Accounting for share warrants

This article aims to:

Highlight the principles of Ind AS that would affect the classification of share warrants.

Introduction

Share warrants are instruments that give the holder a right, but not an obligation, to purchase the entity's shares at specified price (generally at discounted prices) and date. Warrants are often issued to the investors investing in start-ups, the lenders in a debt arrangement or the private equity investor(s) to provide them with specific rights. For example, warrants issued to investors to enable them to purchase additional shares in future at discounted/fixed prices thereby providing additional value to the holder of these warrants. In certain cases, these warrants are conditional and get triggered based on specific conditions in future (example Initial Public Offer (IPO), Qualified Institutional Placement (QIP), purchase of shares by a new investor, existing investor or occurrence of other liquidity event that could be mentioned in the share purchase agreement) which are generally outlined in the initial investment agreement between the company and the investor. Based on the terms, these are either classified as equity or debt instruments in line with the requirements of Indian Accounting Standard (Ind AS) 32, *Financial Instruments: Presentation*. The classification of the warrants into equity or liability is generally not straight forward and requires significant judgement e.g. when warrants are attached to existing debt or equity shares.

In this article, we aim to illustrate some of the practical application issues with respect to the classification of warrants and the valuation of such instruments.

Is warrant an equity or a liability?

Classification of a warrant either as liability or equity determines accounting of these instruments. This would in turn significantly affect an entity's balance sheet, including significant accounting ratios particularly when these instruments are liability classified.

There are various considerations which need to be evaluated when determining the classification of the warrants, including the substance of the contractual arrangement. A careful analysis is required for all the terms and conditions attached to the warrants as these terms will affect the initial and the subsequent measurement of these instruments.

Figure 1, on the next page, summarises the concept of a financial liability and equity.

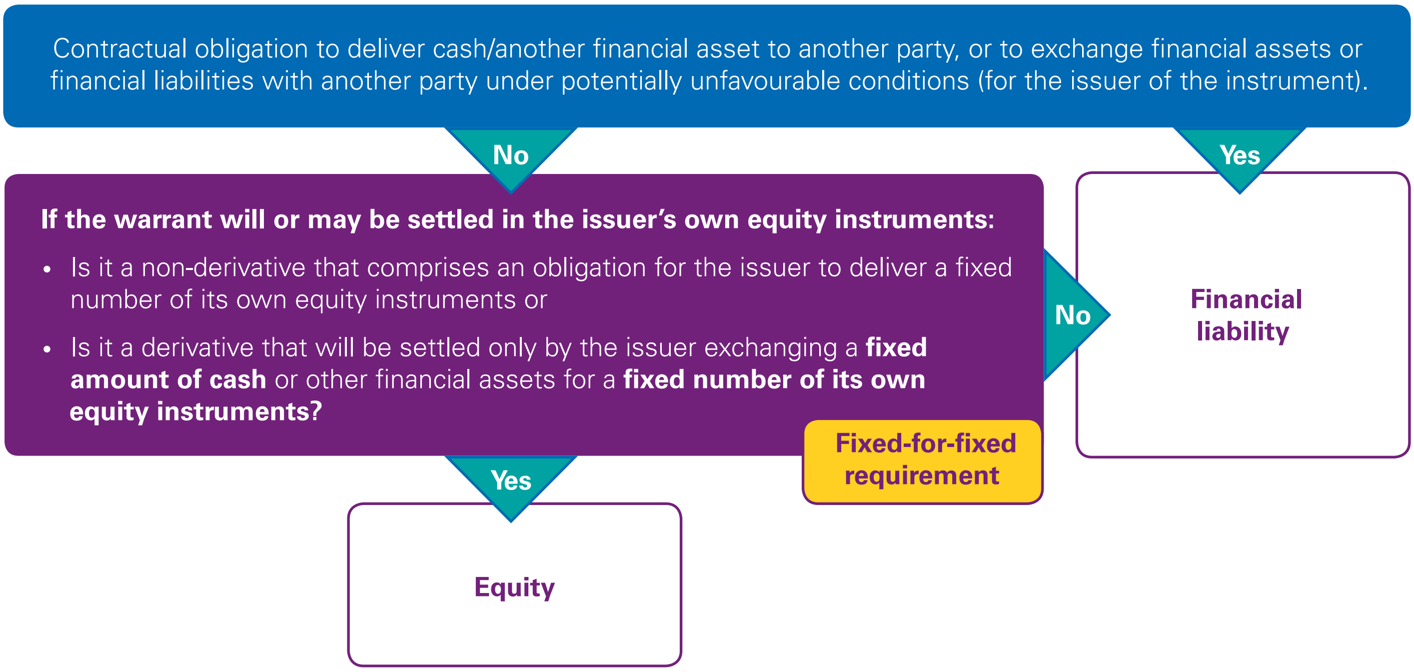
Figure 1: Identifying financial liabilities and equity

Source: KPMG in India's analysis, 2018

Generally, a warrant would not create any obligation to deliver cash, instead, it would be settled by the issuer company by issuing additional shares of the company. Therefore, one may say that warrants would be classified as 'equity' and not a 'financial liability'. However, in practice, other facts and circumstances could add complexities, for example, the number of shares issued against a warrant are not fixed, but variable, the warrants may be issued with other conditions, warrants not being issued at a fair value, etc.

Figure 2 summarises the classification of financial instruments as debt or equity instruments.

Figure 2: Classification of financial instruments into financial liability and equity



Source: KPMG in India's analysis, 2018

The following examples will clarify the concept explained in Figure 2:

a. Company A issues share warrants to the investor B. The share warrants give the investor rights to convert the warrants into a fixed number of equity shares for fixed amount in its functional currency. Whether the instrument meets the fixed for fixed criteria?

   In example a, the warrants will be classified in their entirety as equity instruments since the 'fixed-for-fixed' criteria has been met.

b. Will the classification of the instrument change if in the above example the fixed amount is denominated in foreign currency instead of the functional currency?

   In example b, though the warrant is denominated in a foreign currency, it would not affect its classification, this is because Ind AS 32 has a specific exception in the definition of a financial liability based on which exchange of a fixed number of shares in any currency will enable the financial instrument to be classified as equity.[1]

c. Continuing with the example 'a' above if investor B, instead of having the option to convert the fixed number of equity shares, is entitled to a fixed percentage of company A's issued and outstanding shares. Will the fixed-for-fixed criteria be met?

   In example c, the fixed-for-fixed criteria will not be met since the number of equity shares to be received upon conversion will vary when there are changes in the number of outstanding shares of A.

Practical issues

Change in conversion ratio - Impact of anti-dilution features

Often the warrant agreements have clauses to protect the right of the holder of the instrument from the possible impact of dilution caused due to issue of bonus, share splits, etc. As a general rule, if the number of warrants that are issued upon exercise is variable, it would be classified as a financial liability. However, it is to be noted that if the effect of proportionate adjustment in these circumstances is to preserve the rights of the warrant-holders to other equity holders then it would not preclude equity classification. However, if the effect of adjustment is to increase the conversion ratio if the share price of the company declines or new shares are issued at a lower price (anti-dilution), it would indicate that it is like underwriting the value of the conversion option. This only favours the existing warrant holders at the cost of the other shareholders. Therefore, in those situation, any anti-dilution clause which in substance compensates the holder for the fair value losses fails the fixed-for-fixed criteria and accordingly would be classified as liability.

Contingent settlement provisions

Sometimes the warrants can be exercised by the investor only on the occurrence of certain contingent events as specified in the agreement. The occurrence or non-occurrence of these events are outside the control of the entity and the holder of the instrument.

If the issuer of a warrant is able to control the outcome of an event that would otherwise trigger a payment obligation, i.e. it is able to avoid payment, then no liability arises. Conversely, if the holder can control the outcome, the holder is effectively able to demand payment and the instrument is classified as a liability.

However, there could be situations when neither party controls the 'event'. Examples of such uncertain events are changes in stock market index, interest rate, taxation requirements or the issuer's future revenues or debt-to-equity ratio.

The classification of warrants in such cases generally is liability, subject to the following exceptions:

i. The part of the contingent settlement provision that could require settlement in cash or another financial asset is not genuine; or

ii. The issuer can be required to settle in cash or another financial asset only in the event of its own liquidation (as long as liquidation is neither predetermined nor at the option of the holder).

The following examples clarify the concepts discussed above:

a. Company A issues warrants to investor B. The warrants issued can be exercised by B only on the happening of a specific liquidity event such as IPO/QIP which is planned for in three years' time and requires the approval of a regulator. The warrants are redeemable in cash only if the IPO/QIP does not take place within three years.

   In example a, the company does not have an unconditional right to avoid the payment as the warrants can be redeemed in cash if the IPO/QIP does not happen as planned. The happening of IPO/QIP is beyond the control of the company.

   The answer does not change even if the likelihood of IPO/QIP not happening or company settling the instrument in cash is remote.

b. If in example a, company A can convert the warrants into fixed number of equity instruments any time after three years or company can redeem the warrant in cash only on the happening of IPO/QIP and no time is stipulated for such IPO/QIP. Will the classification change?

   In example b, the issuer would have the unconditional ability to avoid the obligation if it can decide whether to launch an IPO or not. Also in case IPO does not happen the holder is only left with an option to convert the warrants into equity which meets the fixed-for-fixed criterion.

1. The classification of the warrant would vary under International Accounting Standard (IAS) 32, Financial Instruments: Presentation. As per IAS 32, an obligation denominated in a foreign currency represents a variable amount of cash in functional currency and accordingly, the instrument is to be classified as a liability.

Other aspects

Undertaking from the holder that the warrants will not be called for settlement in cash

In many cases, entities may consider that some of the features of the instrument are protective in nature and investor may not exercise some of the rights particularly related to redemption in cash. They may obtain a letter of undertaking from the holder of warrants indicating that the issued warrants would not be redeemed in cash. Such an undertaking, unless it is legally enforceable and irrevocable, is not sufficient to classify the instrument as equity rather than as a financial liability.

For example, assume that the holder of warrant has signed such a letter of undertaking but is able to sell the instrument. Furthermore, assume that the subsequent purchaser would not be restricted by the letter of undertaking that was signed by the seller. In this scenario, the instrument would be classified as a financial liability.

Consider this...

Under Indian GAAP, typically, such warrants would be accounted for only when the warrants are finally exercised and converted into shares. However, with companies transitioning to Ind AS/IFRS, these instruments could impact the balance sheet of the investee companies as some of these instruments would get classified as a liability. In particular, accounting for warrants issued as part of private equity financing transaction/arrangements could become challenging and would depend on the contractual terms. Entities involved in such transactions would need to re-assess their instruments and understand the various terms and conditions, rights and obligations and assess if there is a change in the classification of such warrants from equity under Indian GAAP to a financial liability under Ind AS or IFRS.