04
May 2021

Earnings Per Share (Topic 260), Debt—Modifications and Extinguishments (Subtopic 470-50), Compensation—Stock Compensation (Topic 718), and Derivatives and Hedging—Contracts in Entity's Own Equity (Subtopic 815-40)

Issuer's Accounting for Certain Modifications or Exchanges of Freestanding Equity-Classified Written Call Options

a consensus of the FASB Emerging Issues Task Force

An Amendment of the *FASB Accounting Standards Codification*®

Financial Accounting Standards Board

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FASB

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Issuer's Accounting for Certain Modifications or Exchanges of Freestanding Equity-Classified Written Call Options

May 2021

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Summary

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

The FASB is issuing this Update to clarify and reduce diversity in an issuer's accounting for modifications or exchanges of freestanding equity-classified written call options (for example, warrants) that remain equity classified after modification or exchange.

Stakeholders asserted that there is diversity in an issuer's accounting for economically similar modifications or exchanges of freestanding equity-classified written call options due to a lack of explicit guidance in the Codification. Stakeholders requested that the Board provide guidance that will clarify whether an issuer should account for a modification or an exchange of a freestanding equity-classified written call option that remains equity classified after modification or exchange as (1) an adjustment to equity and, if so, the related earnings per share (EPS) effects, if any, or (2) an expense and, if so, the manner and pattern of recognition.

Who Is Affected by the Amendments in This Update?

The amendments in this Update affect all entities that issue freestanding written call options that are classified in equity. Specifically, the amendments affect those entities when a freestanding equity-classified written call option is modified or exchanged and remains equity classified after the modification or exchange. The amendments that relate to the recognition and measurement of EPS for certain modifications or exchanges of freestanding equity-classified written call options affect entities that present EPS in accordance with the guidance in Topic 260, Earnings Per Share.

The amendments in this Update do not apply to modifications or exchanges of financial instruments that are within the scope of another Topic. That is, accounting for those instruments continues to be subject to the requirements in other Topics.

The amendments in this Update do not affect a holder's accounting for freestanding call options.

What Are the Main Provisions?

The amendments in this Update provide the following guidance for a modification or an exchange of a freestanding equity-classified written call option that is not within the scope of another Topic:

1. An entity should treat a modification of the terms or conditions or an exchange of a freestanding equity-classified written call option that remains equity classified after modification or exchange as an exchange of the original instrument for a new instrument.
2. An entity should measure the effect of a modification or an exchange of a freestanding equity-classified written call option that remains equity classified after modification or exchange as follows:
    a. For a modification or an exchange that is a part of or directly related to a modification or an exchange of an existing debt instrument or line-of-credit or revolving-debt arrangements (hereinafter, referred to as a "debt" or "debt instrument"), as the difference between the fair value of the modified or exchanged written call option and the fair value of that written call option immediately before it is modified or exchanged. Specifically, an entity should consider:
        i. An increase or a decrease in the fair value of the modified or exchanged written call option in applying the 10 percent cash flow test and/or calculating the fees between debtor and creditor in accordance with Subtopic 470-50, Debt—Modifications and Extinguishments.
        ii. An increase (but not a decrease) in the fair value of the modified or exchanged written call option in calculating the third-party costs in accordance with Subtopic 470-50.
    b. For all other modifications or exchanges, as the excess, if any, of the fair value of the modified or exchanged written call option over the fair value of that written call option immediately before it is modified or exchanged.
3. An entity should recognize the effect of a modification or an exchange of a freestanding equity-classified written call option that remains equity classified after modification or exchange on the basis of the substance of the transaction, in the same manner as if cash had been paid as consideration, as follows:
    a. *A financing transaction to raise equity*. The effect should be recognized as an equity issuance cost in accordance with the guidance in Topic 340, Other Assets and Deferred Costs.
    b. *A financing transaction to raise or modify debt.* The effect should be recognized as a cost in accordance with the guidance in Topic 470, Debt, and Topic 835, Interest.
    c. *Other modifications or exchanges that are not related to financings or compensation for goods or services or other exchange*

transactions within the scope of another Topic. The effect should be recognized as a dividend. For entities that present EPS in accordance with Topic 260, that dividend should be an adjustment to net income (or net loss) in the basic EPS calculation.

An entity should recognize the effect of a modification or an exchange of a freestanding equity-classified written call option to compensate for goods or services in accordance with the guidance in Topic 718, Compensation—Stock Compensation.

In a multiple-element transaction (for example, one that includes both debt financing and equity financing), the total effect of the modification should be allocated to the respective elements in the transaction.

When Will the Amendments Be Effective and What Are the Transition Requirements?

The amendments in this Update are effective for all entities for fiscal years beginning after December 15, 2021, including interim periods within those fiscal years. An entity should apply the amendments prospectively to modifications or exchanges occurring on or after the effective date of the amendments.

Early adoption is permitted for all entities, including adoption in an interim period. If an entity elects to early adopt the amendments in this Update in an interim period, the guidance should be applied as of the beginning of the fiscal year that includes that interim period.

Amendments to the *FASB Accounting Standards Codification®*

Introduction

1. The Accounting Standards Codification is amended as described in paragraphs 2–16. In some cases, to put the change in context, not only are the amended paragraphs shown but also the preceding and following paragraphs. Terms from the Master Glossary are in **bold** type. Added text is <u>underlined</u>, and deleted text is ~~struck out~~.

Amendments to Topic 260

2. This amendment provides that for an entity that presents earnings per share (EPS) in accordance with Topic 260, the effects of a modification or an exchange of a freestanding equity-classified written call option that is recognized as a dividend should be an adjustment to net income (or net loss) in the basic EPS calculation.

3. Add paragraph 260-10-45-15 and its related heading, with a link to transition paragraph 815-40-65-2, as follows:

Earnings Per Share—Overall

Other Presentation Matters

> Basic EPS

<u>> > Issuer's Accounting for Modifications or Exchanges of Freestanding Equity-Classified Written Call Options</u>

260-10-45-15 ~~Paragraph not used.~~ <u>For a modification or an exchange of a freestanding equity-classified written call **option** described in paragraph 815-40-35-17(d), an entity shall deduct the effect of the modification or exchange (as measured in accordance with paragraph 815-40-35-16) in computing income available to common stockholders when the modification or exchange is executed by the issuer and the holder or unilaterally by the issuer (see paragraph 815-40-15-7H).</u>

Amendments to Subtopic 470-50

4. These amendments require that an entity apply the guidance in Subtopic 470-50 to a modification or an exchange of a freestanding equity-classified written call option that is a part of or directly related to a modification or an exchange of an existing debt.

5. Amend paragraphs 470-50-40-12 and 470-50-40-21 and add paragraphs 470-50-40-12A, 470-50-40-17A, and 470-50-40-18A, with a link to transition paragraph 815-40-65-2, as follows:

Debt—Modifications and Extinguishments

Derecognition

> Modifications and Exchanges

470-50-40-12 The following guidance shall be used to calculate the present value of the cash flows for purposes of applying the 10 percent cash flow test described in paragraph 470-50-40-10:

a. The cash flows of the new debt instrument include all cash flows specified by the terms of the new debt instrument plus any amounts paid by the debtor to the creditor less any amounts received by the debtor from the creditor as part of the exchange or modification. For a modification or an exchange of a freestanding equity-classified written call option held by a creditor that is a part of or directly related to a modification or an exchange of an existing debt instrument held by that same creditor (see paragraphs 815-40-35-14 through 35-15 and 815-40-35-17(c)), an entity shall apply the guidance in paragraph 470-50-40-12A.
b. If the original debt instrument or the new debt instrument has a floating interest rate, then the variable rate in effect at the date of the exchange or modification shall be used to calculate the cash flows of the variable-rate instrument.
c. If either the new debt instrument or the original debt instrument is callable or puttable, then separate cash flow analyses shall be performed assuming exercise and nonexercise of the call or put. The cash flow assumptions that generate the smaller change would be the basis for determining whether the 10 percent threshold is met.
d. If the debt instruments contain contingent payment terms or unusual interest rate terms, judgment shall be used to determine the appropriate cash flows.

e. The discount rate to be used to calculate the present value of the cash flows is the effective interest rate, for accounting purposes, of the original debt instrument.
f. If within a year of the current transaction the debt has been exchanged or modified without being deemed to be substantially different, then the debt terms that existed a year ago shall be used to determine whether the current exchange or modification is substantially different.
g. The change in the fair value of an embedded conversion option resulting from an exchange of debt instruments or a modification in the terms of an existing debt instrument shall not be included in the 10 percent cash flow test. Rather, a separate test shall be performed by comparing the change in the fair value of the embedded conversion option to the carrying amount of the original debt instrument immediately before the modification, as specified in paragraph 470-50-40-10(a).

470-50-40-12A If a modification or an exchange of a freestanding equity-classified written call option held by a creditor is a part of or directly related to a modification or an exchange of an existing debt instrument held by that same creditor (see paragraphs 815-40-35-14 through 35-15 and 815-40-35-17(c)), an increase or a decrease in the fair value of the freestanding equity-classified written call option held by the creditor, calculated in accordance with paragraph 815-40-35-16, shall be included in the application of the 10 percent cash flow test described in paragraph 470-50-40-10.

> Fees between Debtor and Creditor

470-50-40-17 Fees paid by the debtor to the creditor or received by the debtor from the creditor (fees may be received by the debtor from the creditor to cancel a call option held by the debtor or to extend a no-call period) as part of the exchange or modification shall be accounted for as follows:

a. If the exchange or modification is to be accounted for in the same manner as a debt extinguishment and the new debt instrument is initially recorded at fair value, then the fees paid or received shall be associated with the extinguishment of the old debt instrument and included in determining the debt extinguishment gain or loss to be recognized.
b. If the exchange or modification is not to be accounted for in the same manner as a debt extinguishment, then the fees shall be associated with the replacement or modified debt instrument and, along with any existing unamortized premium or discount, amortized as an adjustment of interest expense over the remaining term of the replacement or modified debt instrument using the interest method.

For fees between the debtor and creditor for exchanges of or modifications to line-of-credit or revolving-debt arrangements, see paragraph 470-50-40-21.

470-50-40-17A An increase or a decrease in the fair value of a freestanding equity-classified written call option held by a creditor (calculated in accordance with paragraph 815-40-35-16) that is modified or exchanged as a part of or is directly related to a modification or an exchange of a debt instrument held by that same creditor (see paragraphs 815-40-35-14 through 35-15 and 815-40-35-17(c)) shall be accounted for in the same manner as fees between the debtor and the creditor as described in paragraph 470-50-40-17.

> Third-Party Costs of Exchange or Modification

470-50-40-18 Costs incurred with third parties directly related to the exchange or modification (such as legal fees) shall be accounted for as follows:

a. If the exchange or modification is to be accounted for in the same manner as a debt extinguishment and the new debt instrument is initially recorded at fair value, then the costs shall be associated with the new debt instrument and amortized over the term of the new debt instrument using the interest method in a manner similar to debt issue costs.
b. If the exchange or modification is not to be accounted for in the same manner as a debt extinguishment, then the costs shall be expensed as incurred.

For third-party costs for exchanges of or modifications to line-of-credit or revolving-debt arrangements, see paragraph 470-50-40-21.

470-50-40-18A An increase (but not a decrease) in the fair value of a freestanding equity-classified written call option held by a third party (calculated in accordance with paragraph 815-40-35-16) that is modified or exchanged as a part of or is directly related to a modification or an exchange of a debt instrument (see paragraphs 815-40-35-14 through 35-15 and 815-40-35-17(c)) shall be accounted for in the same manner as third-party costs incurred that are directly related to the modification or exchange of a debt instrument as described in paragraph 470-50-40-18.

> Line-of-Credit or Revolving-Debt Arrangements

470-50-40-21 Modifications to or exchanges of **line-of-credit or revolving-debt arrangements** resulting in either a new line-of-credit or revolving-debt arrangement or resulting in a traditional term-debt arrangement shall be evaluated in the following manner:

a. The debtor shall compare the product of the remaining term and the maximum available credit of the old arrangement (this product is referred to as the borrowing capacity) with the borrowing capacity of the new arrangement.

b. If the borrowing capacity of the new arrangement is greater than or equal to the borrowing capacity of the old arrangement, then any unamortized deferred costs, any fees paid to the creditor, and any third-party costs incurred shall be associated with the new arrangement (that is, deferred and amortized over the term of the new arrangement).
c. If the borrowing capacity of the new arrangement is less than the borrowing capacity of the old arrangement, then:
    1. Any fees paid to the creditor and any third-party costs incurred shall be associated with the new arrangement (that is, deferred and amortized over the term of the new arrangement).
    2. Any unamortized deferred costs relating to the old arrangement at the time of the change shall be written off in proportion to the decrease in borrowing capacity of the old arrangement. The remaining unamortized deferred costs relating to the old arrangement shall be deferred and amortized over the term of the new arrangement.

<u>Fees between the debtor and the creditor include an increase or a decrease in the fair value of a freestanding equity-classified written call option held by a creditor (calculated in accordance with paragraph 815-40-35-16) that is modified or exchanged as a part of or is directly related to a modification or an exchange of a line-of-credit or revolving-debt arrangement held by that same creditor (see paragraphs 815-40-35-14 through 35-15 and 815-40-35-17(c)). Third-party costs include an increase (but not a decrease) in the fair value of a freestanding equity-classified written call option held by a third party (calculated in accordance with paragraph 815-40-35-16) that is modified or exchanged as a part of or is directly related to a modification or an exchange of a line-of-credit or revolving-debt arrangement (see paragraphs 815-40-35-14 through 35-15 and 815-40-35-17(c)).</u>

For fees between the debtor and the creditor or third-party costs not related to exchanges of or modifications to a line-of-credit or revolving-debt arrangements resulting in either a new line-of-credit or revolving-debt arrangement, see paragraphs 470-50-40-17 through ~~40-18~~<u>40-18A</u>.

Amendments to Topic 505

6. Add paragraph 505-10-60-8, with a link to transition paragraph 815-40-65-2, as follows:

Equity—Overall

Relationships

> Financial Instruments

505-10-60-8 For guidance on accounting for modifications or exchanges of freestanding equity-classified written call options (for example, warrants) that remain equity classified after modification or exchange, see Subtopic 815-40 on contracts in entity's own equity.

Amendments to Topic 718

7. This amendment adds a reference to Example 22 in Subtopic 815-40 on contracts in an entity's own equity to clarify that modifications or exchanges of freestanding equity-classified written call options to compensate for goods or services are within the scope of Topic 718 on stock compensation.

8. Amend paragraph 718-10-15-5, with a link to transition paragraph 815-40-65-2, as follows:

Compensation—Stock Compensation—Overall

Scope and Scope Exceptions

General

> Transactions

718-10-15-5 The guidance in this Topic does not apply to transactions involving share-based payment awards granted to a lender or an investor that provides financing to the issuer. However, see paragraphs 815-40-35-14 through 35-15, 815-40-35-18, 815-40-55-49, and 815-40-55-52 for guidance on an issuer's accounting for modifications or exchanges of written call options to compensate grantees.

a. Subparagraph superseded by Accounting Standards Update No. 2018-07.
b. Subparagraph superseded by Accounting Standards Update No. 2019-08.
c. Subparagraph superseded by Accounting Standards Update No. 2019-08.

Amendments to Subtopic 815-40

9. These amendments provide measurement, recognition, and disclosure guidance for an issuer's accounting for modifications or exchanges of freestanding equity-classified written call options that remain equity classified after modification or exchange.

10. Add paragraphs 815-40-35-3, 815-40-35-14 through 35-18 and their related heading, 815-40-50-6 and its related heading, and 815-40-55-49 through 55-52 and their related headings, with a link to transition paragraph 815-40-65-2, as follows:

Derivatives and Hedging—Contracts in Entity’s Own Equity

Subsequent Measurement

> Overall

> > Equity Instruments—Permanent Equity

815-40-35-3 ~~Paragraph not used.~~ See paragraphs 815-40-35-14 through 35-18 for guidance on an issuer’s accounting for modifications or exchanges of freestanding equity-classified written call options that remain equity classified after modification or exchange.

> Issuer’s Accounting for Modifications or Exchanges of Freestanding Equity-Classified Written Call Options

815-40-35-14 The guidance in paragraphs 815-40-35-15 through 35-18 applies to an issuer’s accounting for a modification of the terms or conditions or an exchange of a freestanding equity-classified written call option (for example, a warrant) that remains equity classified in accordance with this Subtopic after the modification or exchange and is not within the scope of another Topic. An entity shall account for the effects of a modification or an exchange in accordance with paragraphs 815-40-35-15 through 35-18. The disclosure requirements in paragraphs 815-40-50-5 through 50-6 and 505-10-50-3 shall apply to a modification or an exchange of a freestanding equity-classified written call option. The guidance in paragraphs 815-40-35-16 through 35-17 does not apply to freestanding equity-classified written call options that are modified or exchanged to compensate grantees in a **share-based payment arrangement**. An entity shall recognize the effect of such modifications of freestanding equity-classified written call options by applying the requirements in Topic 718; however, classification of the instrument will remain subject to the requirements in this Subtopic.

815-40-35-15 An entity shall consider the circumstances of the modification or exchange of a freestanding equity-classified written call option to determine whether the modification or exchange is related to a financing or other arrangement or a multiple-element arrangement (for example, an arrangement involving both debt financing and equity financing). In making that determination, an entity shall consider all of the terms and conditions of the modification or exchange, other **transactions** entered into contemporaneously or in contemplation of the modification or exchange, other rights and privileges obtained or obligations incurred (including services) as a result of the modification or exchange, and the overall economic effects of the modification or exchange. If the modification or exchange is not within the scope of another Topic, an entity shall apply the guidance in paragraphs 815-40-35-16 through 35-18.

815-40-35-16 An entity shall treat a modification of the terms or conditions or an exchange of a freestanding equity-classified written call option as an exchange of the original instrument for a new instrument. In substance, the entity repurchases the original instrument by issuing a new instrument. For transactions recognized in accordance with paragraph 815-40-35-17(c), the effect of a modification or an exchange shall be measured as the difference between the **fair value** of the modified or exchanged instrument and the fair value of that instrument immediately before it is modified or exchanged. For all other transactions recognized in accordance with paragraph 815-40-35-17, the effect of a modification or an exchange shall be measured as the excess, if any, of the fair value of the modified or exchanged instrument over the fair value of that instrument immediately before it is modified or exchanged. In a multiple-element transaction, the total effect of the modification or exchange shall be allocated to the respective elements in the transaction.

815-40-35-17 An entity shall recognize the effect of a modification or an exchange (calculated in accordance with paragraph 815-40-35-16) in the same manner as if cash had been paid as consideration, as follows:

a. Equity issuance. An entity shall recognize the effect of a modification or an exchange that is directly attributable to a proposed or actual equity offering as an equity issuance cost. For additional guidance see SAB Topic 5.A, Expenses of Offering (paragraph 340-10-S99-1).
b. Debt origination. An entity shall recognize the effect of a modification or an exchange that is a part of or directly related to an issuance of a debt instrument as a debt discount or debt issuance cost in accordance with the guidance in Topic 835 on interest.
c. Debt modification. An entity shall recognize the effect of a modification or an exchange that is a part of or directly related to a modification or an exchange of an existing debt instrument in accordance with the guidance in Subtopic 470-50 on debt modifications and extinguishments and Subtopic 470-60 on troubled debt restructurings by debtors.
d. Other. An entity shall recognize the effect of a modification or an exchange that is not related to a financing transaction in (a) through (c) and is not within the scope of any other Topics (such as Topic 718) as a dividend. Additionally, for an entity that presents earnings per share (EPS) in accordance with Topic 260, that effect shall be treated as a reduction of income available to common stockholders in **basic earnings per share** in accordance with the guidance in paragraph 260-10-45-15.

815-40-35-18 Example 22 (see paragraphs 815-40-55-49 through 55-52) illustrates the application of the guidance in paragraphs 815-40-35-14 through 35-17.

Disclosure

> Issuer's Accounting for Modifications or Exchanges of Freestanding Equity-Classified Written Call Options

815-40-50-6 For a freestanding equity-classified written call option modified or exchanged during any of the periods presented and for which an entity has recognized the effect in accordance with paragraph 815-40-35-17, an entity shall disclose the following:

a. Information about the nature of the modification or exchange transaction (see paragraph 815-40-35-15)
b. The amount of the effect of the modification or exchange (see paragraph 815-40-35-16)
c. The manner in which the effect of the modification or exchange has been recognized (see paragraph 815-40-35-17).

Implementation Guidance and Illustrations

> Illustrations

> > Example 22: Modification of Equity-Classified Warrants

815-40-55-49 This Example illustrates the application of the guidance in paragraphs 815-40-35-14 through 35-17. Entity A issues warrants that permit the holder to buy 100 shares of its common stock for $10 per share. The warrants have a 10-year term and are exercisable at any time. At issuance, Entity A determines that the warrants are equity classified in accordance with this Subtopic. Prior to the modifications described in Cases A, B, and C, the warrants have not been modified since issuance and remain equity classified.

> > > Case A: Warrant Modification Recognized as an Equity Issuance Cost

815-40-55-50 Entity A reduces the exercise price of the warrants to $9 per share for a 60-day period to induce exercise of the outstanding warrants. Entity A determines that the warrants remain equity classified in accordance with this Subtopic after the modification. Entity A considers the guidance in paragraphs 815-40-35-14 through 35-15 and determines that the circumstances of the warrant modification indicate that the modification is executed in contemplation of an equity offering (that is, to induce the imminent exercise of the outstanding warrants and raise equity capital). Entity A concludes that the incremental fair value of the outstanding warrants is an incremental cost directly attributable to a proposed equity offering. Entity A recognizes the incremental fair value of the outstanding warrants as an equity issuance cost in accordance with paragraph 815-40-35-17(a). At the date on which the modification is executed by Entity A and the warrant holder, Entity A recognizes deferred costs of an offering (calculated in accordance with paragraph 815-40-35-16) to be charged against the gross proceeds of the offering. See paragraphs 815-40-50-5 through 50-6 and 505-10-50-3 for disclosure guidance.

> > > Case B: Warrant Modification Recognized as a Dividend

815-40-55-51 Entity A extends the term of the outstanding warrants, which results in an increase in the fair value of the outstanding warrants. Entity A determines that the warrants remain equity classified in accordance with this Subtopic after the modification. The warrant holder is a nonemployee investor that has no other commercial relationship with Entity A. The modification is not executed in contemplation of an imminent equity offering or a financing transaction. Entity A considers the guidance in paragraphs 815-40-35-14 through 35-15 and determines that the circumstances of the warrant modification do not indicate that there are other transactions entered into contemporaneously or in contemplation of the warrant modification or other rights and privileges obtained or obligations incurred to achieve an overall economic effect. Entity A concludes that the warrant modification is not related to a financing or compensation for goods and services and is not within the scope of another Topic. At the date on which Entity A and the warrant holder execute the modification, Entity A recognizes the incremental fair value of the outstanding warrants as a dividend to the warrant holder in accordance with paragraph 815-40-35-17(d). See paragraphs 260-10-45-15 and 260-10-45-22 through 45-27 for earnings-per-share guidance and paragraphs 815-40-50-5 through 50-6 and 505-10-50-3 for disclosure guidance.

> > > Case C: Warrant Modification Recognized as Compensation

815-40-55-52 Entity A reduces the exercise price of the warrants to $8 per share for the remaining term as a consideration for certain services received from the warrant holder. Entity A determines that the warrants remain equity classified in accordance with this Subtopic after the modification. Entity A considers the guidance in paragraphs 815-40-35-14 through 35-15 and determines that the circumstances of the warrant modification indicate that the modification is executed to compensate the warrant holder for the services provided to Entity A. Because the warrant modification is executed to compensate the warrant holder in a **share-based payment arrangement**, Entity A accounts for that modification by applying the requirements in Topic 718 (that is, the guidance in paragraphs 815-40-35-16 through 35-17 is not applicable).

11. Add paragraph 815-40-65-2 and its related heading as follows:

Transition and Open Effective Date Information

> Transition Related to Accounting Standards Update No. 2021-04, *Earnings Per Share (Topic 260), Debt—Modifications and Extinguishments (Subtopic 470-50), Compensation—Stock Compensation (Topic 718), and Derivatives and Hedging—Contracts in Entity's Own Equity (Subtopic 815-40): Issuer's Accounting for Certain Modifications or Exchanges of Freestanding Equity-Classified Written Call Options*

815-40-65-2 The following represents the transition and effective date information related to Accounting Standards Update No. 2021-04, *Earnings Per Share (Topic 260), Debt—Modifications and Extinguishments (Subtopic 470-50), Compensation—Stock Compensation (Topic 718), and Derivatives and Hedging—Contracts in Entity's Own Equity (Subtopic 815-40): Issuer's Accounting for Certain Modifications or Exchanges of Freestanding Equity-Classified Written Call Options:*

a. The pending content that links to this paragraph shall be effective for all entities for fiscal years beginning after December 15, 2021, including interim periods within those fiscal years. Early application, including early application in an interim period as of the beginning of the fiscal year that includes that interim period, is permitted for all entities.
b. An entity shall apply the pending content that links to this paragraph to modifications or exchanges of freestanding equity-classified written call options within the scope of the pending content that links to this paragraph on a prospective basis to modifications or exchanges occurring on or after the date at which the entity first applies the pending content that links to this paragraph.
c. An entity shall provide the following transition disclosures consistent with Topic 250:
    1. The nature of and reason for the change in accounting principle
    2. The transition method
    3. A qualitative description of the financial statement line items affected by the change.
d. An entity that issues interim financial statements shall provide the disclosures in (c) in the financial statements of both the interim period of the change and the fiscal year of the change.

Amendments to Status Sections

12. Amend paragraph 260-10-00-1, by adding the following item to the table, as follows:

260-10-00-1 The following table identifies the changes made to this Subtopic.

Paragraph	Action	Accounting Standards Update	Date
260-10-45-15	Added	2021-04	05/03/2021

13. Amend paragraph 470-50-00-1, by adding the following items to the table, as follows:

470-50-00-1 The following table identifies the changes made to this Subtopic.

Paragraph	Action	Accounting Standards Update	Date
470-50-40-12	Amended	2021-04	05/03/2021
470-50-40-12A	Added	2021-04	05/03/2021
470-50-40-17A	Added	2021-04	05/03/2021
470-50-40-18A	Added	2021-04	05/03/2021
470-50-40-21	Amended	2021-04	05/03/2021

14. Amend paragraph 505-10-00-1, by adding the following item to the table, as follows:

505-10-00-1 The following table identifies the changes made to this Subtopic.

Paragraph	Action	Accounting Standards Update	Date
505-10-60-8	Added	2021-04	05/03/2021

15. Amend paragraph 718-10-00-1, by adding the following item to the table, as follows:

718-10-00-1 The following table identifies the changes made to this Subtopic.

Paragraph	Action	Accounting Standards Update	Date
718-10-15-5	Amended	2021-04	05/03/2021

16. Amend paragraph 815-40-00-1, by adding the following items to the table, as follows:

815-40-00-1 The following table identifies the changes made to this Subtopic.

Paragraph	Action	Accounting Standards Update	Date
815-40-35-3	Added	2021-04	05/03/2021
815-40-35-14 through 35-18	Added	2021-04	05/03/2021
815-40-50-6	Added	2021-04	05/03/2021
815-40-55-49 through 55-52	Added	2021-04	05/03/2021
815-40-65-2	Added	2021-04	05/03/2021

The amendments in this Update were adopted by the unanimous vote of the seven members of the Financial Accounting Standards Board:

Richard R. Jones, *Chair*
James L. Kroeker, *Vice Chairman*
Christine A. Botosan
Gary R. Buesser
Susan M. Cosper
Marsha L. Hunt
R. Harold Schroeder

Background Information and Basis for Conclusions

Introduction

BC1. The following summarizes the Task Force's considerations in reaching the conclusions in this Update. It includes the Board's basis for ratifying the Task Force conclusions when needed to supplement the Task Force's considerations. It also includes reasons for accepting certain approaches and rejecting others. Individual Task Force and Board members gave greater weight to some factors than to others.

Background Information

BC2. The Board is issuing this Update to clarify and reduce diversity in an issuer's accounting for modifications or exchanges of freestanding equity-classified written call options (for example, warrants) that remain equity classified after modification or exchange.

BC3. Stakeholders asserted that there is diversity in an issuer's accounting for economically similar modifications or exchanges of freestanding equity-classified written call options due to a lack of explicit guidance in the Codification. Stakeholders requested that the Board provide guidance that would clarify whether an issuer would account for a modification or an exchange of a freestanding equity-classified written call option that remains equity classified after modification or exchange as (a) an adjustment to equity and, if so, the related EPS effects, if any, or (b) an expense and, if so, the manner and pattern of recognition.

BC4. On September 18, 2019, the Board added a narrow scope project to the EITF agenda with the objective of providing authoritative guidance to clarify and reduce the diversity in an issuer's accounting for modifications or exchanges of freestanding equity-classified warrants that remain equity classified after modification. At that meeting, the Board clarified that the scope of that project included all freestanding written call options that are similar to warrants in economic substance but may differ in legal form. In deliberating that issue, one Task Force member noted the similarities with an issuer's considerations in accounting for modifications or exchanges of other freestanding equity-classified derivative instruments (such as forwards) that remain equity classified after modification or exchange because there is a lack of explicit guidance in the Codification. That Task Force member suggested that the scope of the project should be expanded to address forwards and options. The Task Force reached a consensus-for-exposure to expand the scope of the project to include modifications or exchanges of freestanding equity-classified forwards and options that remain equity classified after modification or exchange.

BC5. The Board issued proposed Accounting Standards Update, *Earnings Per Share (Topic 260), Debt—Modifications and Extinguishments (Subtopic 470-50), Compensation—Stock Compensation (Topic 718), and Derivatives and Hedging—Contracts in Entity's Own Equity (Subtopic 815-40): Issuer's Accounting for Certain Modifications or Exchanges of Freestanding Equity-Classified Forwards and Options*, on October 26, 2020, with comments due by December 28, 2020. The Board received nine comment letters. Overall, respondents supported the amendments in the proposed Update, noting that the proposed amendments would clarify and reduce diversity in an issuer's accounting for modifications of equity-classified freestanding written call options that remain equity classified after modification. However, many respondents raised concerns about the decision to expand the scope of the proposed amendments beyond written call options to include forwards and purchased options. Specifically, stakeholders highlighted that the application of the proposed amendments to purchased call options could result in unintended consequences of entities (a) recognizing gains for modifications or exchanges that result in increased fair value of purchased call options or (b) not recognizing economically detrimental modifications or exchanges that result in decreased fair value of purchased call options.

BC6. The Task Force considered feedback received on the proposed Update at its March 11, 2021 meeting and reached a consensus. In redeliberating this issue, the Task Force decided to limit the scope of the amendments in the final Update to an issuer's accounting for modifications of freestanding equity-classified written call options that remain equity classified after modification. The Board ratified the consensus on March 24, 2021, resulting in the issuance of this Update.

Benefits and Costs

BC7. The objective of financial reporting is to provide information that is useful to present and potential investors, creditors, donors, and other capital market participants in making rational investment, credit, and similar resource allocation decisions. However, the benefits of providing information for that purpose should justify the related costs. Present and potential investors, creditors, donors, and other users of financial information benefit from improvements in financial reporting, while the costs to implement new guidance are borne primarily by present investors. The Task Force's assessment of the costs and benefits of issuing new guidance is unavoidably more qualitative than quantitative because there is no method to objectively measure the costs to implement new guidance or to quantify the value of improved information in financial statements.

BC8. Overall, the Task Force believes that the amendments in this Update will clarify and reduce the diversity in an issuer's accounting for modifications or exchanges of freestanding equity-classified written call options that remain equity classified after modification or exchange and will either improve or maintain the decision usefulness of information provided to present and potential investors, creditors, donors, and other users. Additionally, the Task Force believes that stakeholders will benefit from reduced costs and complexity related to preparing, auditing, and regulating the financial information about those modifications or exchanges. The Task Force noted that depending on the frequency of those transactions, a full retrospective adoption could be a costly and time-intensive undertaking and, therefore, decided to require a prospective adoption.

BC9. The Task Force's specific considerations about costs and benefits of the amendments are further discussed within each of the following sections.

Basis for Conclusions

BC10. The Task Force reached a consensus that an entity should treat a modification of the terms or conditions or an exchange of a freestanding equity-classified written call option that remains equity classified after modification or exchange as an exchange of the original instrument for a new instrument. The Task Force noted that the amendments in this Update should be applicable regardless of whether a modification is executed through an amendment to an existing instrument or a replacement of an existing instrument with a new instrument. The Task Force also noted that the amendments in this Update provide guidance for a modification or an exchange of a freestanding equity-classified written call option that is not within the scope of another Topic.

BC11. The Task Force reached a consensus that an entity should measure the effect of a modification or an exchange of a freestanding equity-classified written call option that remains equity classified after modification or exchange as follows:

- a. For a modification or an exchange that is a part of or directly related to a modification or an exchange of an existing debt instrument, as the difference between the fair value of the modified or exchanged written call option and the fair value of that written call option immediately before it is modified or exchanged. Specifically, an entity should consider:
    1. An increase or a decrease in the fair value of the modified or exchanged written call option in applying the 10 percent cash flow test and/or calculating the fees between debtor and creditor in accordance with Subtopic 470-50.
    2. An increase (but not a decrease) in the fair value of the modified or exchanged written call option in calculating the third-party costs in accordance with Subtopic 470-50.
- b. For all other modifications or exchanges, as the excess, if any, of the fair value of the modified or exchanged written call option over the fair value of that written call option immediately before it is modified or exchanged.

BC12. The Task Force noted that the measurement approach for modifications or exchanges of written call options that are related to a modification of existing debt is consistent with the requirements under Subtopic 470-50. For other modifications or exchanges of written call options within the scope of the amendments in this Update, the Task Force noted that the measurement approach in this Update is similar to the share-based payment model in Topic 718 on stock compensation, which does not result in accounting by the issuer for modifications that result in a reduction in the value of an instrument.

BC13. The Task Force deliberated whether an issuer's recognition of modifications or exchanges of freestanding equity-classified written call options should be based on the substance of the transaction. The Task Force noted that an issuer should recognize those modifications or exchanges in the same manner as if cash were paid instead of modifying or exchanging those instruments. That is, an issuer should not reach a different accounting conclusion depending on the form of the consideration (cash or noncash). Additionally, the Task Force considered that while the facts and circumstances of those modifications or exchanges may differ and, thus, justify differences in recognition, sufficient guidance or accounting principles exist in the Codification to address those fact patterns. Therefore, the Task Force decided to provide a principles-based recognition framework that leverages existing guidance and specifies its application according to the substance of a modification or an exchange transaction.

BC14. The Task Force reached a consensus that an entity should recognize the effect of a modification or an exchange of a freestanding equity-classified written call option that remains equity classified after modification or exchange and is not within the scope of another Topic on the basis of the substance of the transaction, in the same manner as if cash had been paid as consideration, as follows:

a. If the modification or exchange is executed in a financing transaction to raise equity, the effect should be recognized as an equity issuance cost in accordance with the guidance in Topic 340 on other assets and deferred costs.
b. If the modification or exchange is executed in a financing transaction to raise new debt or modify existing debt, the effect should be recognized as a cost in accordance with the guidance in Topic 470 on debt and Topic 835 on interest.
c. For other modifications that are not related to financings or compensation for goods or services or other exchange transactions addressed by other Topics, the effect should be recognized as a dividend. For entities that present EPS in accordance with Topic 260, that dividend should be an adjustment to net income (or net loss) in the basic EPS calculation.

BC15. The Task Force noted that if a modification or exchange is executed to compensate for the transfer of goods or services, the effect should be recognized in accordance with the guidance in Topic 718.

BC16. Additionally, the Task Force noted that to determine the substance of a modification or an exchange, an entity should analyze all relevant facts and circumstances of the modification such as reasons for the modification, relationship of the holder of the freestanding equity-classified written call option to the entity, other relationships affecting the transaction, other transactions consummated with or entered into in contemplation of the modification, and other rights and privileges obtained or obligations incurred.

BC17. The Task Force considered whether the substance of a modification or an exchange executed in a financing transaction to raise equity, such as that described in Example 22, Case A in paragraph 815-40-55-50 of Subtopic 815-40 on contracts in entity's own equity, might be viewed as a dividend because the modification is not made available to all common stockholders and because recognizing the modification as an equity issuance cost is not consistent with the accounting for the inducement of conversion of convertible preferred stock. The Task Force noted, however, that had the issuer paid cash to the holder (instead of modifying warrants) to raise equity in that example, the issuer would recognize it as an equity issuance cost. The Task Force considered that the issuer should not reach a different accounting conclusion depending on the form of the consideration and concluded that recognizing the effect of the warrant modification as an equity issuance cost is appropriate in that example. One Task Force member disagreed with the view that the effect of a modification or exchange executed in a financing transaction to raise equity should be recognized as an equity issuance cost and preferred recognizing the effect as a dividend. That member noted that a modification or an exchange made available disproportionately to some common stockholders is akin to a preferential distribution of dividends and should be reflected in EPS, consistent with the accounting for the inducement of conversion of convertible preferred stock.

BC18. While the Task Force noted that modifications or exchanges that are not related to financings or compensation for goods or services (as discussed in paragraph 815-40-35-17(d)) are not prevalent in practice, the Task Force concluded that a transaction that does not represent costs of financing and is not within the scope of other Topics (for example, compensation cost under Topic 718) should be recognized as a dividend by the issuer. Some Task Force members disagreed with including that category in the recognition framework because in their view that type of modification or exchange is not common in practice. Some Task Force members disagreed with dividend treatment for the modifications or exchanges in that category because their preferred recognition approach for that category was either (a) as an expense or (b) as a dividend or an expense based on the facts and circumstances of the transaction.

BC19. Additionally, the Task Force noted that if a modification or an exchange is executed in exchange for an agreement by the holder of the written call option to abandon certain acquisition plans, forgo other planned transactions, settle litigation, settle employment contracts, or voluntarily restrict its purchase of shares of the issuing entity or the issuing entity's affiliates within a stated time period, those rights and privileges obtained, both stated and unstated, or other elements of the transaction should be accounted for according to their substance (that is, as a cost to the issuing entity) rather than as a dividend distribution.

BC20. The Task Force rejected alternatives that would have required that an entity recognize the effects of all modifications or exchanges within the scope of this Update as an expense or a dividend because the Task Force concluded that the accounting outcome under those alternatives would not necessarily represent the substance of the transaction.

BC21. In a multiple-element transaction (for example, one that includes both debt financing and equity financing), an entity should allocate the total effect of the modification or exchange to the respective elements in the transaction.

BC22. The Task Force decided to require incremental disclosures for an issuer to improve transparency about the nature and effects of the transactions within the scope of the amendments in this Update.

Effective Date and Transition

BC23. The Task Force decided that the amendments in this Update should be effective for all entities for fiscal years beginning after December 15, 2021, including interim periods within those fiscal years.

BC24. The Task Force reached a consensus that an entity should apply the amendments in this Update prospectively to all new modifications or exchanges occurring after the effective date of the amendments. Early adoption is permitted. If early adoption is elected in an interim period, the guidance will be effective as of the beginning of the fiscal year that includes that interim period.

BC25. The Task Force reached a consensus to require that in accordance with Topic 250, Accounting Changes and Error Corrections, an entity disclose in the period of adoption the nature of and reasons for the change in accounting principle, the transition method, and a qualitative description of the financial statement line items affected by the change.

Amendments to the GAAP Taxonomy

The amendments to the *FASB Accounting Standards Codification*® in this Accounting Standards Update require improvements to the GAAP Financial Reporting Taxonomy and SEC Reporting Taxonomy (collectively referred to as the "GAAP Taxonomy"). Those improvements, which will be incorporated into the proposed 2022 GAAP Taxonomy, are available through GAAP Taxonomy Improvements provided at www.fasb.org, and finalized as part of the annual release process.