CPE

CURRICULUM:
Accounting and auditing

LEVEL:
Basic

DESIGNED FOR:
CPAs in public practice, management

OBJECTIVES:
To explain the classification and accounting implications of warrants issued with debt instruments, discuss different types of warrant instruments and analyze their classifications and accounting treatment based on relevant accounting standards

KEY TOPICS:
Debt instruments; fair value accounting; warrants; fair allocation methods; distinguishing detachable from embedded instruments; hybrid instruments; and indexed debts with embedded features

PREREQUISITES:
None

ADVANCED PREPARATION:
None

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Distinguishing Debts from Equity - Warrants Issued in Conjunction with Debt Instruments

BY JOSEF RASHTY

Stock warrant instruments give an entity the right to buy or sell a security at a certain price before a specific date. It is a type of derivative, similar to stock options, which derives its value from its underlying asset (the equity stock). Companies may issue stock warrants in conjunction with equity or debt instruments.

This article expounds on warrants issued in conjunction with debt instruments, one of the topics of *distinguishing debts from equity*. It discusses different types of warrant instruments issued in conjunction with debt instruments and analyzes their classifications and their accounting implications based on ASC 470, *Debt*; ASC 825, *Financial Instruments*; ASC 480, *Distinguishing Debt from Equity*; and ASC 815, *Derivatives and Hedging*.

The article begins with an introduction to debt instruments and their accounting features relevant to stock warrants that companies issue in conjunction with debt instruments (e.g., fair value accounting).

Debt Instruments

Debtors issue debt instruments in exchange for cash; a future privilege; property, goods, services; or a combination of them. The debt instruments usually carry a stated interest rate that may differ from the market interest rate at the time of issuance and as a result, the debt may be issued at a premium (if the bond's stated interest rate is higher than the market interest rate) or a discount (if the bond's stated interest rate is lower than the market interest rate).

Debtors ground classification of their debts as current or noncurrent in the expectation of their settlement – noncurrent (long term) debt is any amount of outstanding debt a company holds that has a maturity of 12 months or longer. This guidance also applies to the classification of warrants issued with debt instruments; however, the classification of awards as current or noncurrent does not depend on the classification of debt instruments.

Fair Value Accounting

Debtors can make a one-time irrevocable policy election at the inception of the transaction to elect the fair value option (under ASC 825 or Subtopic ASC 815-15 on embedded derivatives) to reflect changes in fair value recognized in net income on an instrument-by-instrument basis (ASC 825-10-45-5). Electing the fair value option to measure debt may result in recording a

Stock warrant instruments are derivatives that grant the right to buy or sell a security at a predetermined price before a set date, deriving their value from the underlying equity stock and often issued alongside equity or debt instruments.

different initial fair value for debts – which is usually based on the present value of the proceeds.

Debt's fair value is usually the present value of its cash flows. ASC 835-30 provides guidance on the initial measurement of debt under ASC 815-15 or ASC 825-10. The key concept of ASC 835-30 is that the initial recognition of debt is the present value of the debt's principal and interest cash flows. Debtors usually measure the debt in the subsequent periods at amortized cost unless they have elected the fair value accounting option.

Residual and Relative Fair Allocation Methods

Companies use "relative fair value allocation method" for equity classified awards and "residual method ('with or without' method) for liability classified awards for the fair value allocation.

Relative Fair Value Allocation Method

The issuer (the debtor) determines the fair value of each separate component issued in a financing transaction. Then, it allocates the total proceeds to their relative fair values.

For example, a debtor issues a $1,000 par value bond with detachable equity-classified warrants. The fair value of the bond is $990 and the fair value of the warrants is $110. The debtor classifies the warrants as equity instruments under ASC 470-20-25-2 and 470-20-30-1.

Cash	$1,000	
Bond discount	$100	
APIC (warrants)		$100
Bond payable		$1,000

Value of bond is $900 = $1,000 x [$990 / ($990 + $110)]
Bond discount $1,000 - $900 = $100
Value of warrants is $100 = $1000 x [$110 / ($110 + $990)]
The net bond payable is $900 ($1000 - $100)

GAAP requires companies to amortize the bond discount based on a straight-line or effective interest method. However, most companies in practice choose the straight-line method due to its simplicity and immateriality. (The effective interest method results in front-loaded interest.)

Residual Method ("With or Without" Method)

The issuer (the debtor) determines the fair values of each component. Then, it records one or more components at the fair value and the remaining at the residual value. If the facts remain the same as in the previous example, the debtor classifies the warrants as a liability and accounts for them at fair value based on their residual values.

Cash	$1,000	
Bond (discount)	$110	
Bond (par value)		$1,000
Warrants		$110

Continued on page 24

CPE

The net bond payable in the above example is $890 ($1000 - $110) compared with $900 in the previous example.

Warrants

Warrant instruments give the holder the right, but not the obligation, to purchase or sell equity shares for a specified price (the exercise or strike price) during a specified period. For example, a debtor may issue a $1,000 two-year par value bond with detachable warrants that matures at the end of the second year.

Warrants are similar to stock options and companies often use the Black-Scholes-Merton model to determine their values. However, companies often issue warrants with a $0.01 strike price, which makes their value nearly identical to the underlying per-share value when run through an option pricing model.

Redeemable Warrants (Mandatory or Optional)

Redeemable warrants are financial instruments that may be redeemed at the issuer's option (e.g., a callable warrant), holder's option (e.g., a puttable warrant) or by contract (e.g., maturity of the instrument at a specific date) for cash or other securities. For example, if an issuer decides to redeem its redeemable warrants, the holder surrenders them for cash or other securities in exchange.

The redemption feature is in the underlying shares rather than the warrant. The redemption attribute can be mandatory or optional at any time or upon the occurrence of certain designated events (e.g., change of control). ASC 480-10-25-4 requires that companies classify the mandatorily redeemable warrants as liabilities unless the redemption is to occur upon liquidation or termination of the reporting entity.

Detachable (Freestanding) Warrants

Companies may issue debts with detachable warrants. ASC 480 defines a detachable (freestanding) financial instrument as follows: (1) it is separate and apart from any of entity's other financial instruments or equity transactions, or (2) it is in conjunction with some other transaction and is legally detachable and separately exercisable. ASC 470-20-30-2 states:

> When detachable warrants (detachable call options) are issued in conjunction with a debt instrument as a consideration in purchase transactions, the amounts attributable to each class of instrument issued shall be determined separately, based on values at the time of issuance. The debt discount or premium shall be determined by comparing the value attributed to the debt instrument with the face amount thereof.

Accounting for warrants issued with debt instruments is complex and involves significant management judgment, with companies preferring equity classification to avoid earnings volatility, though the SEC has recently challenged this preference in some cases.

Embedded Warrants

Debts may have embedded features (e.g., embedded warrants) that introduce variability into a fixed contract and are part of a conversion function. An issuer may issue multiple instruments to the same counterparty in one transaction (e.g., debts and warrants). ASC 815 requires that companies initially identify all freestanding financial instruments, then account for their embedded features, if any, and bifurcate them and account for them separately.

A holder can exercise the warrants only upon surrender of the debt instrument. In this scenario, companies shall allocate the proceeds to the two elements based on their relative fair values: the debt instrument's fair value without the warrants and the warrants themselves at the time of issuance (ASC 470-20-25-3 and 25-12).

Call Warrants

Call options give the holder the right, but not the obligation, to buy an underlying (an underlying is the common stock that must be delivered when a warrant is exercised) at a specific price on or before a specified date. For example, companies may issue detachable warrants (call options) in conjunction with a debt instrument as consideration in purchase transactions.

Put Warrants

Put options give the holder the right, but not the obligation, to sell an underlying at a specified price on or before a specific date. A put warrant is an embedded put option that allows the holder to require the issuer to pay cash at a specified date for a fixed amount to either (1) repurchase the warrant itself or (2) purchase the shares that the holder has received upon the exercise of the warrant.

Distinguishing Detachable (Freestanding) from Embedded Instruments

Identifying whether an instrument is detachable (freestanding) or embedded involves understanding the form and substance of the transaction and requires substantial judgment. The contract per se that describes the transaction may not be determinative when evaluating that an instrument is freestanding or embedded in the transaction.

Companies should follow the following guidelines in exercising their judgment:

- If they have issued the instruments separately or concurrently in contemplation of each other;

TABLE 1. TYPES OF DEBTS AND DETACHABLE WARRANTS

Type of Debt Transaction	Subsequent Measurement	Type of Allocation	GAAP Reference
Debt with detachable equity-classified stock purchase warrants	No subsequent remeasurement	Relative fair value method	ASC 470-20-25-2 and 470-20-30-1
Debt with detachable liability-classified stock purchase warrants	Periodic remeasurement for warrants only	Residual method	ASC 815
Mandatory redeemable instrument issued with detachable liability-classified warrants	Periodic remeasurement for warrants only	Residual method	ASC 480-10-30-1, 480-10-55-63 and ASC 815
Mandatory redeemable instruments issued with detachable equity-classified warrants	No subsequent remeasurement	Relative fair value method	ASC 480-10-30-1

- If the instruments can or cannot be separated. (If the exercise of one instrument results in the termination of the other instrument.)

Hybrid Instruments (Debt Issued with Other Instruments)

Financial instruments may not meet the definition of derivatives entirely; however, they may contain contractual terms that function similarly to derivatives. For example, debt and equity transactions often have embedded features that require additional analysis to determine their nature. These financial instruments are hybrid instruments and issuers may need to bifurcate embedded features and account for them separately. The most common embedded derivatives in debt and stock instruments are conversion options, puts, calls, and interest rate features.

In practice, companies first complete an evaluation to determine whether an instrument is within the scope of ASC 470 and ASC 480 for recognition and measurement. If the instrument is not within the scope of ASC 480, the company further evaluates it to determine if it is a derivative within the scope of ASC 815. If so, the instrument is subject to ASC 815-40 guidance for accounting and its required disclosures. The company should also evaluate the provisions of ASC 815-40-25-1 through 25-43 and its implementation guidance ASC 815-40-55-1 through 55-18 for its proper classification.

Classification of Detachable Warrants

If an issuer classifies an equity contract as equity, it should initially measure it at fair value and it will not recognize any subsequent changes in fair value. In contrast, if an equity contract indexed to the issuer's stock fails the requirements for equity classification, it will classify it as an asset or liability at fair value with subsequent changes in fair value recorded in earnings.

Debts with Detachable Equity-Classified Stock Purchase Warrants

ASC 470 provides accounting and reporting guidance for debt instruments with detachable warrants. Equity classification of warrants requires that companies reflect their fair values in additional paid-in capital (APIC). 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 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.

Issuers often charge a lower interest rate in their debt securities with warrants. In these transactions, the issuer usually cannot force the holders of the warrants to exercise them and purchase the stock (ASC 470-20-05-3). Furthermore, companies may need to evaluate equity contracts under ASC 480 according to ASC 815.

The equity classification guidance generally indicates that a company with an equity contract indexed to its stock should classify the warrants as equity under either of the following types of settlement (ASC 815-40-25-1 through 25-43 and ASC 815-40-55-2 through 55-18):

- Contract requires physical or net share settlement;
- Issuer has an alternative of physical or net share settlement regardless of its intent.

However, a contract cannot have equity classification if the following two conditions exist:

Continued on page 26

CPE

- The contract requires net cash settlement (including a requirement to net cash settle if an event occurs that is outside the control of the issuer);
- The holder has a choice of net cash settlement or settlement in shares (physical settlement or net share settlement).

ASC 815-40-25-7 through 25-8 include additional conditions for equity classification. The following is a list of some of the requirements:

- Settlement allows for unregistered shares;
- Issuer has sufficient authorized and unissued shares;
- Equity contract has an explicit share limit.

Public business entities (PBEs) should consider SEC staff guidance for their balance sheet presentations. ASC 480-10-S99-3A, *SEC Staff announcement: Classification and Measurement of Redeemable Securities*, requires companies to classify redeemable instruments in their balance sheets as temporary equity in the mezzanine section of the balance sheet.

Debts with Mandatory Redeemable Liability-Classified Purchase Warrants

ASC 480-10-25-4 states that a mandatorily redeemable financial instrument must be classified as a liability unless redemption occurs only upon the liquidation or termination of the entity. If a financial instrument has multiple components that require the issuer to repurchase shares (or is indexed to such an obligation) and may require a transfer of assets, the entire instrument is classified as a liability (ASC 480-10-25-8 to 25-13). ASC 480 does not specify when to classify these instruments as equity.

There are three scope exceptions: redemption upon liquidation or termination of the entity, non-SEC registrants for instruments with no fixed date and fixed amount (ASC 480-10-15-7A) and certain mandatory redeemable non-controlling interest (NCI). If an instrument qualifies for an ASC 480 exception, PBEs may classify it as temporary equity. (Non-PBEs are not required to follow this guidance.)

ASC 480 mandates that companies classify put warrants and warrants on redeemable shares as liabilities, as they involve an obligation to repurchase the issuer's shares and may require asset transfer to settle the liability (ASC 480-10-25-4). A puttable warrant is a written call option allowing the holder to buy the issuer's shares and a put option enabling them to sell the warrants (or underlying shares) back at a specified price.

In practice, companies usually evaluate whether an instrument is within the scope of ASC 480 for recognition and measurement.

Accounting for puttable shares is identical to that for mandatorily redeemable warrants. ASC 480-10-55-33 states:

> A warrant for puttable shares conditionally obligates the issuer to ultimately transfer assets – the obligation is conditioned on the warrant's being exercised and the shares obtained by the warrant being put back to the issuer for cash or other assets.

Accounting for redeemable and mandatory redeemable warrants follows the guidance in ASC 480-10-25-8 through 25-13. These financial instruments have the following two characteristics:

- The instrument embodies an obligation (conditional or unconditional) to repurchase the issuer's equity shares or is indexed to such an obligation. The instrument may require the issuer to settle the obligation by transferring assets.
- The instrument (call options) provides the right, but not the obligation, to buy from the seller shares of the issuer's stock at a specified price. If the holder exercises the options, the issuer can settle the contract by physical settlement, net cash settlement or the choice of the issuer for settlement method (ASC 815-40-55-14).

Indexed Debts with Embedded Features

Equity and debt generally do not meet the definition of a derivative because they typically require payment in cash (or other assets) equal to the fair value of the debt or stock at inception unless they are hybrid instruments. A derivative is a financial instrument or an embedded feature that has all of the following characteristics:

- It has one or more underlying (e.g., an interest rate or a share price). An underlying has verifiable changes in its value that cause changes in the cash flow or fair value of the derivative;
- It has one or more notional amounts or payment provisions or both; the notional amount is a quantity that determines the size of the change that the underlying may cause;
- There is no requirement for an initial net investment;
- There is no net settlement provision through (1) implicit or explicit terms, (2) the existence of a market mechanism outside the contract, or (3) delivery of an asset (ASC 815-10).

In practice, companies usually evaluate whether an instrument is within the scope of ASC 480 for recognition and measurement. If it is not within the scope of ASC 480, companies assess it as derivative within the scope of ASC 815. These instruments may either be derivative or have embedded features as derivatives. If so, companies bifurcate and account for them separately. Companies remeasure derivatives, like liabilities, at fair value in each period.

A comprehensive analysis of debts with embedded derivatives is beyond the scope of this article. However, a summary of accounting implications includes:

- Companies should evaluate whether they need to separately account for embedded features in indexed debts under Topic 815;
- If companies need to bifurcate the embedded feature, they should record it at fair value;
- They should allocate the amount to the host less the fair value of the embedded feature (i.e., the residual amount);
- If the amount allocated to the debt does not equal the debt's par value, companies record the difference as a premium or discount.

In most instances, companies need to bifurcate a hybrid debt. If so, the companies measure the indexing feature at fair value in each period and reflect the changes therein in their earnings; however, the value of the debt remains unchanged.

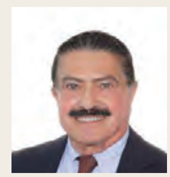
On the other hand, if the indexing feature does not require bifurcation, companies adjust the net carrying amount of the debt to reflect the increased liability from the index value and account for subsequent changes. Non-bifurcated embedded features are classified as equity or liability under ASC 470 or ASC 480 (e.g., call options, put options, conversion options, or contingent interests).

Accounting Complexities of Warrants Issued with Debt Instruments

Please see the TXCPA website at www.tx.cpa for an illustration.

Accounting implications of warrants issued in conjunction with debt instruments are complex. This article covered some of the basics of accounting for warrants.

In most cases, the application of accounting guidance requires significant management judgment. Companies often prefer to classify warrants as equity rather than liabilities and derivatives since liability and derivative classified warrants require periodic valuation and may create volatility in the company's earnings. However, the SEC has challenged the equity classification of awards in some cases recently.



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