

BDO BULLETIN

TARGETED IMPROVEMENTS TO EQUITY INDEXATION (FASB PROPOSAL)

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SUMMARY

The Financial Accounting Standards Board (FASB) has issued a proposed Accounting Standards Update[1] ("Proposed ASU") to simplify Step 2 of the indexation guidance in ASC 815, *Derivatives and Hedging*. It would replace today's "fixed-for-fixed" assessment with an "acceptable variables" approach to reduce the frequency of mark-to-market accounting. That is, the FASB expects fewer warrants, conversion features, and other equity-linked contracts to be remeasured through earnings each period. If finalized, the Proposed ASU would also expand disclosures for equity-classified contracts.

KEY TAKEAWAYS

- **More contracts may qualify for equity classification.** The Proposed ASU would simplify the indexation analysis, including for contracts with settlement adjustments triggered by financing transactions, mergers, changes in control, or other events related to the entity's own operations or activities.
- **The Proposed ASU would address diversity in practice regarding leverage and prespecified inputs.** For example, fixed or prespecified volatility and "greater of" volatility provisions would not preclude a warrant or other equity-linked contract from being indexed to an entity's own stock.
- **Down round features would no longer require separate accounting.** The Proposed ASU would eliminate the down round scope exception and related recognition, measurement, earnings per share (EPS), and disclosure guidance.
- **Additional disclosures would be required for equity-classified contracts.** Entities would disclose variables or contingent events that could significantly affect settlement amounts, as well as any significant settlement changes that occurred and what caused them.
- **Comments are due by January 4, 2027.**

[1] *Derivatives and Hedging — Contracts in Entity's Own Equity (Subtopic 815-40): Targeted Improvements to Indexation*

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WHY IS THE FASB PROPOSING CHANGES TO U.S. GAAP?

Under current U.S. GAAP, determining whether a contract is indexed to an entity's own stock can be complex and costly. In particular, Step 2, which requires entities to determine whether settlement adjustments are consistent with the pricing of a fixed-for-fixed equity contract, has resulted in diversity in practice and frequent financial statement errors.

The FASB is proposing to replace that assessment with a simpler approach based on specified acceptable variables. The Proposed ASU is intended to reduce complexity and diversity in practice, resulting in more contracts being considered indexed to an entity's own stock.

WHO WOULD THIS AFFECT?

The Proposed ASU would apply to all entities with equity-linked contracts, including freestanding instruments, such as warrants and embedded features like conversion options. The changes may be particularly relevant to entities that frequently raise capital or that issue equity-linked instruments with nonstandard terms.

WHAT WOULD CHANGE?

Replace the Fixed-for-Fixed Assessment with Acceptable Variables

Under current U.S. GAAP, Step 2 requires an entity to determine whether a contract's settlement provisions are consistent with a fixed-for-fixed equity contract (see Section 4.5.2 of BDO's Blueprint, Issuer's Accounting for Complex Financial Instruments). The Proposed ASU would replace this assessment with an acceptable variables approach. (The Proposed ASU would not change Step 1, which requires an entity to evaluate any contingent exercise provisions to determine whether they preclude the contract from being considered indexed to the entity's own stock.)

Under the proposed Step 2 guidance, an instrument (or embedded feature) would be considered indexed to an entity's own stock if the variables or contingent events that could change its settlement amount, including through an adjustment to the strike price or the number of shares used to calculate the settlement amount, relate **only** to the following acceptable variables:

- The entity's own stock price
- The term of the instrument
- The entity's own expected dividends or other dilutive activities
- Stock borrow costs associated with the entity's own stock
- Interest rates
- The entity's own stock price volatility
- The entity's own credit spread
- The entity's own operations or activities.

The indexation assessment would **not** be affected by either of the following:

- The magnitude of a settlement adjustment
- Whether the variable or contingent event causing the adjustment is within the entity's control.

When a contract contains multiple settlement adjustments, each would need to be evaluated against the list of acceptable variables. If any adjustment relates to a variable that is not on that list, the contract would not be considered indexed to the entity's own stock, regardless of the probability that the adjustment will occur.

BDO INSIGHT: A NEW ACCEPTABLE VARIABLE — THE ENTITY'S OWN OPERATIONS OR ACTIVITIES

Most of the proposed acceptable variables already exist under current guidance. However, the entity's own operations or activities would be a new acceptable variable. For example, under current guidance, a warrant with a strike price that adjusts based on the entity's revenue target would not be considered indexed to the entity's own stock because revenue is not an input to the fair value of a fixed-for-fixed option. However, under the Proposed ASU, such adjustment to the strike price would qualify for indexation because the entity's revenue relates to its own operations or activities.

In many cases, the connection to the entity's own operations or activities would be clear. For example, if a settlement adjustment is based on the entity's revenue (or other financial or operational measures) or is based on

events such as an initial public offering or a change in control, there is a clear connection to the entity's own operations or activities. On the other hand, if the settlement adjustment is based on general market prices, such as commodity prices, general market indexes, or the operations or activities of the instrument holder, there is no clear connection to the entity's own operations or activities (even if the market prices relate to the entity's business, such as the price of gold for a mining company).

In other cases, determining whether a variable relates to the entity's own operations or activities may require judgment. To draw a conclusion, entities would need to identify the specific measure or event driving the settlement adjustment and assess whether it relates to their own operations or activities. If the adjustment also depends on an external factor or another party's operations or activities, this assessment may require additional analysis. For example, if a change in control (an acceptable variable) triggers a payoff using a nonacceptable input, such as an index or the holder's funding cost, indexation would still be precluded.

The Proposed ASU would also clarify how to evaluate the entity's own stock price volatility. This acceptable variable would include any fixed or prespecified volatility, including a floor or cap, and any magnitude or multiple of the entity's own stock price volatility. Accordingly, provisions based either on a fixed volatility or on the greater of a fixed volatility and the entity's historical volatility would not preclude indexation. These clarifications are intended to address diversity in practice in evaluating leverage associated with these provisions. In addition, for an entity without observable stock price volatility, the Proposed ASU would permit the use of the volatility of a reasonably appropriate peer company or peer group. However, for an entity with its own observable stock price volatility, a settlement amount based explicitly on the volatility of an unrelated entity would preclude indexation.

BDO INSIGHT: OTHER U.S. GAAP WOULD CONTINUE TO PROVIDE GUARDRAILS

Citing that retaining a leverage limitation would add complexity and could continue to result in inconsistent application, the FASB decided that the magnitude of leverage associated with an acceptable variable would not, by itself, preclude indexation. However, meeting the proposed indexation guidance would not automatically result in equity classification. The existing classification requirements in ASC 480, *Distinguishing Liabilities from Equity* (ASC 480) and ASC 815-40-25 would continue to serve as guardrails and may result in liability classification for some highly leveraged instruments. Accordingly, an entity that concludes that an instrument is indexed to its own stock under the proposed Step 2 guidance would still need to complete the remaining classification analysis. This includes evaluating ASC 480 for freestanding instruments and the equity-classification requirements in ASC 815-40-25, including whether the entity has sufficient authorized and unissued shares to settle the contract.

See Chapter 2 and Section 4.6 of BDO's Blueprint, **Issuer's Accounting for Complex Financial Instruments**, for guidance on classification under ASC 480 and ASC 815-40-25, respectively.

The Proposed ASU would exclude the "ability to maintain a standard hedge position in the underlying shares" as a separate acceptable variable because that concept is tied to the fixed-for-fixed assessment that the FASB is proposing to eliminate. The FASB does not expect this exclusion to alter the treatment of related settlement adjustments. For example, an adjustment resulting from a merger announcement or similar event that affects the counterparty's ability to maintain a standard hedge position would generally be evaluated as part of the entity's own operations or activities under the Proposed ASU.

Lastly, equity indexation would continue to be precluded for contracts indexed to a foreign currency; the proposal would not change this aspect of ASC 815-40-15.

Eliminate Separate Guidance for Down Round Features

The Proposed ASU would eliminate the separate scope exception for down round features because these features generally relate to the entity's own operations or activities and therefore would qualify for indexation under the acceptable variables approach. Accordingly, the new guidance would encompass down round features without having to specify an exception. It would also encompass economically similar instruments, such as strike price reductions that are triggered by the modification of another equity-linked instrument to a lower strike price.

The Proposed ASU would also eliminate the related recognition, measurement, and EPS guidance for down round features. If a down round feature is triggered, an entity would no longer recognize its value as a deemed dividend and reduce the income available to common stockholders when calculating basic EPS. Significant changes to the settlement amount would instead be subject to the proposed disclosure requirements for equity-classified contracts.

Require Additional Disclosures about Settlement Variability

The Proposed ASU would require entities to provide additional annual disclosures about equity-classified contracts with variable settlement amounts. Entities would disclose the following:

- Variables or contingent events that could significantly affect a contract's settlement amount (for example, adjustments related to the entity's stock price volatility that contain a leverage factor)
- Variables that changed or events that occurred during the period which significantly affected the settlement amount, and what caused the change (for example, a warrant's exercise price was reduced because of a financing event or a change in control)

The disclosures are intended to provide investors with greater transparency into the terms and features of contracts classified in equity under the proposed guidance.

WHEN WOULD THE CHANGES BE EFFECTIVE?

The following table summarizes transition for the Proposed ASU:

PROVISION	GUIDANCE
Effective date	To be determined after the FASB considers stakeholders' feedback.
Early adoption	To be determined after the FASB considers stakeholders' feedback.
Transition	Applied on a modified prospective basis to: ▶ New contracts entered into on or after adoption ▶ Contracts outstanding at adoption Guidance for contracts outstanding at adoption: ▶ Asset- or liability-classified instruments and qualifying bifurcated embedded features that would be reclassified to equity would be marked to fair value immediately before reclassification. Previously recognized gains and losses would not be reversed, and a previously bifurcated embedded feature would not be recombined with its host contract.
Transition disclosures	▶ The nature of and reason for the change in accounting principle ▶ Any amounts reclassified from assets or liabilities to equity upon adoption

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Link to **Proposed ASU**.

The proposed ASU is not authoritative and may change before a final ASU is issued. Entities must continue to apply existing U.S. GAAP while monitoring the FASB's standard-setting activities. Stakeholders may submit comments to the FASB through January 4, 2027, **here**.

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The experienced professionals in BDO's Accounting Advisory practice can help navigate the complexities of applying U.S. GAAP and adopting new accounting guidance.

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