Price Protection in Financing Transactions May Trigger Fair Value Accounting

By Rick Martin

With tight credit markets making “down rounds” more prevalent, issuers of securities need to pay close attention to how they account for derivatives that may be buried within a securities offering. Many well-known companies have restated their financial statements—some for multiple reporting periods—due to improper accounting for derivatives, including General Electric, Bank of America, Ford Motor Company, AIG, Fannie Mae, and Freddie Mac.

The issue arises from price protection provisions that are often embedded in securities offerings. Price protection—also referred to as antidilution, price reset, or down-round protection—is designed to shield investors from the dilutive effects of subsequent securities offerings, and is increasingly used when credit conditions tighten and stock prices decline.

If a company issues securities with price reset protection, it may not only need to account for the effects of that protection as a liability instead of equity, it may also find it has an embedded derivative that must be bifurcated and fair valued through earnings initially and at each reporting period.

Issuers may at first overlook the accounting implications of price reset protection, only to discover during a down round that the impact can be huge. A down round takes place when a company issues securities at a lower price than in a previous offering in order to attract capital. For example, a company that issued preferred shares at $6 a share in 2007 with price protection and then issues similar preferred shares at $5 a share in 2010 would have to reset the price of the preferred shares to $5 a share and treat the fair value of the price protection as a derivative liability. For companies that have properly accounted for antidilution protection since inception, this represents business as usual. But for companies that have not, the down round may reveal a derivative liability.

How can companies identify price protection features, and how should they be treated for accounting purposes?

Under Accounting Standards Codification (ASC) Topics 815-40 and 815-10 (EITF 07-5, Determining Whether an Instrument [or an Embedded Feature] Is Indexed to an Entity’s Own Stock), companies must account for this obligation when price protection is initially granted, not when it is applied. ASC 815-40 and 815-10 became effective on January 1, 2009, for most calendar-year companies. It applies to any free-standing financial instrument or embedded feature that has the characteristics of a derivative for the purpose of determining whether it meets a scope exception. If the instrument or feature qualifies for a scope exception, it does not need to be treated as a derivative.

Evaluating Price Protection Features

Reset price protection or antidilution features can be embedded in a variety of securities, including preferred shares, convertible securities, warrants, and rights with warrants. When price protection is applied during a down round, holders of common shares often suffer an amplified dilution effect, as they are the least shielded. Issuers need to evaluate price protection features to determine whether they represent debt or equity and whether they meet the definition of a derivative subject to fair value accounting.

Fair value accounting was on FASB’s agenda throughout 2008, and the application of ASC 820, Fair Value Measurements and Disclosures, to price protection fea-
...the characteristics of a derivative.

- Features may still be deemed to have all of the characteristics of a derivative, but it would still be treated as though it did. For example, a nonpublic company whose shares are not treated as though it did. For example, a nonpublic company whose shares are not readily convertible into cash may issue a security with down-round protection, but net settlement is not permitted. Even without net settlement, the instrument or feature may still be deemed to have all of the characteristics of a derivative.

- If the instrument or feature is deemed to have characteristics of a derivative, it may qualify for a scope exception according to the provisions of ASC 815, Derivatives and Hedging. Whether the item meets the definition of a derivative or not will help determine whether fair value accounting should be applied, as most derivatives are required to be marked-to-market through earnings unless they qualify for hedge accounting.

In some situations, the instrument or feature may not possess all of the characteristics of a derivative, but it would still be treated as though it did. For example, a nonpublic company whose shares are not readily convertible into cash may issue a security with down-round protection, but net settlement is not permitted. Even without net settlement, the instrument or feature may still be deemed to have all of the characteristics of a derivative.

- If the instrument or feature is deemed to have characteristics of a derivative, it may qualify for a scope exception according to the provisions of ASC 815-40 and 815-10, depending upon whether it is indexed to the issuer’s stock. ASC 815-40 and 815-10 established a two-step method for evaluating whether equity-linked financial instruments or embedded features are indexed to the company’s stock. The first step includes an evaluation of any contingent exercise provisions and usually presents no serious challenges. The second step, however, includes an evaluation of settlement provisions and can trigger derivative liability accounting.

An instrument or embedded feature can be considered to be indexed to a company’s own stock only if the settlement provides that the company will receive or deliver a fixed number of its own equity instruments in exchange for a fixed amount of cash or other financial assets. Generally speaking, unless the strike price or number of shares used to determine settlement is fixed, antidilution protection provisions would not be considered to be indexed for the purposes described above.

The following are examples of price protections that should be carefully evaluated for balance sheet classification, bifurcation as an embedded derivative, and the application of fair value accounting.

**Sample Legal Language**

**Conversion option.** If ABC Company, at any time while any of the securities are outstanding, issues or sells 1) any common stock at a price per share that is less than the applicable conversion price then in effect or 2) any common stock equivalents that entitle the holder to subscribe for, purchase, or exercise a conversion or exchange right for shares of common stock at a price that is less than the applicable conversion price then in effect, the applicable conversion rate then in effect shall be adjusted to equal the adjusted conversion rate.

**Warrant 1.** If ABC Company shall issue, or be deemed to issue, any additional shares of common stock other than excluded stock for a consideration per share less than $X (excluding subdivisions, stock dividends, combinations, reclassifications, and reorganizations that are specified herein), the warrant price shall be reduced concomitantly with each such issuance to the price per share for which such additional shares of common stock were issued.

**Warrant 2.** If, at any time while the warrant is outstanding, ABC Company issues common shares, rights, warrants, or securities convertible into common shares that entitle the holder to acquire common shares at an effective price per share that is less than the exercise price in this offering, the exercise price shall be reduced to equal the effective price.

**Treatment**

Warrants with down-round protection may need to be classified as derivative liabilities and measured at fair value initially and on an ongoing basis, with changes in fair value flowing through the income statement. Convertible securities, the embedded conversion option may need to be bifurcated as a derivative and fair valued in the same manner. There are exceptions in which an embedded conversion option featuring down-round protection would not be bifurcated as a derivative. For example, a contingent reduction in conversion price might be considered a contingent beneficial conversion feature under ASC 470-20, Debt (EITFs 98-5 and 00-27).

**Seek Expert Advice**

An evaluation of the deal documents by an accountant experienced in financing transactions should provide the issuer with a good understanding of how any features or provisions embedded within securities offerings should be classified and whether fair value accounting is required.

Opinions of auditors vary on whether the Black-Scholes model is sufficient to comply with ASC 820 because Black-Scholes is a theoretical model and cannot adequately address illiquidity in the underlying security. Private securities often reflect more illiquidity than public securities, and funds raised in private placements exceeded funds raised by public offerings in both 2008 and 2009, according to PrivateRaise, a research and data provider. If fair value accounting is applied, an independent valuation services firm with experience in bifurcating embedded derivatives should be engaged to determine initial and ongoing fair values.

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