FASB Clarifies the Accounting Treatment for Warrant Modifications

The FASB issued ASU 2021-04[1] ("Update") to clarify the accounting by issuers for modifications or exchanges of equity-classified warrants. The new ASU is available here and effective for all entities in fiscal years starting after December 15, 2021. Early adoption is permitted.

Background

There has been diversity in accounting for modifications of equity-classified warrants due to a lack of explicit guidance in the Codification. For example, one entity may recognize an expense, while another may record a dividend for an economically similar warrant modification. The FASB issued the ASU to reduce this diversity and establish a principles-based recognition framework according to the substance of the modification transaction.

The framework applies to freestanding written call options, such as warrants, that were and remain equity classified by the issuer after the modification and are not in the scope of another Codification Topic. For example, the framework does not apply to warrants that are modified to compensate for goods or services within the scope of ASC 718[2]. The framework applies regardless of whether the modification is through an amendment to the existing terms or issuance of a replacement warrant.

Main Provisions

The effect of the modification of the warrant is measured as the difference in its fair value immediately before and after the modification.

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[1] Earnings Per Share (ASC 260), Debt— Modifications and Extinguishments (Subtopic 470-50), Compensation—Stock Compensation (ASC 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

[2] ASC 718, Compensation—Stock Compensation

The effect is recognized in the same manner as if cash had been paid as consideration, as follows:

Related Event	Recognition
Financing transaction to raise equity	Increase in fair value is recognized as an equity issuance cost
Financing transaction to raise debt	Increase in fair value is recognized as a debt issue cost
Multiple-element transaction (e.g., both equity and debt financing)	Allocate the total effect to the respective elements in the transaction
Modification of debt – warrant held by a creditor	The increase or decrease in fair value is accounted for as debt fees between the debtor and the creditor
Modification of debt – warrant held by third-party	The increase (but not a decrease) in fair value is accounted for as third-party issue costs
Modification of debt – evaluating a troubled debt restructuring (TDR) or whether the debt is modified or extinguished for accounting purposes	The increase or decrease in fair value of creditor warrants is included in determining the effective borrowing rate of the restructured debt for assessing whether a concession has been granted under the TDR guidance and in applying the 10% cash flow test under the debt modification guidance
Other modifications (unrelated to equity or debt financings, or other exchange transactions not within the scope of another Topic)	Increase in fair value is recognized as a dividend. If EPS is presented, the dividend would be an adjustment to net income or loss in computing basic EPS

Additionally, other modifications may need to be accounted for as a cost to the issuing entity based on the substance of the transaction, rather than as a dividend, for example, a modification related to an agreement by the warrant holder to abandon certain acquisition plans, forgo other planned transactions, settle litigation, settle employment contracts, or restrict share purchases.[3]

Disclosures

The Update requires incremental disclosures related to information about the nature and effect of the modification and how it is recognized in the financial statements.

[3] See paragraph BC19 of ASU 2021-04

Effective Dates and Transition

The Update is effective prospectively for fiscal years beginning after December 15, 2021 including interim periods therein, with early adoption permitted. If an entity early adopts in an interim period, the Update will be effective as of the beginning of the fiscal year of adoption.

The Update requires transition disclosures of the nature of and reasons for the accounting change, the transition method, and a qualitative description of the financial statement line items affected.