Today’s CPA did not print this illustration but is available online.

Illustration

A debtor issues 10 puttable warrants to a holder in conjunction with a two-year $1,000 debt instrument. The put feature allows the holder to surrender the warrants to the issuer at any time prior to the maturity of the debt to acquire 1 common share for any single warrant outstanding (10 common shares in this example) at a strike price of $10. The feature allows the holder to put the acquired shares back to the issuer for $13 and demand physical settlement in cash.

The warrants for puttable shares conditionally obligate the issuer to transfer assets since the holder must exercise the warrants and put them to the issuer for cash or other assets.
In this example, the holder exercises the option if and only if the market price of the share is $13 or higher. If the market price is lower than $13, the holder may not take any action and permit the warrants to expire. This feature does not prohibit classification of warrants as equity.

The bond instrument and warrants are issued concurrently and in contemplation with each other; however, the contract permits the separation of the two since the holder can exercise the warrants independent of the debt instrument. Therefore, the puttable warrants in this example are detachable (freestanding).

The warrants are redeemable by the holder (a puttable warrant) or by contract (maturity of instrument). However, they are not mandatory redeemable since the issuer cannot force the holder to exercise the warrants (ASC 470-20-05-3). (The holder can let the warrants expire by not taking any action.)

Equity classification guidance generally requires that an issuer with an equity contract indexed to its stock should classify the warrants as equity when it has either a physical or net share settlement option. In this illustration, the contract requires physical or net share settlement.

Therefore, these transactions permit equity classification of awards—assuming that the transaction meets the criteria in ASC 815-40-25-1 through 25-43 and ASC 815-40-55-2 through 55-18, and ASC 815-40-25-7 through 25-8.

The following additional information is available: At the outset, the fair value of the two-year bond is $900, and the fair value of the warrants is $100. The fair value of warrants is $120 and $150, at the end of Year 1 and Year 2, respectively. The bond’s interest rate is 4% payable annually in arrears at the end of each year.

In this illustration, since the market price of the warrant is $15 (greater than $13), the holder puts the acquired shares back to the issuer for $13 and demand physical settlement in cash.

Initial Journal Entries

Cash	$1,000	
Bonds		$900
Discount		$100
Warrants	$100	
APIC		$100

Year 1 Journal Entries

Interest	$40	
Cash		$40

Since the debtor has classified the warrants as equity, it does not adjust fair value of warrants.

Year 2 Journal Entries

Interest	$40	
Cash		$40
Bonds	$900	
Discount	$100	
Cash		$1,000
APIC	$100	
Warrants		$100
Earnings	$30	
Cash		$30

However, if the condition that "the holder exercises the option if and only if the market price of the share is $13 or higher" changes, and the issuer had to pay the holder $3 regardless of market condition, then it had to classify the warrants as liabilities. ASC 480 requires companies to classify put warrants as a liability when they embody an obligation to repurchase the issuer's shares that require the issuer to transfer of assets to settle the obligation (ASC 480-10-25-4).