Statutory Accounting Principles (E) Working Group

**Maintenance Agenda Submission Form**

**Form A**

**Issue:** *ASU 2017-11 - Financial Instruments with Down Round Features*

**Check (applicable entity):**

 P/C Life Health

Modification of existing SSAP [x]  [x]  [x]

New Issue or SSAP [ ]  [ ]  [ ]

Interpretation [ ]  [ ]  [ ]

Description of Issue: *ASU 2017-11, Accounting for Certain Financial Instruments with Down Round Features; Replacement of the Indefinite Deferral for Mandatorily Redeemable Financial Instruments of Certain Noncontrolling Interests with a Scope Exception* to address issues identified with applying U.S. GAAP for certain financial instruments with characteristics of liabilities and equity. The purpose of this agenda item is to review ASU 2017-11 and to consider statutory accounting guidance on distinguishing liabilities from equity.

This ASU addresses the complexity of accounting for certain freestanding financial instruments (or embedded features such as a conversion option) with *down round* features. A down round feature is a provision in certain financial instruments (most often warrants or convertible instruments) that allows for the reduction in the strike price of the financial instrument if the issuer sells additional shares of common stock for an amount less than the financial instrument’s stated strike price, or if the issuer issues another equity-linked instrument with a strike price below the current strike price of the original financial instrument. Down (financing) rounds typically occur when additional capital is required, but the company’s valuation is now lower than it was in an earlier stock offering. Financial instruments with down round features help protect the holder from declines in the issuer’s share price because if a company issues additional equity shares at a lower price than had been previously sold, the holder is allowed to exercise its purchase option at a lower strike price than was originally stated on the financial instrument.

Existing U.S. GAAP for financial instruments with down round features requires fair value measurement of the entire instrument or conversion option. Stakeholders asserted that accounting for freestanding and embedded instruments with down round features as liabilities, subject to fair value measurement, created a reporting burden and associated income statement volatility due to changes in an entity’s share price. Stakeholders also suggested that this accounting may not reflect the economics of the down round feature, which exist to protect certain investors from declines in the issuer’s share price. With the current accounting guidance, changes in fair value of an instrument with a down round feature are recognized in earnings for both increases and decreases in share price. However, down round features are only likely to be exercised in the event the share price decreases and the issuer engages in a subsequent equity offering.

Prior to this ASU’s issuance under U.S. GAAP, a free-standing financial instrument or embedded feature was not considered indexed to the issuer’s stock if it has a down round feature. Thus, the instrument was classified as a liability and if it meets the definition of a derivative, it must be measured at fair value with changes recorded through current period earnings. ASU 2017-11 changes the guidance in that a down round feature shall no longer be considered when determining whether the instrument is indexed to a company’s stock. As a result of the ASU, if the instrument is now deemed to be indexed and settled in company stock, a free-standing or embedded equity-linked financial instrument will be classified as equity and the embedded feature that was originally bifurcated and accounted for as a derivative may qualify for scope exception to also be treated as equity.

Revisions in ASU 2017-11 also include earning per share (EPS) guidance detailing that the effect of exercising a down round feature shall be treated as a dividend to reduce the income available to common shareholders for computing and reporting basic EPS. Recognition of the value of the down round feature is calculated when triggered and is measured as the difference between the fair value of the instrument (without regarding the down round feature) of the pre-trigger exercise price and the fair value of the instrument (again, without regarding the down round feature) using the reduced and executed exercise price.

Existing Authoritative Literature:

1. Earnings per share – Rejected as Not Applicable for Statutory Accounting:

The concept of earnings per share (Topic 260) has previously been reviewed with the following U.S. GAAP standards rejected as not applicable in *Appendix D—Nonapplicable GAAP Pronouncements:*

* *FASB Statement No. 128, Earnings per Share* (FAS 128)
* *EITF 07-04, Application of the Two-Class Method under FASB Statement No. 128 to Master Limited Partnerships*
1. Distinguishing Liabilities from Equity / Derivatives and Hedging:

With ASU 2017-11, entities will no longer consider a down round feature when determining whether a freestanding financial instrument is indexed to an entity’s stock. Consequently, upon adoption, these instruments which are currently being reported as a liability may be reclassified as equity. Additionally, fewer embedded features will likely have to be bifurcated and accounted for as a derivative and may qualify for scope exemption to be treated as equity.

NAIC staff believes the spirit of freestanding down round features represents a quantifiable liability of the issuing company and should remain accounted for as a liability and not as equity. Down round features embedded in derivatives would not be separated from the host contract pursuant to *SSAP No. 86—Derivatives*.

As detailed below, the down round feature satisfies the definition of a liability and recognition as a liability would be consistent with existing guidance for share-based payments.

*SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets*, defines a liability with excerpts below:

1. A liability is defined as certain or probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or to provide services to other entities in the future as a result of a past transaction(s) or event(s).
2. A liability has three essential characteristics: (a) it embodies a present duty or responsibility to one or more other entities that entails settlement by probable future transfer or use of assets at a specified or determinable date, on **occurrence of a specified event**, or on demand, (b) **the duty or responsibility obligates a particular entity, leaving it little or no discretion to avoid the future sacrifice, and (c) the transaction or other event obligating the entity has already happened.** This includes, but is not limited to, liabilities arising from policyholder obligations (e.g., policyholder benefits, reported claims and reserves for incurred but not reported claims). Liabilities shall be recorded on a reporting entity’s financial statements when incurred.

*SSAP No. 104R—Share-Based Payments, Exhibit A – Classification Criteria: Liability or Equity*, details circumstances under which certain financial instruments are to be identified as liabilities. While this guidance is limited to share-based payments, the overall accounting concepts are applicable in these situations. Specifically, Exhibit A, paragraph 7, supports recognition as a liability as the company is obligated to sell additional common stock for an amount *less* than the originally stated strike price as both circumstances require a unilateral outflow of assets or equity. The liability associated with a down round feature, although settled with the issuance of additional shares (without the receipt of assets), will adversely affect the economic interests of current equity shareholders by diluting ownership. Additionally, paragraph 10 broadly indicates instruments that obligate the issuer to transfer assets are to be reported as liabilities.

**Excerpts from SSAP No. 104R, Exhibit A:**

Mandatorily Redeemable Financial Instruments

1. A mandatorily redeemable financial instrument shall be classified as a liability unless the redemption is required to occur only upon the liquidation or termination of the reporting entity.
2. A [financial instrument](http://asc.fasb.org/glossarysection%26trid%3D2175798%26id%3DSL2268724-110875) that embodies a conditional obligation to redeem the instrument by [transferring](http://asc.fasb.org/glossarysection%26trid%3D2175798%26id%3DSL2272196-110875) assets upon an event not certain to occur becomes mandatorily redeemable if that event occurs, the condition is resolved, or the event becomes certain to occur.
3. In determining if an instrument is mandatorily redeemable, all terms within a redeemable instrument shall be considered. The following items do not affect the classification of a mandatorily redeemable financial instrument as a liability:
	1. A term extension option
	2. A provision that defers redemption until a specified liquidity level is reached
	3. A similar provision that may delay or accelerate the timing of a mandatory redemption.
4. If a financial instrument will be redeemed only upon the occurrence of a conditional event, redemption of that instrument is conditional and, therefore, the instrument does not meet the definition of mandatorily redeemable financial instrument in this statement. However, that financial instrument would be assessed at each reporting period to determine whether circumstances have changed such that the instrument now meets the definition of a mandatorily redeemable instrument (that is, the event is no longer conditional). If the event has occurred, the condition is resolved, or the event has become certain to occur, the financial instrument is reclassified as a liability.

Obligations to Repurchase Issuer’s Equity Shares by Transferring Assets

1. **An entity shall classify as a liability (or an asset in some circumstances) any financial instrument, other than an outstanding share, that, at inception, has both of the following characteristics:**
	1. **It embodies an** [**obligation**](http://asc.fasb.org/glossarysection%26trid%3D2175798%26id%3DSL2272201-110875) **to repurchase the** [**issuer’s equity shares**](http://asc.fasb.org/glossarysection%26trid%3D2175798%26id%3DSL2272207-110875), or is indexed to such an obligation, and
	2. **It requires or may require the** [**issuer**](http://asc.fasb.org/glossarysection%26trid%3D2175798%26id%3DSL2272211-110875) **to settle the obligation by transferring assets.**
2. In this statement, “indexed to” is used interchangeably with “based on variations in the [fair value](http://asc.fasb.org/glossarysection%26trid%3D2175798%26id%3DSL2268666-110875) of.” The phrase “requires or may require” encompasses instruments that either conditionally or unconditionally obligate the issuer to [transfer](http://asc.fasb.org/glossarysection%26trid%3D2175798%26id%3DSL2267936-110875) assets. If the obligation is conditional, the number of conditions leading up to the transfer of assets is irrelevant.
3. Examples of financial instruments that meet the criteria in paragraph 7 of this Exhibit include forward purchase contracts or written put options on the issuer’s equity shares that are to be physically settled or net cash settled.
4. **All obligations that permit the holder to require the issuer to transfer assets result in liabilities, regardless of whether the settlement alternatives have the potential to differ.**

As noted in SSAP No. 86, paragraph 16, down round features embedded in derivative contracts (such as a warrant) would not be separated from the host contract. Such features would impact the fair value accounting for derivatives (assuming fair value accounting is followed) in recognizing the derivative asset or derivative liability. Recognizing freestanding down round features as a liability (and not as equity) would be consistent with the impact of such features embedded in a derivative contract.

*SSAP No. 86—Derivatives*

1. Contracts that do not in their entirety meet the definition of a derivative instrument, such as bonds, insurance policies, and leases, may contain “embedded” derivative instruments—implicit or explicit terms that affect some or all of the cash flows or the value of other exchanges required by the contract in a manner similar to a derivative instrument. The effect of embedding a derivative instrument in another type of contract (“the host contract”) is that some or all of the cash flows or other exchanges that otherwise would be required by the contract, whether unconditional or contingent upon the occurrence of a specified event, will be modified based on one or more underlyings. An embedded derivative instrument shall not be separated from the host contract and accounted for separately as a derivative instrument.

Activity to Date (issues previously addressed by the Working Group, Emerging Accounting Issues (E) Working Group, SEC, FASB, other State Departments of Insurance or other NAIC groups): None

**Information or issues (included in *Description of Issue*) not previously contemplated by the Working Group: None**

**Convergence with International Financial Reporting Standards (IFRS):***IAS 32 – Financial Instruments* outlines the accounting requirements for the presentation of certain financial instruments, particularly as to the classifications into assets, liabilities, or equity. The fundamental principle of IAS 32 is that a financial instrument should be classified as either a financial liability or as an equity instrument according to the substance of the contract, not its legal form. IAS 32.20 states a contractual right or obligation to receive or deliver a number of its own shares or other equity instruments that varies so that the fair value of the entity’s own equity instruments to be received or delivered equals the fixed monetary amount of the contractual right or obligation is a financial liability.

Staff Recommendation: NAIC staff recommends the Working Group move this item to the active listing, categorized as nonsubstantive, and expose revisions to SSAP No. 86 to reject ASU 2017-11(Topics 480 & 815) and expose revisions to SSAP No. 5R and SSAP No. 72 to incorporate guidance on when certain freestanding instruments shall be recognized as liabilities and not equity.

1. Proposed Revisions to SSAP No. 86—Derivatives:
2. This statement adopts with modification revisions to ASC 815 as reflected within *ASU 2016-05, Effect of Derivative Contract Novations on Existing Hedge Accounting Relationships*. This guidance is modified to require prospective application, as such it is only applicable to future counterparty changes in derivative instruments, and this guidance cannot be used to adjust derivative transactions previously terminated. This statement adopts revisions to ASC 815-20-25-15 as reflected within *ASU 2010-08, Technical Corrections to Various Topics*. This statement adopts revisions to ASC 815-10-50-4K as reflected within *ASU 2010-11, Derivatives and Hedging (Topic 815), Scope Exception Related to Embedded Credit Derivatives.*
	1. *This statement*  rejects all other GAAP revisions from ASU 2010-11 and *ASU 2014-16, Derivatives and Hedging, Determining Whether the Host Contract in a Hybrid Financial Instrument Issued in the Form of a Share is More Akin to Debt or to Equity* and *ASU 2016-06, Derivatives and Hedging, Contingent Put and Call Options in Debt Instruments*. These GAAP revisions are rejected as embedded derivatives are not separated from the host contract and recognized as derivatives under SSAP No. 86. Revisions are also incorporated to SSAP No. 86 to require disclosures on embedded credit derivatives that expose the holder of a financial instrument to the possibility of being required to make future payments. This disclosure is a modification to the GAAP disclosures specific to statutory accounting as embedded credit derivatives are not separately recognized under statutory accounting.
	2. This statement rejects *ASU 2017-11, Accounting for Certain Financial Instruments with Down Round Features; Replacement of the Indefinite Deferral for Mandatorily Redeemable Financial Instruments of Certain Noncontrolling Interests with a Scope Exception*.
3. It should be noted that the conclusions reached in this statement are not intended to usurp the rules and regulations put forth by states in their respective investment laws. The contents of this statement are intended to provide accounting guidance on the use of derivatives as allowed by an insurer’s state of domicile. It is not intended to imply that insurers may use derivatives or cash instruments that the insurer’s state of domicile does not allow under the state’s insurance regulatory requirements, e.g., in replication transactions.
4. Proposed Revisions to SSAP No. 5R—Liabilities, Contingencies and Impairments of Assets:

Although NAIC previously believed that instruments with both characteristics of debt and equity were not commonly issued by insurance entities, NAIC Staff has recently received a state query focused on this issue. NAIC staff recommends introducing key concepts from *ASC Topic 480, Distinguishing Liabilities from Equity, Subsection 25,* (which are materially identified in *SSAP No. 104R—Share-Based Payments*) into SSAP No. 5R.

*SSAP No. 5R—Liabilities, Contingencies and Impairment of Assets.*

Financial Instruments with Characteristics of both Liabilities and Equity

1. Issued, free-standing financial instruments with characteristics of both liability and equity shall be reported as a liability to the extent the instruments embodies an unconditional obligation of the issuer. (Pursuant to SSAP No. 86, embedded features in derivative contracts shall not be separated from the host contract for separate recognition.) Free-standing financial instruments that meet any of the criteria below meet the definition of a liability:
	1. A mandatorily redeemable financial instrument shall be classified as a liability unless the redemption is required to occur only upon the liquidation or termination of the issuing reporting entity.
	2. A financial instrument, other than an outstanding share, that at inception both 1) embodies an obligation to repurchase the issuer’s equity shares or is indexed to such an obligation and 2) requires or may require the issuer to settle the obligation by transferring assets.
	3. Obligations that permit the holder to require the issuer to transfer assets.
	4. A financial instrument is a liability if the issuer must settle the obligation by issuing a variable number of its equity shares and the obligation’s monetary value is based solely or predominantly on: 1) a fixed monetary amount, 2) variation in something other than the fair value of the issuer’s equity shares, or 3) variations inversely related to changes in the fair value of the issuer’s equity shares.
	5. Instruments in which the counterparty (holder) is not exposed to the risks and benefits that are similar to those of a holder of an outstanding share of the entity’s equity shall be classified as a liability.
2. If a free-standing financial instrument will be redeemed only upon the occurrence of a conditional event, redemption of that instrument is conditional and, therefore, the instrument does not meet the definition of mandatorily redeemable financial instrument. However, that financial instrument shall be assessed each reporting period to determine whether circumstances have changed such that the instrument meets the definition of a mandatorily redeemable instrument (that is, the event is no longer conditional). If the event has occurred, the condition is resolved, or the event has become certain to occur, the financial instrument shall be reclassified as a liability.
3. The classification of a free-standing financial instrument as a liability or equity shall only apply to the instrument issuer. Holders or purchasers of such instruments shall refer to the appropriate investment statement for valuation and reporting.

For brevity, the remaining paragraphs for SSAP No. 5R have been omitted but will be renumbered accordingly.

1. Proposed Revisions to SSAP No. 72—Surplus and Quasi-Reorganizations:

While proposed key concepts from *ASC Topic 480* are detailed in SSAP No. 5R, additional reference language for the statutory accounting of capital stock is detailed below.

*SSAP No. 72—Surplus and Quasi-Reorganizations*

### Capital Stock

The articles of incorporation set forth the number of authorized shares of capital stock and the par value of each share. The capital stock account represents the number of shares issued times the par value of each share. When no par value is set forth, the reporting entity shall declare a “stated value” and record such amount in the capital stock account. Changes in the par value of a reporting entity’s capital stock shall be reflected as a reclassification between the capital stock account and gross paid-in and contributed surplus. Issued, free-standing financial instruments with characteristics of both liability and equity shall be reported as a liability to the extent described in SSAP No. 5R.

Staff Review Completed by: Jim Pinegar – October 2019

Status:

On December 7, 2019, the Statutory Accounting Principles (E) Working Group moved this agenda item to the active listing, categorized as nonsubstantive, and exposed revisions, as illustrated above, to *SSAP No. 86—Derivatives* to reject *ASU 2017-11, Earning Per Share, Distinguishing Liabilities from Equity, Derivatives & Hedging* and incorporate guidance into *SSAP No. 5R—Liabilities, Contingencies and Impairment of Assets* and *SSAP No. 72—Surplus and Quasi-Reorganizations* for when certain freestanding instruments shall be recognized as liabilities and not equity.

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