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Viewpoint

Issuers' accounting for SAFEs

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Introduction

A simple agreement for future equity (SAFE) is a common form of financing for early-stage private companies. Fundamentally, when investing in a SAFE, the investor transfers cash to the issuer in exchange for the issuer's promise to deliver a variable number of shares with a fixed aggregate monetary value to the investor at a later date. In addition, SAFEs typically include other settlement terms triggered by certain events, such as a change in control of the issuer or the issuer's liquidation.

Despite the name, accounting for SAFEs can be anything but simple given the various settlement outcomes typically incorporated into the contractual terms. An issuer of a SAFE must determine whether the instrument should be classified either as a liability or within equity, and in order to reach an appropriate accounting conclusion, an issuer must apply judgment and understand the complex authoritative guidance on accounting for equity-linked contracts.

This Viewpoint covers accounting considerations for issuers of financial instruments with certain characteristics of SAFEs, which are described in Section 1. These instruments are referred to throughout this publication as "SAFEs," although in practice this term is not narrowly defined. This publication does not address an issuer's accounting for financial instruments that are debt or equity shares in legal form, or those that require the issuer to transfer cash or shares to the investor on a fixed or determinable date. This publication also does not address the investor's accounting for a SAFE.

Section 2 addresses the issuer's identification of the "unit of account," which determines the instrument, or part(s) of an instrument, to be evaluated, along with which accounting guidance the issuer should apply to account for the SAFE. This publication addresses an issuer's accounting for a SAFE determined to be a single freestanding financial instrument that is within the scope of either ASC 480 or ASC 815-40; it does not address the accounting for a SAFE-like instrument determined to be a hybrid financial instrument that is evaluated under ASC 815-15 or a derivative embedded within a hybrid financial instrument.

Section 3 summarizes and illustrates the issuer's application of certain guidance in ASC 480 to SAFEs. Specifically, this section addresses how to determine whether a SAFE is required to be accounted for as a liability because it embodies (a) an issuer obligation to repurchase its own shares, or an obligation that is indexed to such an obligation, that requires or may require the issuer to transfer assets, or (b) an issuer obligation that the issuer must or may settle in a variable number of shares whose monetary value is based predominantly on a fixed amount, variations in something other than the fair value of the issuer's shares, or variations inversely related to changes in the fair value of the issuer's shares.

Section 4 summarizes and illustrates the issuer's application of the guidance in ASC 815-40 to SAFEs. Specifically, this section addresses how to determine whether a SAFE that is not classified as a liability under ASC 480 is required to be accounted for as either a liability or within equity by considering whether (a) an exercise contingency precludes equity presentation, (b) a SAFE is indexed to the issuer's own stock, and (c) a SAFE satisfies the equity classification conditions in ASC 815-40-25. This publication does not provide guidance on determining whether a SAFE meets the definition of a derivative in ASC 815-10. From the issuer's perspective, whether a freestanding equity-linked financial instrument meets the definition of a derivative is typically irrelevant in terms of accounting for the instrument, because the guidance in ASC 815-40 must be applied whether the instrument is a derivative or not.

In practice, it is common for an issuer to classify a SAFE as a liability and subsequently measure it at fair value as a result of applying the guidance outlined above. However, issuers should not presume that a SAFE requires liability classification and subsequent measurement at fair value—issuers must apply the applicable guidance step-by-step to determine whether the instrument is appropriately classified as a liability or within equity.

Further, an issuer of a SAFE cannot elect to forgo the accounting analysis described above by preemptively electing the fair value option in ASC 825, because the fair value option is not applicable to financial instruments that are, in whole or in part, classified by the issuer as a component of shareholder's equity. Without first applying the guidance in ASC 480 and ASC 815-40, an issuer cannot determine whether a SAFE is classified as a component of shareholders' equity, and if a SAFE is not classified as a component of shareholders' equity, that means it is required under either ASC 480 or ASC 815-40 to be classified as a liability and subsequently measured at fair value. In other words, the appropriate balance sheet classification for the SAFE must be determined in order to know whether the SAFE is eligible for the fair value option, and, if the SAFE is eligible for the fair value option, then its eligibility is moot because the SAFE must be subsequently measured at fair value regardless.

1. What is a SAFE?

A simple agreement for future equity (SAFE) is an equity-linked financial instrument that some early-stage entities issue to investors in exchange for cash. In practice, SAFEs include a wide variety of provisions, but generally share the following characteristics:

- An up-front cash investment, which may be referred to as the "purchase amount."
- A promise by the issuer that, in connection with a future equity offering, it will transfer a variable number of the class of shares sold in the equity offering to the investor, with the variable number of shares calculated as the quotient of the purchase amount divided by either the price per share in the equity offering or a fixed percentage (often referred to as the "discount rate") of that price per share. To trigger this type of variable-share settlement, the equity offering might have to satisfy certain requirements, such as a minimum amount of capital raised by the issuer.
- A promise by the issuer that, upon certain events like a change in control or an IPO (often referred to collectively as "liquidity events"), it will transfer to the investor cash or a variable number of shares with a monetary value equal to the greater of (1) the purchase amount, or (2) the fair value of a number of shares, calculated as the quotient of the purchase amount divided by a price per share (often referred to as the "liquidity price"). The liquidity price might be specified in many ways, such as a fixed price or a price calculated by dividing either a fixed amount or an implied valuation of the issuer (often referred to as a "valuation cap") by the number of issuer shares outstanding on the liquidity event date (often referred to as the issuer's "capitalization") on a fully or semidiluted basis.
- A promise by the issuer that, upon its dissolution, the issuer will transfer to the investor an amount of cash typically based on the amounts payable to the investor upon a liquidity event if the SAFE remains outstanding.
- A specified liquidation priority in the event of a liquidity event or dissolution.

In this publication, the term "SAFE" refers to a financial instrument that has characteristics consistent with those listed above, and (1) is neither an equity share nor debt in legal form, and (2) does *not* require the issuer to settle the instrument by transferring cash or shares to the investor on a fixed or determinable date.

2. Unit of account

The starting point for determining the accounting for a transaction involving a SAFE is to identify the unit(s) of account.

Unit of Account: The level at which an asset or liability is aggregated or disaggregated in a Topic for recognition purposes.

The unit of account refers to the boundaries within which a particular accounting assessment is carried out. Identifying the unit(s) of account involves determining whether the SAFE is a financial instrument and, if so, whether it is freestanding.

2.1 Financial instruments

For accounting purposes, a SAFE generally meets the definition of a financial instrument, as it is a contract that both (a) imposes on the issuer a contractual obligation to deliver cash or equity to the holder of the instrument, and (b) conveys to the holder a contractual right to receive cash or equity from the issuer. Even though the delivery of either cash or equity may be conditional, a SAFE nevertheless typically meets the criteria specified in the definition of a financial instrument, because the definition specifies that "[c]ontractual rights and contractual obligations encompass both those that are conditioned on the occurrence of a specified event and those that are not."

Financial Instrument: Cash, evidence of an ownership interest in an entity, or a contract that both:

a. Imposes on one entity a contractual obligation either:
   1. To deliver cash or another financial instrument to a second entity
   2. To exchange other financial instruments on potentially unfavorable terms with the second entity.
b. Conveys to that second entity a contractual right either:
   1. To receive cash or another financial instrument from the first entity
   2. To exchange other financial instruments on potentially favorable terms with the first entity.

The use of the term financial instrument in this definition is recursive (because the term financial instrument is included in it), though it is not circular. The definition requires a chain of contractual obligations that ends with the delivery of cash or an ownership interest in an entity. Any number of obligations to deliver financial instruments can be links in a chain that qualifies a particular contract as a financial instrument.

Contractual rights and contractual obligations encompass both those that are conditioned on the occurrence of a specified event and those that are not. All contractual rights (contractual obligations) that are financial instruments meet the definition of asset (liability) set forth in FASB Concepts Statement No. 6, Elements of Financial Statements, although some may not be recognized as assets (liabilities) in financial statements—that is, they may be off-balance-sheet—because they fail to meet some other criterion for recognition.

For some financial instruments, the right is held by or the obligation is due from (or the obligation is owed to or by) a group of entities rather than a single entity.

2.2 Freestanding financial instruments

If a SAFE is a financial instrument, an issuer then considers the definition of a "freestanding financial instrument" in ASC 480.

To be freestanding, a financial instrument must either be (a) entered into separately and apart from an issuer's other financial instruments or equity transactions, or (b) entered into in conjunction with another transaction or instrument(s), and both legally detachable and separately exercisable from the other instrument(s) issued in the transaction.

Freestanding Financial Instrument: A financial instrument that meets either of the following conditions:

a. It is entered into separately and apart from any of the entity's other financial instruments or equity transactions.

b. It is entered into in conjunction with some other transaction and is legally detachable and separately exercisable.

For example, a transaction involving a convertible loan might have a single unit of account consisting of the entire hybrid debt instrument, including the debt host contract and the embedded equity option. The accounting analysis for this transaction would therefore focus initially on the single hybrid financial instrument. Alternatively, a transaction involving a loan and a detachable stock warrant might have at least two units of account: the debt instrument and the warrant. Separate accounting analyses would be required in this case, one for the debt instrument and another for the warrant.

In practice, SAFEs are often issued separately and apart from other financial instruments or equity transactions, such that criterion (a) in the definition of a freestanding financial instrument is met. However, it is possible for an entity to issue a SAFE to an investor as part of a bundled financing transaction that might include the issuance of debt instruments or shares of common or preferred equity. It is possible, but not common, for multiple freestanding financial instruments to be issued together and characterized collectively as a SAFE. Therefore, it is important to identify the freestanding financial instrument(s) before proceeding with an accounting analysis to identify applicable recognition, measurement, and presentation requirements.

U.S. GAAP does not define the terms “legally detachable” or “separately exercisable” in criterion (b) in the definition of a freestanding financial instrument. Generally, an instrument is “legally detachable” if it can be separated from another instrument and freely transferred by the holder to a third party. This is typically a legal determination that depends on the type of instrument and any transfer restrictions. If the instrument may be transferred by the holder but only with the issuer’s consent, it is important to consider whether that consent can be unreasonably withheld by the issuer. Sometimes contracts specify that the rights and obligations may be assigned to a third party, but only with the counterparty’s consent, which may not be unreasonably withheld. If the issuer’s consent may not be unreasonably withheld, the instrument is often viewed as transferable by the holder. When a transaction involves two financial instruments, only one financial instrument needs to be transferable in order for both financial instruments to satisfy the legal detachability criterion. In transactions involving more than two financial instruments, a single financial instrument that is transferable would meet the legal detachability criterion, while other financial instruments that are not transferable may together comprise a single freestanding hybrid financial instrument.

An instrument is “separately exercisable” if the exercise or settlement of the financial instrument will not affect, or result in the termination of, other financial instruments, and if the exercise or settlement of other financial instruments will not affect, or result in the termination of, the financial instrument under consideration. For example, assume an entity issues debt and detachable stock warrants to an investor. If the debt could be repaid while the warrants remain outstanding, and if the warrants could be exercised while the debt remains outstanding, both the debt and the warrants satisfy the “separate exercisability” criterion of a freestanding financial instrument.

If both the "legally detachable” and “separately exercisable” criteria are met, then a financial instrument is freestanding.

Is a SAFE a freestanding financial instrument?

Generally, a SAFE is considered to be a freestanding financial instrument. In practice, SAFEs are often entered into in standalone transactions not involving the issuance of other financial instruments, and, in these cases, it is easy to determine that a SAFE is a freestanding financial instrument.

However, if a SAFE is issued concurrently with other financial instruments to the same counterparty, the issuer should consider whether the SAFE may be settled without impacting the other financial instruments. For example, if a SAFE is issued along with a loan and the issuer is required to simultaneously repay the loan concurrent with settling the SAFE, the SAFE might not meet the “separately exercisable” criterion of a freestanding financial instrument. Likewise, if that SAFE can be settled without settling the loan but the counterparty can only transfer the SAFE to another party if it also transfers the loan to the same transferee, the SAFE might not meet the “legally detachable” criterion of a freestanding financial instrument.

If a SAFE is issued in a standalone transaction or in a multiple-element transaction in which the SAFE is determined to be a freestanding financial instrument relative to the other components, the issuer should further consider whether the SAFE is actually comprised of multiple freestanding financial instruments. A contract might consist of multiple freestanding financial instruments if it either consists of multiple component obligations to transfer cash or shares and one or more of those obligations may be independently settled without concurrently extinguishing other component obligations, or if any of the component obligations are transferable to another party unaccompanied by other component obligations.

In practice, it is unusual for the components of a contract described as a SAFE to individually satisfy the criteria of a freestanding financial instrument, because the components of a SAFE are typically not separately exercisable from one another.

The following examples illustrate the application of the definition of a freestanding financial instrument in the context of a SAFE.

Examples – Identifying freestanding financial instruments in SAFE transactions

Scenario A – Multiple freestanding financial instruments

XYZ Corp. issues Series B preferred stock and a SAFE to Investor X in exchange for $10 million in cash. The SAFE requires XYZ Corp. to transfer a variable number of Series C preferred shares with a monetary value equal to $6 million to Investor X if and when XYZ Corp. completes its Series C round of equity financing.

Investor X can transfer the Series B preferred stock to third parties without also transferring the SAFE. The SAFE cannot be transferred to a third party. In addition, if the SAFE is settled, the Series B preferred stock is not affected and remains outstanding.

XYZ Corp. concludes that the Series B preferred stock and the SAFE are both freestanding financial instruments because

- The Series B preferred stock and the SAFE are legally detachable, as the shares can be transferred to a third party without transferring the SAFE.
- The Series B preferred stock and the SAFE are separately exercisable, as settlement of the SAFE does not affect the Series B preferred stock.

Scenario B – Single freestanding financial instrument

ABC Corp. issues a SAFE to Investor Y in exchange for $5 million in cash. The SAFE requires ABC Corp. to transfer a variable number of preferred shares with a monetary value equal to $6 million to Investor Y if and when ABC Corp. completes a qualifying preferred stock issuance. If ABC Corp. undergoes a change in control or completes an IPO prior to completing a qualifying preferred stock issuance, then ABC Corp. must transfer cash to Investor Y in an amount equal to the greater of (a) the fair value of a number of its common shares, calculated by dividing $5 million by a fixed price per common share, and (b) $5 million.

ABC Corp. considers whether the SAFE represents multiple financial instruments based on the two possible settlement outcomes linked to a qualifying preferred stock issuance and a change in control or an IPO.

Investor Y cannot transfer the right to receive preferred shares upon a qualifying preferred stock issuance without also transferring the right to receive cash upon a change in control or an IPO, nor vice versa.

If Investor Y receives a variable number of preferred shares upon a qualifying preferred stock issuance, its right to receive cash upon a change in control or an IPO is terminated. Likewise, if Investor Y

receives cash upon a change in control or an IPO, its right to receive a variable number of preferred shares upon a qualifying preferred stock issuance is terminated.

Therefore, ABC Corp. concludes that the SAFE represents a single freestanding financial instrument, encompassing both Investor Y’s right to receive preferred shares upon a qualifying preferred stock issuance and its right to receive cash upon a change in control or an IPO.

Scenario C – Multiple freestanding financial instruments

DEF Corp. issues what it calls a SAFE to Investor Z in exchange for $5 million in cash. The so-called SAFE consists of a bridge loan and a written call option on DEF Corp.’s common stock. The bridge loan matures two years after issuance. If DEF Corp. completes a qualifying preferred stock issuance prior to the loan’s maturity, the loan is automatically settled with a variable number of preferred shares, calculated by dividing the unpaid loan principal by the price per share in the qualifying preferred stock issuance. The written call option expires 10 years after issuance, has a fixed exercise price, and is only exercisable by Investor Z if DEF Corp. undergoes a change in control or completes an IPO.

DEF Corp. documents the terms of the bridge loan and the written call option in a single contract, which it titles “Simple Agreement for Future Equity.” DEF Corp. considers whether the bridge loan and the written call option are separate freestanding financial instruments.

Investor Z is permitted to transfer the written call option to third parties with DEF Corp.’s consent, which may not be unreasonably withheld. The bridge loan, however, is not transferrable. Therefore, the bridge loan and the call option are legally detachable.

If Investor Z receives from the settlement of the bridge loan a variable number of preferred shares upon a qualifying preferred stock issuance, or if the bridge loan is otherwise settled at maturity, Investor Z retains the right to exercise the call option upon a future change in control or an IPO. If a change in control or an IPO occurs before the bridge loan is settled, then Investor Z retains the right to receive its principal and any yield upon a qualifying preferred equity financing or maturity of the bridge loan, whether or not it exercises the call option in connection with the change in control or an IPO. In other words, the bridge loan and the call option are both separately exercisable, as the settlement of one does not affect the potential settlement of the other and vice versa.

Therefore, DEF Corp. concludes that the bridge loan and the written call option are separate freestanding financial instruments, despite their documentation as a single arrangement characterized as a SAFE.

3. ASC 480 recognition criteria

If an issuer identifies a single freestanding financial instrument with characteristics of a SAFE, as discussed in Section 1, it must then determine whether that instrument falls within the scope of ASC 480. If the SAFE is within the scope of ASC 480, then the issuer is required to present the instrument as a liability. The guidance in ASC 480 applies to

- Mandatorily redeemable financial instruments
- Certain obligations to repurchase equity shares by transferring assets
- Certain obligations that may be settled with a variable number of shares

The guidance on mandatorily redeemable financial instruments applies only to financial instruments in the form of a share. Since this publication only addresses the issuer's accounting for instruments with characteristics of SAFEs that are neither debt nor shares in legal form, as described in Section 1, the mandatorily redeemable financial instrument guidance in ASC 480 is not covered in this publication.

However, the guidance in ASC 480 on (a) certain obligations to repurchase equity shares by transferring assets, and (b) certain obligations that may be settled with a variable number of shares applies to freestanding financial instruments that are neither debt nor shares in legal form. Both of these concepts in ASC 480 apply only to financial instruments that embody an obligation. Section 3.1 examines what it means for a financial instrument to "embody an obligation" in the context of ASC 480.

3.1 Embodies an obligation

A "financial instrument," as defined, imposes on one party to the instrument a contractual obligation to deliver cash or another financial instrument to the other party, and therefore it may appear that any arrangement that meets the definition of a "financial instrument" necessarily embodies an obligation of one party to the contract. However, it is important to note that the definition of a "financial instrument" refers to a *contractual* obligation, which is not a defined term in the FASB Codification and may be interpreted differently than an "obligation" as defined for purposes of applying the guidance in ASC 480.

Solely for the purpose of applying the guidance in ASC 480, an obligation is defined as a conditional or unconditional duty or responsibility to transfer assets or to issue equity shares. Generally, if the terms of a financial instrument require an issuer to transfer assets (such as cash) or its own equity shares to the investor upon the occurrence of an event that an issuer lacks the discretion to avoid, the financial instrument embodies an obligation from the issuer's perspective.

Obligation (ASC 480): A conditional or unconditional duty or responsibility to transfer assets or to issue equity shares.

A financial instrument might require the issuer to transfer assets or shares upon the occurrence of a future event. Whether such a requirement represents an obligation depends on whether occurrence of the event is a “condition,” such that the requirement is a “conditional obligation.”

What is a ‘conditional’ obligation?

We believe a conditional obligation exists if an issuer lacks the discretion to avoid being required to transfer its shares or assets.

ASC 480 does not explain what the term “conditional” means, nor does it clarify what constitutes a “duty or responsibility” in the context of the definition of an “obligation.”

Conditional

ASC 480 does, however, provide several examples of conditions, including:

- An investor’s decision to exercise, or not to exercise, an option
- The fair value of a counterparty’s investment in another entity falling below a specified level
- Occurrence of a change in control of the issuer

The first two of these conditions are clearly outside the financial instrument issuer’s control. The issuer of an option cannot control whether or when the option holder exercises the option, nor can the issuer of a financial instrument that is linked to the fair value of an investment in another entity control how the fair value of that investment changes. ASC 480 does not specify whether the third example, the occurrence of a change in control of the issuer, is outside the issuer’s control. In practice, whether a change in control of an issuer is within the issuer’s control typically depends on whether approval from the issuer’s board of directors is required for the change in control to occur. In many cases, a change in control of an issuer is determined to be outside that issuer’s control.

Therefore, it appears that all of the examples of conditional obligations in ASC 480 illustrate conditions that are outside the financial instrument issuer’s control.

Duty or responsibility

Regarding the meaning of “duty or responsibility,” the Basis for Conclusions in FASB Statement 150 includes the following explanation:

> The duty or responsibility to issue shares leaves an entity little or no discretion to avoid taking an action that it might otherwise wish to avoid. Therefore, the Board concluded that a duty or responsibility to issue shares is an obligation and, potentially, a liability.

According to the Basis for Conclusions in Statement 150, an entity has a duty or responsibility, and thus an obligation, to issue its shares if the entity has little or no discretion in avoiding the issuance of its shares. Conversely, if an entity has discretion to avoid an action, such as issuing shares, then the entity does not have a duty or responsibility to take that action and, likewise, lacks an obligation.

Conclusion

Based on all of these factors, we believe it is reasonable to conclude that the occurrence of an event that is within the issuer’s control or that the issuer has the discretion to avoid does not represent a

“condition” in the context of ASC 480 from the issuer’s perspective, and that taking an action that an issuer could avoid does not constitute a duty or responsibility. Accordingly, an issuer’s promise to transfer assets or shares upon the occurrence of an event that is entirely within the issuer’s control, or one that the issuer has the discretion to avoid, does not constitute an obligation in the scope of ASC 480.

An event is generally considered to be within the control of the issuer, or one that the issuer has the discretion to avoid, if either the issuer’s board of directors must render its approval for the event to occur or if management of the issuer can unilaterally decide whether the event occurs. For example, selling equity shares to new or existing investors or merging with another entity typically requires approval from an issuer’s board of directors and is therefore a type of event that the issuer has the discretion to avoid.

However, even if board approval is required for an event to occur, Example 6 in ASC 480-10-S99-3A(11) explains that if the board is controlled by the holder(s) of the financial instrument(s) being evaluated, then an event requiring board approval, such as a merger, is considered to be outside the issuer’s control and is instead within the instrument holders’ control.

ASC 480-10-S99-3A(11)

Example 6. A preferred security may have a provision that provides for redemption in cash or other assets if the issuing company is merged with or consolidated into another company, and pursuant to state law, approval of the board of directors is required before any merger or consolidation can occur. In that case, assuming the preferred stockholders cannot control the vote of the board of directors through direct representation or through other rights, the security would be appropriately classified in permanent equity because the decision to merge with or consolidate into another company is within the control of the issuer. Again, all of the relevant facts and circumstances should be considered when determining whether the preferred stockholders can control the vote of the board of directors.

In circumstances in which the counterparty to the financial instrument being evaluated is able to appoint a majority of the issuer’s board of directors, or otherwise controls decisions made by or on behalf of the issuer, events that require approval of the issuer’s board of directors are not considered to be within the issuer’s control for purposes of determining the issuer’s accounting for that financial instrument. This concept is explained in ASC 480-10-S99-3A(7), which illustrates a scenario in which holders of preferred shares control a majority of the votes of the issuer’s board of directors and, as a result, the ability to exercise the call option embedded in the preferred shares is not within the issuer’s control.

ASC 480-10-S99-3A(7)

Example 2. A preferred security that is not required to be classified as a liability under other applicable GAAP may have a redemption provision that states it may be called by the issuer upon an affirmative vote by the majority of its board of directors. While some might view the decision to call the security as an event that is within the control of the company because the governance structure of the company is vested with the power to avoid redemption, if the preferred security holders control a majority of the votes of the board of directors through direct representation on the board of directors or through other

rights, the preferred security is redeemable at the option of the holder and classification in temporary equity is required. In other words, any provision that requires approval by the board of directors cannot be assumed to be within the control of the issuer. All of the relevant facts and circumstances should be considered.

The questions and answers below address common settlement provisions in a SAFE and whether they indicate that a SAFE embodies an obligation of the issuer.

Does a SAFE embody an obligation of the issuer?

Based on the SAFE characteristics outlined in Section 1, an issuer must deliver cash or shares to the investor upon (1) a qualifying equity issuance, (2) the occurrence of an event, such as a change in control or an IPO, or (3) the dissolution of the issuer. Determining if a SAFE that must be settled in any one of these circumstances embodies an obligation depends on whether the issuer lacks the discretion to avoid whether such circumstances arise.

Does an obligation exist when the SAFE investor controls the issuer?

The SAFE investor might own other interests in the issuer, such as common or preferred stock, that allow the investor to appoint a majority of the issuer's board of directors or otherwise control decisions made on behalf of the issuer. In these circumstances, decisions that would otherwise be deemed to be within the control of the issuer must be considered to be within the control of the investor, as articulated in in ASC 480-10-S99-3A(7). Generally, a SAFE held by an investor that controls the issuer embodies an obligation of the issuer, since the SAFE holder could decide to have the issuer execute a qualifying equity raise or a liquidity event, each of which would require the issuer to settle the SAFE. In other words, the issuer lacks the discretion to avoid the occurrence of the events that require settlement, such that an obligation exists.

Does an obligation exist when the issuer must settle a SAFE upon an equity issuance?

Typically, an issuer has the discretion to avoid an issuance of its own shares. Therefore, in situations where the SAFE investor does not control the issuer, the issuer generally has the discretion to avoid any settlement outcomes associated with issuing equity, and a requirement for the issuer to settle the SAFE upon a qualifying equity issuance would not represent an obligation within the SAFE. However, it is important to consider whether any other contracts exist, such as forwards, that obligate the issuer to issue additional shares in a manner that would require settling the SAFE. If other arrangements outside the SAFE obligate the issuer to complete a qualifying equity raise, then it is likely that the SAFE embodies an obligation because the issuer lacks discretion to avoid taking an action that would require it to settle the SAFE.

Does an obligation exist when the issuer must settle a SAFE upon a liquidity event?

Financial instruments often refer to liquidity events and deemed liquidity events affecting the issuer, including events such as a change in control or an IPO. To determine whether the issuer has the discretion to avoid the occurrence of such events, it is important to consider whether the issuer's board of directors must render approval for the event to occur. Typically, an event such as a merger or an IPO would require approval from the issuer's board of directors. However, a change in control in many

cases does not require approval by the issuer's board, and it could be effected by an investor or group of investors arranging to sell their shares in the issuer to a new investor.

Accordingly, SAFEs that require settlement upon a change in control that does not require issuer approval, or upon other events that could occur without approval from the issuer's management or board of directors, embody an issuer obligation, as the issuer lacks the discretion to avoid such an event occurring.

Does an obligation exist when the issuer must settle a SAFE upon its dissolution?

In general, an issuer's dissolution or ordinary liquidation does not give rise to an issuer obligation, based on various areas of guidance applicable to issuers of financial instruments, as follows:

- The scope exception in ASC 480-10-25-4 for shares that are mandatorily redeemable only upon the liquidation or termination of the issuer, in which case, liability classification is not required.
- The scope exception in ASC 480-10-S99-3A, the mezzanine equity guidance applicable to public business entities. Specifically, ASC 480-10-S99-3A(3)(f) states that "[o]rdinary liquidation events, which involve the redemption and liquidation of all of an entity's equity instruments for cash or other assets of the entity, do not result in an equity instrument being subject to ASR 268. In other words, if the payment of cash or other assets is required only from the distribution of net assets upon the final liquidation or termination of an entity (which may be a less-than-wholly-owned consolidated subsidiary), then that potential event need not be considered when applying ASR 268."
- The provision in ASC 815-40-25-9, the equity classification guidance for contracts in an entity's own equity, which states that "if the payment of cash is only required upon the final liquidation of the entity, then that potential outcome need not be considered…."

Therefore, a requirement for the issuer to settle a SAFE upon the issuer's dissolution does not represent an obligation within the SAFE of the issuer.

Must an issuer reassess at each reporting date whether a SAFE embodies an obligation?

The guidance in ASC 480 addresses reassessment only for mandatorily redeemable financial instruments, which are outside the scope of this publication. For other financial instruments, ASC 480 requires an assessment only at inception of the financial instrument. Therefore, post-inception, an issuer is not required to reassess whether a SAFE that is within the scope of this publication embodies an obligation, unless a SAFE is modified in such a manner that, for accounting purposes, results in the inception of a new financial instrument.

3.2 Obligations to repurchase equity shares by transferring assets

ASC 480-10-25-8 requires an issuer to present as a liability (or as an asset, in some circumstances) any freestanding financial instrument, other than an outstanding share, that satisfies both of the following criteria at its inception date:

a. The instrument embodies an obligation to repurchase the issuer's shares or is indexed to such an obligation.

b. The instrument requires, or may require, the issuer to settle the obligation by transferring assets.

ASC 480-10-25-8

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:

a. It embodies an obligation to repurchase the issuer's equity shares, or is indexed to such an obligation.

b. It requires or may require the issuer to settle the obligation by transferring assets.

In addition to understanding whether a financial instrument embodies an obligation of the issuer, as discussed in Section 3.1, it is important to understand what it means, in the context of ASC 480-10-25-8, for an instrument to embody, or to be indexed to, an obligation to repurchase the issuer's equity shares and to settle an obligation by transferring assets.

Embodies, or is indexed to, an obligation to repurchase the issuer's shares

A financial instrument that may require the issuer, upon the occurrence of an event that the issuer lacks the discretion to avoid, to repurchase its own shares embodies an obligation to repurchase the issuer's shares in accordance with ASC 480-10-25-8(a).

For example, an issuer may issue a fixed-price written put option that allows the holder to sell back to the issuer the issuer's own shares. The put will be settled on a gross basis, which means that cash is exchanged for the full number of shares underlying the put option. The put option itself embodies a conditional obligation of the issuer to purchase its own shares if both (1) the issuer's share price declines to the point where the put option is "in the money," and (2) the holder decides to exercise the put option. The issuer does not have the discretion to avoid purchasing its shares, and, accordingly, the issuer must classify such an instrument as a liability.

Additionally, an issuer may issue a fixed-price written call option that allows the holder to purchase from the issuer shares that are themselves puttable to the issuer at a fixed price (that is, the shares underlying the written call option contain a fixed-price written put option). The fixed-price written call option embodies a conditional obligation of the issuer to repurchase its shares. If the holder exercises the written call option (a condition), receives the underlying shares, and then exercises the put embedded in the shares (a condition), the issuer must transfer assets to the holder in exchange for its own shares.

An example in ASC 480-10-55-32 provides implementation guidance for this type of arrangement.

ASC 480-10-55-32

Entity B issues a warrant for shares that can be put back by Holder immediately after exercise of the warrant. The warrant feature allows Holder to purchase 1 equity share at a strike price of $10 on a specified date. The put feature allows Holder to put the shares obtained by exercising the warrant back to Entity B on that date for $12, and to require physical settlement in cash. If the share price on the settlement date is greater than $12, Holder would be expected to exercise the warrant obligating Entity B to issue a fixed number of shares in exchange for a fixed amount of cash, and retain the shares. That feature alone does not result in a liability under paragraphs 480-10-25-8 through 25-12. However, if the share price is equal to or less than $12, Holder would be expected to put the shares back to Entity B

and could choose to obligate Entity B to pay $12 in cash. That feature does result in a liability, because the financial instrument embodies an obligation to repurchase the issuer's shares and may require a transfer of assets. Therefore, those paragraphs require Entity B to classify the warrant as a liability. A warrant to issue shares that will be mandatorily redeemable is also classified as a liability, and should be analyzed under Topic 815.

ASC 480-10-25-8(a) also includes in its scope an obligation that is "indexed to such an obligation," meaning the obligation is indexed to an obligation to purchase the issuer's shares. Therefore, an obligation with a fair value that is positively correlated to the fair value of a written put option on the issuer's shares meets the criterion to be "indexed to such an obligation" in ASC 480-10-25-8(a) and requires the instrument containing that obligation to be classified by the issuer as a liability, even though the obligation does not require the issuer to actually repurchase its shares.

For example, assume that an issuer enters into a fixed-price written put option, as discussed in the example above. However, instead of gross settlement, the put will be net cash settled, meaning the entity in the loss position will pay cash to the entity in the gain position based on the intrinsic value of the put option on the settlement date. As the fair value of the issuer's stock decreases, the value of the written put to the holder increases, since the holder is entitled to a larger net cash settlement payment from the issuer as the issuer's share price declines. As a result, the monetary value of the issuer's obligation increases as the share price decreases, in the same way as the gross settled written put option described earlier. Even though the put option will be net cash settled and does not involve the actual repurchase of the issuer's shares, the monetary value of the obligation is indexed to the fair value of an obligation to repurchase the issuer's shares. Therefore, the issuer would classify this put option as a liability under ASC 480-10-25-8.

Requires, or may require, the transfer of assets

The second criterion in ASC 480-10-25-8 specifies that the issuer may be required to transfer assets to settle an obligation. As defined in ASC 480, an "obligation" requires the transfer of either assets or shares. However, in the context of ASC 480-10-25-8, the obligation must involve the transfer of assets.

As explained in ASC 480-10-25-9, the phrase "requires or may require" refers to an issuer's conditional or unconditional obligation. If an obligation exists but is conditional, the number of conditions leading up to the possible transfer of assets is irrelevant when classifying the instrument.

ASC 480-10-25-9

In this Subtopic, *indexed to* is used interchangeably with *based on variations in the fair value of*. The phrase *requires or may require* encompasses instruments that either conditionally or unconditionally obligate the issuer to transfer assets. If the obligation is conditional, the number of conditions leading up to the transfer of assets is irrelevant.

ASC 480-10-25-10

Examples of financial instruments that meet the criteria in paragraph 480-10-25-8 include forward purchase contracts or written put options on the issuer's equity shares that are to be physically settled or net cash settled.

ASC 480-10-25-11

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.

The guidance in ASC 480-10-25-13 specifies that if an issuer settles a financial instrument by transferring to the investor another financial instrument that ultimately may require cash settlement, the original financial instrument is classified as a liability. For example, an issuer may enter into a written call option that is settled in redeemable, or puttable, shares, for which the ultimate settlement may require the transfer of assets. In this circumstance, the issuer must present the written call option as a liability.

ASC 480-10-25-13

An instrument that requires the issuer to settle its obligation by issuing another instrument (for example, a note payable in cash) ultimately requires settlement by a transfer of assets, accordingly:

a. When applying paragraphs 480-10-25-8 through 25-12, this also would apply for an instrument settled with another instrument that ultimately may require settlement by a transfer of assets (warrants for puttable shares).

b. It is clear that a warrant for mandatorily redeemable shares would be a liability under this Subtopic.

Is a SAFE within the scope of ASC 480-10-25-8?

To assess whether a SAFE that embodies an obligation (see Section 3.1) is in the scope of ASC 480-10-25-8, an issuer should determine whether that obligation (1) might ultimately require the issuer to repurchase its own shares or is indexed to such an obligation, and (2) may require the issuer to transfer assets, such as cash.

Does a SAFE embody an obligation to repurchase the issuer's own shares that may require transferring assets?

While many SAFEs do not directly embody an issuer's obligation to repurchase its own shares, such as a written put option on issuer shares held by a counterparty, a SAFE's settlement may require the issuer to transfer an existing class of contingently redeemable shares that conditionally obligate the issuer to repurchase its own shares by transferring assets.

As noted in ASC 480-10-25-9, if an obligation is conditional, the number of conditions leading up to the transfer of assets is irrelevant. Assume that an obligation for the issuer to repurchase its shares by transferring assets is conditional on (1) a change in control occurring, which requires the issuer to transfer contingently redeemable shares to the investor, (2) the contingently redeemable shares becoming puttable, and (3) the investor deciding to exercise the put option embedded in the shares. A SAFE that embodies such an obligation, requiring the issuer to transfer shares that are themselves redeemable based on events that the issuer lacks discretion to avoid, is within the scope of ASC 480-10-25-8.

Rather than a class of existing, contingently redeemable shares, a SAFE may specify that the issuer will transfer shares of a future class of equity to the holder, for which the redemption rights of the future class of equity, among other rights, are not yet determined when the SAFE is executed. We believe an issuer is not required to presume that a future class of equity will have redemption rights for purposes of classifying the SAFE.

Does a SAFE embody an obligation indexed to a written put option on the issuer's shares that may require transferring assets?

SAFEs generally do not embody obligations that are indexed to an obligation to purchase the issuer's shares, such as a net-cash-settled written put option on the issuer's shares. Rather, cash-settlement features within SAFEs are typically based on fixed monetary values (for example, cash settlement equal to the purchase amount, irrespective of fair value changes in the underlying shares) or have values that are indexed to a fixed-price written call option to purchase the issuer's equity (that is, the obligation is indexed to an obligation to sell, rather than purchase, the issuer's shares at a fixed price).

The following examples illustrate the application of the guidance in ASC 480-10-25-8 through 25-13 to a SAFE.

Examples – Determining whether a SAFE is in the scope of ASC 480-10-25-8

Scenario A – SAFE is in the scope of ASC 480-10-25-8

ABC Corp. issues a SAFE to Investor Y in exchange for $5 million in cash. The SAFE requires ABC Corp. to transfer a variable number of preferred shares with a monetary value equal to $6 million to Investor Y if and when ABC Corp. completes a qualifying preferred stock issuance. If ABC Corp. undergoes a change in control (that ABC Corp. lacks the discretion to avoid) or completes an IPO prior to a qualifying preferred stock issuance, then ABC Corp. must transfer shares of its existing Series B preferred stock to Investor Y, with the number of shares equal to the greater of (a) $5 million divided by the current fair value of a Series B preferred share and (b) $5 million divided by a fixed price per Series B preferred share. ABC Corp.'s Series B preferred shares are convertible into common shares at the investor's option and are puttable to the issuer for a fixed amount of cash upon certain deemed liquidation events, including a change in control that ABC Corp. lacks the discretion to avoid.

ABC Corp. determines that the SAFE embodies an obligation that may ultimately require the transfer of assets to redeem its shares—that is, if a change in control occurs (that ABC Corp. lacks the discretion to avoid), ABC Corp. is required to transfer Series B preferred shares to Investor Y, which in turn may require ABC Corp. to transfer assets to repurchase those shares if another change in control occurs.

Accordingly, ABC Corp. determines that it must present the SAFE as a liability pursuant to ASC 480-10-25-8.

Scenario B – SAFE is not in the scope of ASC 480-10-25-8

DEF Corp. issues a SAFE to Investor Z in exchange for $5 million in cash. The SAFE requires DEF Corp. to transfer a variable number of preferred shares with a monetary value equal to $6 million to Investor Z if and when DEF Corp. completes a qualifying preferred stock issuance. If DEF Corp. undergoes a change in control (that DEF Corp. lacks the discretion to avoid) or completes an IPO prior

to a qualifying preferred stock issuance, then it must transfer cash to Investor Z in an amount equal to the greater of (a) the fair value of a number of its common shares, calculated by dividing $5 million by a fixed price per common share, and (b) $5 million.

DEF Corp. determines that while the SAFE embodies an obligation that may ultimately require the transfer of assets—that is, DEF Corp. is required to transfer cash to Investor Z if a change in control occurs—the SAFE neither embodies an obligation to repurchase DEF Corp.'s shares nor is it indexed to such an obligation. Upon a change in control, DEF Corp. must transfer either a fixed amount of cash, or a variable amount of cash that is indexed to a written call option on DEF Corp.'s common stock (in other words, as the fair value of the stock increases, the obligation's fair value increases), and neither of these amounts is indexed to the fair value of an obligation to repurchase DEF Corp.'s shares, such as a written put option.

Note that the preferred-share-settlement component associated with a qualifying stock issuance is not factored into the ASC 480-10-25-8 analysis, even if the preferred shares are puttable to the issuer for cash upon certain deemed liquidation events that the issuer lacks the discretion to avoid. In other words, DEF Corp. is presumed to have the discretion to avoid the undertaking of a qualifying preferred stock issuance, and, therefore, a requirement to transfer shares or assets after the occurrence of that event does not represent an obligation to the issuer.

Accordingly, DEF Corp. determines that it is not required to present the SAFE as a liability pursuant to ASC 480-10-25-8.

3.3 Financial instruments that may be settled in a variable number of equity shares

ASC 480-10-25-14 is the final condition to consider in ASC 480 to determine if an instrument must be liability-classified. If the following two criteria are met, then an instrument is classified as a liability in accordance with ASC 480-10-25-14:

1. An obligation exists that the issuer must, or may, settle by issuing a variable number of equity shares.
2. At inception, the monetary value of that obligation is based solely or predominantly on any one of the following:
   a. *A fixed monetary amount known at inception (for example, a payable settleable in a variable number of the issuer's equity shares)* – The number of shares to be issued to settle the obligation is variable if, for example, the number is based on a fixed monetary amount divided by the fair value of the issuer's equity shares on the date of settlement.
   b. *Variations in something other than the fair value of the issuer's equity shares* – For example, an issuer may agree to sell its own equity shares, but the number of shares to be issued is based on changes in the value of another entity's shares or on a referenced index, such as the S&P 500.
   c. *Variations inversely related to changes in the fair value of the issuer's equity shares* – A common example is a written put option with a fixed exercise price, in which the issuer agrees to buy back shares at the fixed exercise price if the holder exercises its put right. The holder is motivated to exercise its put right if the fair value of the issuer's shares decreases and is below the fixed exercise price, as the issuer has to pay the fixed price that is in excess of the shares' current fair value. The fair value of the fixed-price written put option is inversely related to the fair value of the underlying shares.

The application of ASC 480-10-25-14 also depends upon whether the instrument being evaluated is a share. For an outstanding share, ASC 480-10-25-14 applies only if the share embodies an unconditional obligation that meets the two criteria noted above. For a financial instrument other than an outstanding share, ASC 480-10-25-14 applies if the instrument embodies either a conditional or unconditional obligation that meets the two criteria noted above. A SAFE that is within the scope of this publication, as described in Section 1, is not considered to be an outstanding share. Therefore, ASC 480-10-25-14 applies if the SAFE embodies either an unconditional or conditional obligation to transfer a variable number of shares with a monetary value based solely or predominantly on any one of items (a) through (c) described above.

ASC 480-10-25-14

A financial instrument that embodies an unconditional obligation, or a financial instrument other than an outstanding share that embodies a conditional obligation, that the issuer must or may settle by issuing a variable number of its equity shares shall be classified as a liability (or an asset in some circumstances) if, at inception, the monetary value of the obligation is based solely or predominantly on any one of the following:

a. A fixed monetary amount known at inception (for example, a payable settleable with a variable number of the issuer's equity shares)

b. Variations in something other than the fair value of the issuer's equity shares (for example, a financial instrument indexed to the Standard and Poor's S&P 500 Index and settleable with a variable number of the issuer's equity shares)

c. Variations inversely related to changes in the fair value of the issuer's equity shares (for example, a written put option that could be net share settled).

See paragraph 480-10-55-21 for related implementation guidance.

In addition to understanding whether a financial instrument embodies an obligation of the issuer, as discussed in Section 3.1, it is important to understand the following concepts in order to appropriately apply the guidance in ASC 480-10-25-14:

1. The distinction between fixed and variable share settlement features;
2. The monetary value of an obligation;
3. What it means for the monetary value of an obligation to be considered *solely or predominantly* based on one of the three factors in ASC 480-10-25-14; and
4. What it means for the monetary value of an obligation to be either indexed to a factor other than, or inversely related to, the issuer's stock price.

Fixed-share-settlement versus variable-share-settlement

There are two main types of share-settlement features seen in practice: (1) variable-share-settlement features (sometimes referred to as "share-settled redemption features"), and (2) fixed-share-settlement features (sometimes referred to as "conversion features"). Variable-share-settlement features often involve the issuer transferring a variable number of shares with a total fair value equal to a fixed monetary amount. In other words, a variable-share-settlement feature may function like a fixed-price cash

redemption feature, except that the issuer's shares are used as currency in place of cash. Fixed-share-settlement features, on the other hand, typically involve the issuer transferring a fixed number of shares with a total fair value that is positively correlated to the issuer's share price. In other words, a fixed-share-settlement feature functions like a fixed-price written call option on the issuer's shares.

Typically, the term "conversion" refers to a fixed-share-settlement feature. However, some contracts, including SAFEs, use the term "conversion" to refer to all types of share-settlement-features, regardless of whether a feature resembles a variable- or fixed-share-settlement feature as described above. Since the guidance in ASC 480-10-25-14 addresses an issuer's accounting for certain freestanding financial instruments that may be settled in a variable number of shares with a fixed monetary value (in other words, instruments that contain a variable-share-settlement feature), it is important to carefully evaluate share-settlement features in a SAFE, including those characterized as conversion features, to determine whether they are variable- or fixed-share-settlement features.

Monetary value

In the Codification's Master Glossary, "monetary value" is defined as the fair value of the cash, shares, or other instruments that a financial instrument obligates an issuer to transfer to the holder.

Monetary Value: What the fair value of the cash, shares, or other instruments that a financial instrument obligates the issuer to convey to the holder would be at the settlement date under specified market conditions.

The monetary value of an obligation embodied in a financial instrument does not necessarily depend on the form of settlement (for example, cash or shares), as illustrated in ASC 480-10-55-2:

- An obligation with a fixed monetary value may be settled in cash or in a variable number of shares based on the quotient of the fixed monetary value divided by the current share price.
- An obligation with a monetary value inversely related to the issuer's share price (for example, a written put option) may be settled either in cash based on the difference between the exercise price and the current share price (called the "intrinsic value") or in a variable number of shares based on the quotient of the intrinsic value divided by the current share price.
- An obligation with a monetary value based on the change in an external variable (for example, the price of gold) may be settled either in cash based on the product of the change in the underlying (the price of an ounce of gold) multiplied by a fixed notional amount (a number of ounces), or in a variable number of shares equal to the quotient of the cash-settlement amount divided by the current share price.

In all of these cases, the monetary value is independent of the form of settlement and, instead, is based upon the fair value of assets or shares conveyed to the holder.

ASC 480-10-55-2

Paragraph 480-10-05-5 explains that how the monetary value of a financial instrument varies in response to changes in market conditions depends on the nature of the arrangement, including, in part, the form of settlement. For example, for a financial instrument that embodies an obligation that requires:

a. Settlement either by transfer of $100,000 in cash or by issuance of $100,000 worth of equity shares, the monetary value is fixed at $100,000, even if the share price changes.

b. Physical settlement by transfer of $100,000 in cash in exchange for the issuer's equity shares, the monetary value is fixed at $100,000, even if the fair value of the equity shares changes.

c. Net share settlement by issuance of a variable number of shares based on the change in the fair value of a fixed number of the issuer's equity shares, the monetary value varies based on the number of shares required to be issued to satisfy the obligation. For example, if the exercise price of a net-share-settled written put option entitling the holder to put back 10,000 of the issuer's equity shares is $11, and the fair value of the issuing entity's equity shares on the exercise date decreases from $13 to $10, that change in fair value of the issuer's shares increases the monetary value of that obligation at settlement from $0 to $10,000 ($110,000 minus $100,000), and the option would be settled by issuance of 1,000 shares ($10,000 divided by $10).

d. Net cash settlement based on the change in the fair value of a fixed number of the issuer's equity shares, the monetary value varies in the same manner as in (c) for net share settlement, but the obligation is settled with cash. In a net-cash-settled variation of the previous example, the option would be settled by delivery of $10,000.

e. Settlement by issuance of a variable number of shares that is based on variations in something other than the issuer's equity shares, the monetary value varies based on changes in the price of another variable. For example, a net-share-settled obligation to deliver the number of shares equal in value at settlement to the change in fair value of 100 ounces of gold has a monetary value that varies based on the price of gold and not on the price of the issuer's equity shares.

For each obligation embodied within a SAFE, the issuer should determine the monetary value of that obligation.

Assessing predominance

The monetary value of an obligation within the scope of ASC 480-10-25-14 must be based solely or predominantly on one of the following:

- A fixed monetary amount;
- Variations in something other than the fair value of the issuer's shares; or
- Variations inversely related to changes in the fair value of the issuer's shares.

If a financial instrument embodies a single obligation, and if the monetary value of that obligation meets any of the three criteria in ASC 480-10-25-14, the instrument is classified as a liability under ASC 480, assuming settlement requires transferring a variable number of shares.

Single obligation

For purposes of evaluating a financial instrument that embodies a single obligation, an issuer should consider the guidance in ASC 480-10-55-22. This example illustrates an issuer's single obligation to deliver a variable number of shares with a total fixed monetary value of $110,000 to the holder of a financial instrument. Rather than the spot rate at the settlement date, the settlement calculation uses the average market price of the shares over a stated period of time to determine the number of shares issuable to the holder. If the spot rate differs from the average market price, then the monetary value of the obligation (that is, the fair value of shares delivered on the settlement date) is not entirely fixed at inception and instead is based, in small part, on variations in the fair value of the issuer's equity shares. The example concludes that even though the monetary value is not entirely fixed, it is still predominantly a fixed monetary amount known at inception. In other words, a small amount of variability present in the financial instrument does not negate the fact that the issuer is settling a predominantly fixed monetary amount in a variable number of shares. Therefore, an instrument that solely embodies such an obligation is classified as a liability under paragraph 480-10-25-14(a).

ASC 480-10-55-22

Certain financial instruments embody obligations that require (or permit at the issuer's discretion) settlement by issuance of a variable number of the issuer's equity shares that have a value equal to a fixed monetary amount. For example, an entity may receive $100,000 in exchange for a promise to issue a sufficient number of its own shares to be worth $110,000 at a future date. The number of shares required to be issued to settle that unconditional obligation is variable, because that number will be determined by the fair value of the issuer's equity shares on the date of settlement. Regardless of the fair value of the shares on the date of settlement, the holder will receive a fixed monetary value of $110,000. Therefore, the instrument is classified as a liability under paragraph 480-10-25-14(a). Some share-settled obligations of this kind require that the variable number of shares to be issued be based on an average market price for the shares over a stated period of time, such as the average over the last 30 days before settlement, instead of the fair value of the issuer's equity shares on the date of settlement. Thus, if the average market price differs from the share price on the date of settlement, the monetary value of the obligation is not entirely fixed at inception and is based, in small part, on variations in the fair value of the issuer's equity shares. Although the monetary amount of the obligation at settlement may differ from the initial monetary value because it is tied to the change in fair value of the issuer's equity shares over the last 30 days before settlement, the monetary value of the obligation is predominantly based on a fixed monetary amount known at inception. The obligation is classified as a liability under paragraph 480-10-25-14(a). Upon issuance of the shares to settle the obligation, equity is increased by the amount of the liability and no gain or loss is recognized for the difference between the average and the ending market price.

Multiple obligations

It is common for financial instruments to embody multiple obligations, possibly both fixed- and variable-share-settlement features, only some of which may meet the conditions listed in ASC 480-10-25-14. When multiple obligations are present, an issuer is required to determine whether a single obligation is predominant based on the likelihood that the equity-linked financial instrument will settle in accordance with that obligation relative to the other obligations embodied in the financial instrument. If a predominant obligation meets any of the three criteria in ASC 480-10-25-14, the instrument is classified as a liability.

According to ASC 480-10-55-42 and 55-43, the assessment of predominance is performed at contract inception by evaluating whether an obligation is predominant *relative to other obligations* in the financial instrument. An issuer would not evaluate whether an obligation is predominant relative to all other possible settlement outcomes of a financial instrument. For example, assume a financial instrument has three potential settlement outcomes: (1) it is settled in a variable number of shares with a fixed monetary value upon a qualifying equity raise, (2) it is settled in a variable amount of cash upon certain liquidity events that the issuer lacks the discretion to avoid, and (3) it is settled in a variable number of shares with a fixed monetary value upon other certain liquidity events that the issuer lacks the discretion to avoid. Since the issuer has the discretion to avoid a qualifying equity raise, only settlement outcomes (2) and (3) represent component obligations. The issuer in this example would assess the predominance of settlement outcome (2) relative to settlement outcome (3).

ASC 480-10-55-44 describes an instrument that embodies two obligations: one a fixed-share-settlement feature and the other a variable-share-settlement feature. The example explains that in order for an issuer to determine which obligation is predominant, it considers all pertinent information, which may include its current stock price and volatility, the strike price of the instrument, and any other relevant factors.

ASC 480-10-55-42

A financial instrument composed of more than one option or forward contract embodying obligations to issue shares must be analyzed to determine whether the obligations under any of its components have one of the characteristics in paragraph 480-10-25-14, and if so, whether those obligations are predominant relative to other obligations. For example, a puttable warrant that allows the holder to purchase a fixed number of the issuer's shares at a fixed price that also is puttable by the holder at a specified date for a fixed monetary amount to be paid, at the issuer's discretion, in cash or in a variable number of shares.)

ASC 480-10-55-43

The analysis can be summarized in two steps:

a. Identify any component obligations that, if freestanding, would be liabilities under paragraph 480-10-25-14. Also identify the other component obligation(s) of the financial instrument.

b. Assess whether the monetary value of any obligations embodied in components that, if freestanding, would be liabilities under paragraph 480-10-25-14 is (collectively) predominant over the (collective) monetary value of other component obligation(s). If so, account for the entire instrument under that paragraph. If not, the financial instrument is not in the scope of this Subtopic and other guidance applies.

ASC 480-10-55-44

In an instrument that allows the holder either to purchase a fixed number of the issuer's shares at a fixed price or to compel the issuer to reacquire the instrument at a fixed date for shares equal to a fixed monetary amount known at inception, the holder's choice will depend on the issuer's share price at the settlement date. The issuer must analyze the instrument at inception and consider all possible outcomes to judge which obligation is predominant. To do so, the issuer considers all pertinent information as applicable, which may include its current stock price and volatility, the strike price of the instrument, and any other factors. If the issuer judges the obligation to issue a variable number of shares based on a fixed monetary amount known at inception to be predominant, the instrument is a

liability under paragraph 480-10-25-14. Otherwise, the instrument is not a liability under this Subtopic but is subject to other applicable guidance such as Subtopic 815-40.

Predominance threshold

U.S. GAAP does not define “predominantly” or provide a quantitative threshold on which to base the predominance assessment. Therefore, judgment is required to appropriately assess predominance, as further discussed below.

On what basis should an issuer assess predominance?

We believe predominance can be interpreted to mean either (a) more likely than not, which is generally interpreted as a 50 percent or greater likelihood, or (b) a higher threshold, such as probable, which is defined in the Master Glossary as “likely to occur.”

Although predominance is assessed in other areas of U.S. GAAP based on a “more likely than not” threshold, we believe that predominance within the context of ASC 480 could be assessed using a higher threshold. This view is based on an understanding that, as originally proposed, the guidance in FASB Statement 150, which was codified in ASC 480-10-25-14(a), applied to instruments that embody obligations for which the monetary value is “solely” based on a fixed monetary amount known at inception. In the final version of FASB Statement 150, the Board decided to use the phrase “solely or predominantly” instead, in response to stakeholders’ concerns that the use of only the term “solely” might prompt entities to circumvent the guidance in ASC 480-10-25-14 by inserting a small amount of variability in the monetary value into an instrument that otherwise would be a liability under ASC 480. Since the term “predominantly” appears to have been used to prevent circumventing the guidance in ASC 480 by adding minor provisions to an instrument, we believe that assessing “predominant” using a higher threshold than “more likely than not” is acceptable.

Entities should establish an accounting policy for assessing predominance under ASC 480 and apply that policy consistently to all of the issuer’s equity-linked financial instruments.

Indexation and inverse relationship to share price

Variable-share-settled obligations with monetary values indexed to variables other than the issuer’s stock price are within the scope of ASC 480-10-25-14. Examples of such variables are commodity prices, published equity index prices such as the S&P 500, and published interest rate indices, such as the Secured Overnight Financing Rate (SOFR).

The concept of an inverse relationship to the issuer’s stock price is similar to the concept of being indexed to an obligation to repurchase the issuer’s shares, as discussed in Section 3.2. If the monetary value of an obligation increases as the issuer’s stock price declines, or if the monetary value decreases as the stock price increases, then an inverse relationship exists between the monetary value of the obligation and the issuer’s stock price. Likewise, the fair value of a fixed-price written put option is inversely related to the price of the shares underlying that option. Therefore, an obligation whose monetary value is indexed to the fair value of a fixed-price put option on the issuer’s shares has an inverse relationship with the issuer’s stock price.

The following examples illustrate the application of ASC 480-10-25-14 to common terms found in a SAFE.

Examples – Determining whether a SAFE is in the scope of ASC 480-10-25-14

Scenario A – SAFE is in the scope of ASC 480-10-25-14

ABC Corp. issues a SAFE to Investor Y in exchange for $5 million in cash. The SAFE requires ABC Corp. to transfer a variable number of preferred shares with a monetary value equal to $6 million to Investor Y if and when ABC Corp. completes a qualifying preferred stock issuance. If ABC Corp. undergoes a change in control (that ABC Corp. lacks the discretion to avoid) or completes an IPO prior to a qualifying preferred stock issuance, then ABC Corp. must transfer shares of its existing Series B preferred stock to Investor Y, with the number of shares equal to the greater of (a) $5 million divided by the current fair value of a Series B preferred share, and (b) $5 million divided by a fixed price per Series B preferred share. ABC Corp.'s Series B preferred shares are convertible into common shares at the investor's option and are nonredeemable.

ABC Corp. determines that the SAFE is not in the scope of ASC 480-10-25-8 (see Section 3.2 for further discussion).

ABC Corp.'s policy for purposes of applying ASC 480-10-25-14 is to use a "more likely than not" threshold to assess predominance.

At contract inception, ABC Corp. assesses the relative likelihood of the SAFE settling in a variable number as opposed to a fixed number of Series B preferred shares, assuming that a change in control occurs, which is the only event associated with the issuer's conditional obligation to settle the SAFE (both a qualifying preferred stock issuance and an IPO are assumed to be events that the issuer has the discretion to avoid and, therefore, do not represent conditional obligations).

Consistent with ASC 480-10-55-42 and 55-43, ABC Corp. evaluates whether the variable-share-settlement feature linked to a change in control is predominant relative to the fixed-share-settlement feature linked to a change in control (the other component obligation) in the SAFE. ABC Corp. determines that it is more likely than not that, assuming a change in control occurs, the SAFE will be settled in a variable number of shares. In other words, based on the issuer's current stock price, volatility, and other relevant information, management believes it is more likely than not that the fair value of a Series B preferred share will be less than the fixed price per Series B preferred share at the change-in-control settlement date. Therefore, the SAFE embodies a conditional obligation with a monetary value based predominantly on a fixed monetary amount that the issuer may settle by issuing a variable number of shares.

ABC Corp. determines that it must present the SAFE as a liability pursuant to ASC 480-10-25-14.

Scenario B – SAFE is not in the scope of ASC 480-10-25-14

Assume the same facts in Scenario A, except that management's expectation at contract inception is that it is more likely than not that the fair value of a Series B preferred share will be greater than the fixed price per Series B preferred share at a change-in-control settlement date. As a result, management believes it is more likely than not that the issuer will settle the SAFE upon a change in control by issuing a fixed number of Series B preferred shares based on the quotient of $5 million divided by the fixed-share price in the contract, which will yield a greater number of shares compared to using the higher fair value of Series B shares. Unlike in the previous example, the SAFE does not

embody a conditional obligation with a monetary value based predominantly on a fixed monetary amount that the issuer may settle by issuing a variable number of shares.

ABC Corp. determines that it cannot present the SAFE as a liability pursuant to ASC 480-10-25-14.

3.4 Initial and subsequent measurement of a SAFE under ASC 480

If the classification guidance in ASC 480 applies to a SAFE, it is typically initially measured at its fair value in accordance with the guidance in ASC 480-10-30-7 that applies to “all other” financial instruments (that is, not a mandatorily redeemable financial instrument or a physically settled forward purchase contract). A SAFE is also subsequently measured at fair value, with changes in fair value recognized in earnings, under ASC 480-10-35-5, as neither ASC 480 nor another Subtopic specifies another measurement attribute for SAFEs that are within the scope of this publication.

An issuer is not required to reassess whether a SAFE within the scope of this publication that was initially determined to be within the scope of ASC 480 continues to meet the criteria in either ASC 480-10-25-8 or 25-14, unless the SAFE is modified in a manner that, for accounting purposes, results in the inception of a new financial instrument.

ASC 480-10-30-7

All other financial instruments recognized under the guidance in Section 480-10-25 shall be measured initially at fair value.

ASC 480-10-35-5

All other financial instruments recognized under the guidance in Section 480-10-25 shall be measured subsequently at fair value with changes in fair value recognized in earnings, unless either this Subtopic or another Subtopic specifies another measurement attribute.

4. ASC 815-40 recognition criteria

If a SAFE is not within the scope of ASC 480, the issuer should evaluate the SAFE under the guidance in ASC 815-40 on contracts in an entity's own equity. According to ASC 815-40-15-5, the Subtopic applies to any freestanding financial instrument that is potentially settled in an entity's own stock, irrespective of whether the instrument meets the definition of a derivative.

ASC 815-40-15-5 (excerpt)

The guidance in this paragraph through paragraph 815-40-15-8 … also applies to any freestanding financial instrument that is potentially settled in an entity's own stock, regardless of whether the instrument has all the characteristics of a derivative instrument for purposes of determining whether the instrument is within the scope of this Subtopic.

There are two general concepts to consider when applying ASC 815-40 to a freestanding financial instrument:

1. Whether the instrument is indexed to the entity's own stock in accordance with ASC 815-40-15 (referred to as the "indexation" guidance); and
2. Whether the instrument is equity-classified in accordance with ASC 815-40-25 (referred to as the "equity classification" guidance).

Both concepts are discussed below.

4.1 Indexation guidance (ASC 815-40-15)

Within the indexation guidance in ASC 815-40-15, there are two conditions that must be met for the freestanding financial instrument to be considered indexed to the entity's own stock:

1. If the instrument is contingently exercisable, the exercise contingency is not based on an observable market (other than the market for the issuer's shares) or on an observable index (other than an index calculated or measured based solely on the issuer's operations).
2. The instrument's settlement amount will equal the difference between (a) the fair value of a fixed number of the entity's shares, and (b) a fixed monetary amount (referred to as "fixed-for-fixed" settlement). If the settlement amount varies, the variables are inputs to a fixed-for-fixed option pricing model.

ASC 815-40-15-7

An entity shall evaluate whether an equity-linked financial instrument (or embedded feature), as discussed in paragraphs 815-40-15-5 through 15-8 is considered indexed to its own stock within the meaning of this Subtopic and paragraph 815-10-15-74(a) using the following two-step approach:

a. Evaluate the instrument's contingent exercise provisions, if any.

b. Evaluate the instrument's settlement provisions.

Exercise contingencies

An "exercise contingency" is a provision that allows the issuer or the holder to exercise an equity-linked financial instrument based on changes in an underlying, including the occurrence or nonoccurrence of a specified event.

Exercise Contingency: A provision that entitles the entity (or the counterparty) to exercise an equity-linked financial instrument (or embedded feature) based on changes in an underlying, including the occurrence (or nonoccurrence) of a specified event. Provisions that accelerate the timing of the entity's (or the counterparty's) ability to exercise an instrument and provisions that extend the length of time that an instrument is exercisable are examples of exercise contingencies.

An exercise contingency causes an instrument not to be indexed to the issuer's stock if the contingency is based on an observable market other than the market for the issuer's stock or on an observable index other than an index calculated solely by reference to the issuer's own operations.

ASC 815-40-15-7A

An exercise contingency shall not preclude an instrument (or embedded feature) from being considered indexed to an entity's own stock provided that it is not based on either of the following:

a. An observable market, other than the market for the issuer's stock (if applicable)

b. An observable index, other than an index calculated or measured solely by reference to the issuer's own operations (for example, sales revenue of the issuer; earnings before interest, taxes, depreciation, and amortization of the issuer; net income of the issuer; or total equity of the issuer).

If the evaluation of Step 1 (this paragraph) does not preclude an instrument from being considered indexed to the entity's own stock, the analysis shall proceed to Step 2 (see paragraph 815-40-15-7C).

An exercise contingency based on an entity-specific transaction or event is not considered to be based on an observable market or index that would preclude the instrument from being indexed to the entity's stock, as discussed in Example 2 in ASC 815-40-55-26, which illustrates that warrants exercisable only

when the issuer completes an IPO contain an exercise contingency that does not preclude the warrants from being indexed to the issuer's own stock.

Example 2: Variability Involving Completion of an Initial Public Offering

ASC 815-40-55-26

Entity A issues warrants that permit the holder to buy 100 shares of its common stock for $10 per share. The warrants have 10-year terms; however, they only become exercisable if Entity A completes an initial public offering. The warrants are considered indexed to Entity A's own stock based on the following evaluation:

a. Step 1. The exercise contingency (that is, the initial public offering) is not an observable market or an observable index, so the evaluation of Step 1 does not preclude the warrants from being considered indexed to the entity's own stock. Proceed to Step 2.

b. Upon exercise, the settlement amount would equal the difference between the fair value of a fixed number of the entity's equity shares (100 shares) and a fixed strike price ($10 per share).

Conversely, an exercise contingency that is satisfied when the S&P 500 Index increases by a specified amount precludes an instrument from being indexed to the entity's stock, because the exercise contingency is based on an observable index other than one that is calculated or measured solely by reference to the issuer's operations. Such an exercise contingency automatically results in the instrument failing the indexation guidance, and the financial instrument is classified as a liability or asset rather than in equity.

'Fixed-for-fixed' settlement

Assuming it lacks an exercise contingency inconsistent with the criteria in ASC 815-40-15-7A, a financial instrument is considered indexed to the issuer's own stock if its settlement amount equals the difference between the fair value of a fixed number of the issuer's shares and a fixed monetary amount (the instrument satisfies the "fixed-for-fixed criterion"). In basic terms, the guidance in ASC 815-40-15 uses a fixed-for-fixed option or forward as a model of an instrument that is indexed to an entity's own stock. In a fixed-for-fixed option to purchase equity instruments, the settlement amount is equal to the difference between the fair value of a fixed number of equity instruments and the fixed strike price of the option.

ASC 815-40-15-7C

Unless paragraph 815-40-15-7A precludes it, an instrument (or embedded feature) shall be considered indexed to an entity's own stock if its settlement amount will equal the difference between the following:

a. The fair value of a fixed number of the entity's equity shares

b. A fixed monetary amount or a fixed amount of a debt instrument issued by the entity.

For example, an issued share option that gives the counterparty a right to buy a fixed number of the entity's shares for a fixed price or for a fixed stated principal amount of a bond issued by the entity shall be considered indexed to the entity's own stock.

According to ASC 815-40-15-7D, if the number of shares or the strike price in a financial instrument is subject to adjustment, then the instrument is not considered indexed to the issuer's own stock, unless the variables that affect the settlement amount are inputs to a fixed-for-fixed option or forward valuation model, such as the Black-Scholes-Merton model. All types of adjustments must be considered, regardless of whether the adjustment is probable or whether the events giving rise to the adjustment are within the issuer's control. Inputs to the Black-Scholes-Merton model include the strike price, term, risk-free rate, and the volatility of the underlying share price, among other factors described in ASC 815-40-15-7E.

An instrument is not considered indexed to the entity's own stock if the settlement calculation either (1) incorporates variables other than those used to measure the fair value of a fixed-for-fixed option or forward, or (2) contains a provision that increases the holder's exposure to variable inputs in a manner inconsistent with a fixed-for-fixed option or forward (for example, a leverage factor).

ASC 815-40-15-7D

An instrument's strike price or the number of shares used to calculate the settlement amount are not fixed if its terms provide for any potential adjustment, regardless of the probability of such adjustment(s) or whether such adjustments are in the entity's control. If the instrument's strike price or the number of shares used to calculate the settlement amount are not fixed, the instrument (or embedded feature) shall still be considered indexed to an entity's own stock if the only variables that could affect the settlement amount would be inputs to the fair value of a fixed-for-fixed forward or option on equity shares (provided that paragraph 815-40-15-7A does not preclude such a conclusion).

ASC 815-40-15-7E

A fixed-for-fixed forward or option on equity shares has a settlement amount that is equal to the difference between the price of a fixed number of equity shares and a fixed strike price. The fair value inputs of a fixed-for-fixed forward or option on equity shares may include the entity's stock price and additional variables, including all of the following:

a. Strike price of the instrument
b. Term of the instrument
c. Expected dividends or other dilutive activities
d. Stock borrow cost
e. Interest rates
f. Stock price volatility
g. The entity's credit spread
h. The ability to maintain a standard hedge position in the underlying shares.

Determinations and adjustments related to the settlement amount (including the determination of the ability to maintain a standard hedge position) shall be commercially reasonable.

Exercise contingencies that adjust the settlement amount

Some exercise contingencies adjust the settlement amount of a financial instrument, and ASC 815-40-15-7B specifies that such exercise contingencies should therefore be evaluated under both the exercise contingency guidance in ASC 815-40-15-7A and the fixed-for-fixed guidance in ASC 815-40-15-7C through 15-7H.

ASC 815-40-15-7B

If an instrument's strike price or the number of shares used to calculate the settlement amount would be adjusted upon the occurrence of an exercise contingency, the exercise contingency shall be evaluated under Step 1 (see the preceding paragraph) and the potential adjustment to the instrument's settlement amount shall be evaluated under Step 2 (see the guidance beginning in the following paragraph).

Like other variables that affect the settlement amount, exercise contingencies that affect the settlement amount must be evaluated to determine whether they constitute inputs to a fixed-for-fixed option pricing model. In general, variables that affect the settlement amount do not preclude a conclusion that an instrument is indexed to the issuer's stock, provided that those variables are inputs to a fixed-for-fixed option pricing model.

However, certain settlement-amount adjustments triggered by the occurrence of an event, such as a merger, that is *not* an explicit input to a fixed-for-fixed option pricing model nevertheless do not preclude an instrument from being considered indexed to the issuer's stock. These include adjustments that (1) are triggered by the occurrence of an event that is inconsistent with an assumption implicit in a fixed-for-fixed option pricing model, and (2) neutralize the effect the event has on the instrument's fair value.

For example, a fixed-for-fixed option pricing model such as the Black-Scholes-Merton model relies, in part, on an implicit assumption that stock price changes will be continuous, such that upon the occurrence of an event such as a merger announcement, the holder of an equity-linked instrument would be able to continuously adjust a position hedging the holder's exposure to changes in the stock price. In reality, events such as merger announcements might cause stock price discontinuities (that is, the stock price might "jump") that would preclude continuous adjustments to maintain an offsetting hedge position (a hedging disruption event). A financial instrument provision that adjusts the settlement amount in such a way that neutralizes the effect of a hedging disruption event does not preclude that instrument from being considered indexed to the issuer's stock.

ASC 815-40-15-7G

Standard pricing models for equity-linked financial instruments contain certain implicit assumptions. One such assumption is that the stock price exposure inherent in those instruments can be hedged by entering into an offsetting position in the underlying equity shares. For example, the Black-Scholes-

Merton option-pricing model assumes that the underlying shares can be sold short without transaction costs and that stock price changes will be continuous. Accordingly, for purposes of applying Step 2, fair value inputs include adjustments to neutralize the effects of events that can cause stock price discontinuities. For example, a merger announcement may cause an immediate jump (up or down) in the price of shares underlying an equity-linked option contract. A holder of that instrument would not be able to continuously adjust its hedge position in the underlying shares due to the discontinuous stock price change. As a result, changes in the fair value of an equity-linked instrument and changes in the fair value of an offsetting hedge position in the underlying shares will differ, creating a gain or loss for the instrument holder as a result of the merger announcement. Therefore, inclusion of provisions that adjust the terms of the instrument to offset the net gain or loss resulting from a merger announcement or similar event do not preclude an equity-linked instrument (or embedded feature) from being considered indexed to an entity's own stock.

Assume that a financial instrument requires the issuer to settle the instrument by delivering (1) a fixed number of its common shares to the investor upon an issuer IPO, or (2) a fixed amount of cash to the investor upon an issuer change in control. There are two exercise contingencies associated with this instrument: the occurrence of an IPO or a change in control. Each exercise contingency is associated with a different settlement amount, and therefore the settlement amount varies depending on which exercise contingency is triggered.

Accordingly, in this example, the exercise contingencies must be evaluated as variables that affect the settlement amount in the context of the fixed-for-fixed criterion. As exercise contingencies, neither an issuer IPO nor a change in control precludes this financial instrument from being indexed to the issuer's stock, because neither is based on an observable market or an observable index. As variables that affect the settlement amount, however, the occurrence of either an issuer IPO or a change in control would preclude this financial instrument from being indexed to the issuer's own stock, because (1) the occurrence of either event is not an input to a fixed-for-fixed option pricing model, and (2) the adjustment to the settlement amount associated with each exercise contingency is not designed to neutralize the effect of an event that is inconsistent with an implicit assumption in a fixed-for-fixed option pricing model.

This concept is illustrated by Example 10 in ASC 815-40-55-35. In this example, the resolution of a contingency (failure to obtain regulatory approval of a drug compound) alters the settlement amount by providing the holder with the option to exchange issuer stock warrants for a fixed payoff.

Example 10: Variability Involving Regulatory Approval

ASC 815-40-55-35

Entity A issues warrants that permit the holder to buy 100 shares of its common stock for $10 per share. The warrants have 10-year terms and are exercisable at any time. However, the terms of the warrants specify that if Entity A does not obtain regulatory approval of a particular drug compound within 5 years, the holder can surrender the warrants to Entity A for $2 per warrant (settleable in shares). The contingently puttable warrants are not considered indexed to Entity A's own stock based on the following evaluation:

a. Step 1. The instruments do not contain an exercise contingency. Proceed to Step 2.

b. Step 2. The settlement amount would equal the difference between the fair value of a fixed number of the entity's equity shares (100 shares) and a fixed strike price ($10 per share), unless regulatory approval of a particular drug compound is not obtained within 5 years. If that approval is not obtained within the allotted time period, the holder could elect to surrender the warrants to Entity A in exchange for $2 per warrant. The contingent obligation to settle the warrants by transferring consideration with a fixed monetary value if regulatory approval of a particular drug compound is not obtained within a specified time period does not represent an input to the fair value of a fixed-for-fixed option on equity shares. A freestanding equity-linked instrument that provides for a fixed payoff upon the occurrence of a contingent event which is not based on the issuer's share price is not indexed to an entity's own stock.

Do typical share-settlement provisions in a SAFE satisfy the fixed-for-fixed criterion?

The following discussion addresses typical share-settlement provisions found in SAFEs and whether they satisfy the fixed-for-fixed criterion, which, if not satisfied, precludes the SAFE from being indexed to the issuer's stock.

Fixed-share settlement

In certain circumstances, fixed-share-settlement provisions, whereby an issuer is required to deliver a number of its shares to the instrument holder equal to the quotient of a fixed amount (such as the purchase amount in a SAFE) and a specified price per share, require adjustments to the specified price per share.

Antidilution adjustments

The specified price per share might be adjusted if, for instance, the issuer declares an ordinary cash or stock dividend, completes a stock split, or issues shares at a discount to the current market price. All of these events would cause "dilution" to the holder of an equity-linked financial instrument with a fixed-share-settlement provision (in other words, the value of the equity-linked instrument would be diminished). Under ASC 815-40-15, so-called "antidilution" adjustments, which are designed to protect the equity-linked instrument holder from diminution in value from dilutive events, do not preclude an instrument from satisfying the fixed-for-fixed criterion. Likewise, adjustments that would reverse the increase in fair value to an equity-linked instrument holder from a stock combination or the sale of stock at a premium to fair value would not preclude an instrument from satisfying the fixed-for-fixed criterion.

An adjustment to the settlement amount of an equity-linked instrument based on the issuance of shares at fair value is not an antidilution adjustment, as an at-market issuance of shares does not economically dilute the holder's investment. Such an adjustment does not satisfy the fixed-for-fixed criterion and precludes equity classification, unless the adjustment is a down round adjustment, as further explained below.

Down round adjustments

In addition to antidilution adjustments, so-called "down round" adjustments do not preclude an instrument from satisfying the fixed-for-fixed criterion. A down round feature is a provision by which the strike price of a financial instrument is reduced if the issuer either (a) sells shares of its stock for an amount less than the currently stated strike price of the issued financial instrument, or (b) issues an equity-linked financial instrument with a strike price below the current strike price of the issued financial

instrument. In the definition of a down round feature, the strike price can be reduced to (a) the current issuance price; (b) a price that is a discount to the original strike price but more than the current issuance price of the shares; or (c) an amount below the current issuance price.

When a down round feature is triggered, the holder of the financial instrument benefits from a reduction in the strike price, even if the issuer sells stock at, or issues a financial instrument with a strike price equal to, the current market price of the issuer's shares. Given that the holder benefits from a strike price reduction in response to non-dilutive at-market issuances, a down round feature is not a standard antidilution provision that protects the holder against economic dilution.

In accordance with ASC 815-40-15-5D and with Example 9 in ASC 815-40-55-33, a down round feature is excluded from the evaluation of whether an instrument is indexed to the entity's own stock, and specifically from whether the fixed-for-fixed criterion is met. In other words, the existence of a down round feature on its own does not preclude an instrument from being indexed to the issuer's own stock.

While the existence of a down round feature does not preclude an instrument from satisfying the fixed-for-fixed criterion, it is important to carefully consider whether any features that require adjustments to an instrument's strike price in a manner that appears similar to a down round adjustment actually meet the definition of a down round feature, as prescribed in U.S. GAAP.

The definition of a down round feature contemplates adjustments to an existing strike price only if either a share or an equity-linked contract is issued in the future. We believe a qualifying adjustment must be triggered by a future *issuance* of shares or equity-linked contracts, and does not extend to adjustments triggered by a *modification* of another existing instrument. In other words, a modification is not treated the same as an issuance when applying the definition of a down round feature.

Adjustments based on the issuer's 'capitalization'

SAFEs often include settlement provisions that require the delivery of cash or shares based on the quotient of a "valuation cap" divided by the issuer's "capitalization." As described in Section 1, a valuation cap typically refers to a fixed or implied valuation of the issuer, whereas capitalization usually refers to the number of issuer shares outstanding on the settlement date on a fully or semidiluted basis. The settlement amount associated with a provision that uses the issuer's capitalization as an input is affected by the number of issuer shares outstanding, which is not an input to a fixed-for-fixed option pricing model. Also, an increase in the issuer's capitalization might occur regardless of the price of a stock issuance relative to a specified strike price, such that it is not a down round feature. Accordingly, adjustments based on the issuer's capitalization typically do not satisfy the fixed-for-fixed criterion.

Variable-share settlement

SAFEs typically contain one or more settlement provisions that require the issuer to transfer a variable number of shares to the holder, with the variable number of shares calculated as the quotient of a fixed amount divided by the fair value (or a fixed percentage of fair value) of a share at the settlement date. If the number of shares transferred under such a provision is solely a function of the issuer's stock price, which is an input to a fixed-for-fixed option pricing model, the provision might appear to satisfy the fixed-for-fixed criterion. However, it is important to consider whether the variability based on the stock price affects the settlement amount (for example, the fair value of the shares transferred to the holder upon settlement) or the number of shares transferred to provide a *fixed* settlement amount.

A fixed settlement amount, whether paid in cash or a variable number of shares, does not in and of itself satisfy the fixed-for-fixed criterion. In general, an instrument is considered indexed to an issuer's own stock if its settlement amount is equal to the difference between the fair value of a fixed number

of the issuer's shares and a fixed monetary amount, in which case, the settlement amount is positively correlated to the issuer's stock price. Adjustments to a variable settlement amount that equals the difference between the fair value of a fixed number of shares and a fixed monetary amount do not preclude an instrument from being indexed to the issuer's own stock, as long as the adjustments are based on inputs to a fixed-for-fixed option pricing model. A fixed settlement amount, on the other hand, does not equal the difference between the fair value of a fixed number of shares and a fixed monetary amount, and, therefore, a financial instrument for which the only settlement amount is fixed does not satisfy the fixed-for-fixed criterion.

Variable- and fixed-share settlement

It is also common for a SAFE to require the issuer to transfer a number of shares equal to the greater of (a) a fixed monetary amount divided by the current fair value of a share, and (b) the same fixed monetary amount divided by a fixed price per share. The fixed price per share under (b) functions like a cap on the share-price-settlement input.

A cap or a floor on the share price input used in calculating the settlement amount does not preclude an instrument from satisfying the fixed-for-fixed criterion. In Example 16 in ASC 815-40-55-41, a forward contract to sell shares for $1,000 in total proceeds is settled in a variable number of shares when the entity's share price is greater than $10 but equal to or less than $12 at settlement, and is otherwise settled in a fixed number of shares when

1. The share price is less than $10 (a fixed number of 100 shares is issued, so the share price floor is $10); and
2. The share price is above $12 (a fixed number of 83.33 shares is issued, so the share price cap is $12).

Example 16 concludes that the forward contract is still considered to be indexed to the entity's own stock, since the adjustments to the settlement amount depend solely on the entity's share price, which is an input to a fixed-for-fixed option pricing model. Note that in Example 16, the settlement amount is not fixed; it increases as the share price appreciates above $12.

Multiple contingent settlement amounts

Many SAFEs require the issuer to settle the instrument at varying settlement amounts depending on the contingent event (exercise contingency) that triggers settlement. For example, a SAFE might require the issuer to settle the instrument by transferring to the holder a variable number of shares with a fixed monetary value upon a qualifying equity raise, or by transferring to the holder either a fixed or variable number of shares with either a variable or fixed monetary value, respectively, upon a change in control. In this example, since the settlement amount varies based on whether a qualifying equity raise or a change in control occurs, neither of which is an input to a fixed-for-fixed option pricing model, and because the adjustment to the settlement amount associated with each exercise contingency is not designed to neutralize the effect of an event that is inconsistent with an implicit assumption in a fixed-for-fixed option pricing model, the SAFE would not satisfy the fixed-for-fixed criterion.

When a financial instrument must be settled at different amounts depending on the nature of the contingent event that triggers settlement, the contingent event must be assessed as both an exercise contingency and as a variable that adjusts the settlement amount. The occurrence of most contingent events neither constitute an input to a fixed-for-fixed option pricing model nor require an adjustment to the settlement amount meant to neutralize the effect of the event on the fair value of a financial instrument, and therefore many financial instruments that must be settled at different amounts

depending on the nature of the contingent event that triggers settlement are not indexed to the issuer's stock and must be presented as liabilities by the issuer.

The following examples illustrate the application of the indexation guidance to terms commonly found in a SAFE.

Examples – Determining whether a SAFE satisfies the fixed-for-fixed criterion

Scenario A – SAFE does not satisfy the fixed-for-fixed criterion

ABC Corp. issues a SAFE to Investor Y in exchange for $5 million in cash. The SAFE requires ABC Corp. to transfer a variable number of preferred shares with a monetary value equal to $6 million to Investor Y if and when ABC Corp. completes a qualifying preferred stock issuance. If ABC Corp. undergoes a change in control (that is outside ABC Corp.'s control) or completes an IPO prior to a qualifying preferred stock issuance, then ABC Corp. must transfer shares of its existing Series B preferred stock to Investor Y, with the number of shares equal to the greater of (a) $5 million divided by the current fair value of a Series B preferred share, and (b) $5 million divided by a fixed price per Series B preferred share. ABC Corp.'s Series B preferred shares are convertible into common shares at the investor's option and are nonredeemable.

ABC Corp. determines that the SAFE is not in the scope of ASC 480 (see Section 3 for further discussion).

ABC Corp. then applies ASC 815-40 to the SAFE. There are three exercise contingencies, including the occurrence of a qualifying preferred stock issuance, a change in control, or an IPO. None of these exercise contingencies precludes the SAFE from being indexed to the issuer's own stock based on the guidance in ASC 815-40-15-7A, as they are not based on an observable market or index.

Since the exercise contingencies affect the settlement amount, they should also be evaluated under the "fixed-for-fixed" guidance in ASC 815-40-15-7C through 15-7H. There are three potential settlement amounts associated with this SAFE:

- $6 million, settled with a variable number of shares upon a qualifying preferred stock issuance.
- $5 million, settled with a variable number of shares upon either a change in control or an IPO, provided that $5 million is greater than the fair value of the fixed number of shares calculated by dividing $5 million by the specified fixed price per share.
- The fair value of the fixed number of shares calculated by dividing $5 million by the specified fixed price per share upon either a change in control or an IPO, provided this amount is higher than $5 million.

Therefore, the SAFE's settlement amount varies based on whether a qualifying preferred stock issuance, a change in control, or an IPO occurs. The occurrence of any of these events is not an input to a fixed-for-fixed option pricing model, and the adjustment to the settlement amount associated with each event is not designed to neutralize the effect of the event on the SAFE's fair value. Although the fair value of a preferred share is used to calculate the number of shares transferred to the investor in a variable-share-settlement scenario, and the fair value of a share is an input to a fixed-for-fixed pricing model, in this case, the fair value of a share does not affect the settlement amount. The settlement

amount in the variable-share-settlement scenarios is a fixed amount equal to the fair value of all the shares transferred to the investor.

Because the SAFE's settlement alternatives do not satisfy the fixed-for-fixed criterion, the SAFE is not indexed to the issuer's own stock.

Scenario B – SAFE does not satisfy the fixed-for-fixed criterion

DEF Corp. issues a SAFE to Investor Z in exchange for $5 million in cash. If and when DEF Corp. completes a qualifying preferred stock issuance, the SAFE requires DEF Corp. to transfer a variable number of those preferred shares equal to the greater of (a) $5 million divided by the fair value of a preferred share, and (b) $5 million divided by the "liquidity price." The liquidity price is equal to the quotient of $15 million divided by DEF Corp.'s "capitalization" on the settlement date. The issuer's capitalization is equal to the number of DEF Corp.'s shares that are outstanding on the settlement date on a fully diluted basis.

DEF Corp. determines that the SAFE is not in the scope of ASC 480 (see Section 3 for further discussion).

DEF Corp. then applies the guidance in ASC 815-40 to the SAFE. There is one exercise contingency: the occurrence of a qualifying preferred stock issuance. This exercise contingency does not preclude the SAFE from being indexed to the issuer's own stock based on the guidance in ASC 815-40-15-7A, as it is not based on an observable market or index.

Next, DEF Corp. evaluates the SAFE's settlement provision based on a variable number of preferred shares equal to the quotient of $5 million divided by the liquidity price. Since the liquidity price is equal to the quotient of $15 million divided by the capitalization, the holder is entitled to a number of shares equal to one-third of DEF Corp.'s total outstanding shares on a fully diluted basis on the settlement date. In other words, Investor Z becomes entitled to more shares under this settlement provision if DEF Corp. issues additional shares at any price, including fair value. Issuing additional shares at fair value is not an economically dilutive event, and whether Investor Z becomes entitled to more shares under this provision is not affected by the issuance price per share relative to a fixed exercise price in the SAFE.

In this scenario, the potential adjustment to the number of shares transferrable to Investor Z is neither an antidilution adjustment nor a down round adjustment. The settlement amount is affected by the number of issuer shares outstanding at a point in time, which is not an input to a fixed-for-fixed option pricing model. Consequently, this provision precludes the SAFE from satisfying the fixed-for-fixed criterion in ASC 815-40-15.

4.2 Equity classification guidance (ASC 815-40-25)

If a freestanding financial instrument is indexed to an entity's own stock, then the next step to classify the instrument is to assess whether the instrument meets the equity classification guidance in ASC 815-40-25. The principle underlying the equity classification guidance is as follows:

- If the instrument requires net cash settlement, it must be classified as an asset or liability, regardless of the likelihood that circumstances would arise requiring net cash settlement.
- If the instrument requires share settlement, it must be classified as equity.

ASC 815-40-25-1 (excerpt)

… The initial balance sheet classification of contracts within the scope of this Subtopic generally is based on the concept that:

a. Contracts that require net cash settlement are assets or liabilities.

b. Contracts that require settlement in shares are equity instruments.

ASC 815-40-25-4(a) expands on this principle, stating that an instrument must be initially classified as an asset or a liability if either one of the following conditions applies:

- The contract requires net cash settlement, including when an event occurs that is outside the issuer's control; or
- The contract gives the counterparty a choice between net cash settlement and share settlement (either physical or net share settlement).

Conversely, under ASC 815-40-25-4(b), instruments that meet either one of the following conditions must be initially classified as equity, provided that other criteria for equity classification are met:

- The contract requires physical or net share settlement; or
- The contract gives the issuer a choice between net cash settlement and share settlement (either physical or net share settlement).

ASC 815-40-25-4

Accordingly, unless the economic substance indicates otherwise:

a. Contracts shall be initially classified as either assets or liabilities in both of the following situations:

    1. Contracts that require net cash settlement (including a requirement to net cash settle the contract if an event occurs and if that event is outside the control of the entity)

    2. Contracts that give the counterparty a choice of net cash settlement or settlement in shares (physical settlement or net share settlement).

b. Contracts shall be initially classified as equity in both of the following situations:

    1. Contracts that require physical settlement or net share settlement

    2. Contracts that give the entity a choice of net cash settlement or settlement in its own shares (physical settlement or net share settlement), assuming that all the criteria set forth in paragraphs 815-40-25-7 through 25-30 and 815-40-55-2 through 55-6 have been met.

There are a couple of caveats to this principle in ASC 815-40-25 that are important to keep in mind.

First, equity classification is not precluded upon certain qualifying events if both (1) an instrument is required to be net cash settled, and (2) holders of the same shares underlying the financial instrument also receive cash in exchange for their shares. As explained in ASC 815-40-25-7 and 25-8 and in 55-2 through 55-6, this limited exception applies if net cash settlement is required upon the occurrence of certain events outside the issuer's control, including a change in control or a nationalization whereby the holders of the underlying shares also receive cash (that is, the same form of consideration).

ASC 815-40-25-7

Contracts that include any provision that could require net cash settlement cannot be accounted for as equity of the entity (that is, asset or liability classification is required for those contracts), except in those limited circumstances in which holders of the underlying shares also would receive cash (as discussed in the following two paragraphs and paragraphs 815-40-55-2 through 55-6).

ASC 815-40-25-8

Generally, if an event that is not within the entity's control could require net cash settlement, then the contract shall be classified as an asset or a liability. However, if the net cash settlement requirement can only be triggered in circumstances in which the holders of the shares underlying the contract also would receive cash, equity classification is not precluded.

ASC 815-40-55-2

An event that causes a change in control of an entity is not within the entity's control and, therefore, if a contract requires net cash settlement upon a change in control, the contract generally must be classified as an asset or a liability.

ASC 815-40-55-3

However, if a change-in-control provision requires that the counterparty receive, or permits the counterparty to deliver upon settlement, the same form of consideration (for example, cash, debt, or other assets) as holders of the shares underlying the contract, permanent equity classification would not be precluded as a result of the change-in-control provision. In that circumstance, if the holders of the shares underlying the contract were to receive cash in the transaction causing the change in control, the counterparty to the contract could also receive cash based on the value of its position under the contract.

ASC 815-40-55-6

In the event of nationalization, cash compensation would be the consideration for the expropriated assets and, as a result, a counterparty to the contract could receive only cash, as is the case for a holder of the stock underlying the contract. Because the contract counterparty would receive the same form of consideration as a stockholder, a contract provision requiring net cash settlement in the event of nationalization does not preclude equity classification of the contract.

Second, cash settlement that is required only upon the final liquidation of the issuer is not considered when applying ASC 815-40-25. Otherwise, the likelihood that an event outside the issuer's control requiring cash settlement will occur does not impact the equity classification analysis. Said differently,

regardless of how likely or unlikely an issuer deems the occurrence of an event requiring cash settlement, the mere existence of the cash-settlement provision triggered by an event outside the issuer's control results in the instrument being classified as an asset or a liability.

ASC 815-40-25-9

This Subtopic does not allow for an evaluation of the likelihood that an event would trigger cash settlement (whether net cash or physical), except that if the payment of cash is only required upon the final liquidation of the entity, then that potential outcome need not be considered when applying the guidance in this Subtopic.

Do typical cash-settlement provisions preclude SAFEs from satisfying the general equity classification criteria?

Determining whether a SAFE satisfies the general equity classification criteria depends on whether the occurrence of an event requiring cash settlement is within the issuer's control and, if not, whether the holders of the underlying shares would also receive cash upon the occurrence of certain events not within the issuer's control, specifically a change in control or a nationalization.

Many SAFEs require or permit the holder to choose cash settlement if a change in control occurs that is outside the issuer's control. If a SAFE contains this sort of provision, the issuer must classify the SAFE as a liability under ASC 815-40-25, unless the holders of the underlying shares would also receive the same form of consideration (in this case, cash) in exchange for their shares upon the change in control. The issuer should consider whether the provisions of the shares underlying the SAFE entitle the holders to redeem their shares for cash upon the occurrence of the same change in control that would require net cash settlement of the SAFE. If so, classifying the SAFE within the issuer's equity is not precluded. However, if the holders of the underlying shares are not entitled to the same form of consideration, then equity classification is precluded.

If the shares underlying the SAFE are common shares, the issuer should consider whether a third-party cash-tender offer accepted by holders of shares representing more than 50 percent of the voting power in the issuer would constitute a change in control entitling the SAFE holders to net cash settlement. If so, then the issuer's requirement to net cash settle the SAFE upon the change in control would not preclude the SAFE from being classified as equity, as long as underlying shareholders receive the same form of consideration. For more information on this particular issue, addressed in the context of a stock warrant, see Section 4.1.3 in our Viewpoint, *Merging with a special purpose acquisition company.*

However, the issuer must classify the SAFE as a liability under ASC 815-40-25 if there are multiple liquidity events defined in the SAFE agreement outside the issuer's control that would require the issuer to net cash settle the SAFE, provided any of those liquidity events do not constitute a change in control (based on voting power) or a nationalization. In these circumstances, even if the holders of the underlying shares would be entitled to receive cash for their shares, then the issuer must present the SAFE as a liability under ASC 815-40-25.

To determine whether events are within the issuer's control, an issuer should carefully consider how a liquidity event is defined in the legal agreements of both the SAFE and any relevant governing

documents, whether the issuer's board of directors controls the ability to effect the liquidity event(s), and any applicable laws in the jurisdiction where the issuer is incorporated.

Additional equity classification criteria

In addition to the general equity classification criteria discussed above, an issuer must consider additional criteria to ensure no scenarios exist that could require net cash settlement of a freestanding financial instrument.

Sufficient authorized and unissued shares

An issuer does not control the share settlement of an instrument and is therefore precluded from classifying the instrument in equity if it lacks sufficient authorized and unissued shares to settle an instrument at the reporting date and must obtain shareholder approval to increase its authorized shares. To determine whether it has sufficient authorized and unissued shares, an issuer calculates the difference between the following amounts:

(1) The number of currently authorized but unissued shares, less the maximum number of shares that the issuer could be required to issue to settle other existing instruments (for example, to settle outstanding warrants) while the instrument being evaluated is outstanding

(2) The maximum number of shares that the issuer could be required to deliver upon settling the financial instrument being evaluated

If the resulting number of shares in item (1) above is less than the total shares in item (2), equity classification for the instrument is precluded.

Explicit share limit

If the number of shares to be delivered in a share settlement is indeterminate, then an instrument is precluded from being classified in equity. For example, with respect to an instrument that contains a variable-share-settlement feature in which the number of shares the issuer is required to transfer to the investor equals the quotient of a fixed dollar amount divided by the current fair value of a share, the fair value of a share could fall to nearly zero and, barring some contractual provision to the contrary (or liquidation of the entity), the issuer could be obligated to deliver an unlimited number of shares to the investor, assuming that settlement could be triggered by an event outside the issuer's control.

No required cash payment for failure to timely file

Some instruments that permit share settlement require cash settlement if the issuer fails to make timely required filings with the SEC and are, therefore, precluded from equity classification, because making timely filings with the SEC depends on factors outside the issuer's control (for example, an auditor's issuance of an opinion on the financial statements). However, the amendments in ASU 2020-06 clarified the guidance in ASC 815-40-25-10(d) by stipulating that payment of a cash penalty if an issuer fails to timely file with the SEC does not preclude equity classification, because these penalty payments do not result in the settlement of the instrument.

Refer to our New Developments Summary (NDS) 2020-10 for further discussion on adopting the guidance in ASU 2020-06.

No cash-settled top-off or make-whole provisions

Some instruments include “top-off” or “make-whole” provisions. These types of provisions require an issuer to make a cash payment to the holder of a financial instrument if the value realized by the holder upon the post-settlement sale of the equity shares underlying the financial instrument decreases relative to the specified total return of the financial instrument (for example, the settlement-date value). The existence of these types of provisions would preclude the instrument from being classified in equity.

Cash settlement required if registered shares unavailable

ASC 815-40-25-10A(a) states that equity classification is precluded for an equity-linked contract that explicitly requires an issuer to settle the instrument in cash if registered shares are unavailable. After an issuer adopts the amendments in ASU 2020-06, the guidance in ASC 815-40-25-10A(a) no longer requires entities to look beyond the contractual terms to evaluate whether there is an *implicit* requirement to cash settle the instrument in the absence of an effective registration statement. In other words, an instrument could meet the equity classification criteria if the contract either (1) requires settlement in registered shares but does not specify the form of settlement in the event that the registered shares are unavailable, or (2) is silent about whether share settlement requires registered shares.

ASC 815-40-25-10

Because any contract provision that could require net cash settlement precludes accounting for a contract as equity of the entity (except for those circumstances in which the holders of the underlying shares would receive cash, as discussed in paragraphs 815-40-25-8 through 25-9 and paragraphs 815-40-55-2 through 55-6), all of the following conditions must be met for a contract to be classified as equity:

a. Subparagraph superseded by Accounting Standards Update No. 2020-06.

b. Entity has sufficient authorized and unissued shares. The entity has sufficient authorized and unissued shares available to settle the contract after considering all other commitments that may require the issuance of stock during the maximum period the derivative instrument could remain outstanding.

c. Contract contains an explicit share limit. The contract contains an explicit limit on the number of shares to be delivered in a share settlement.

d. No required cash payment (with the exception of penalty payments) if entity fails to timely file. There is no requirement to net cash settle the contract in the event the entity fails to make timely filings with the Securities and Exchange Commission (SEC).

e. No cash-settled top-off or make-whole provisions. There are no cash settled top-off or make-whole provisions.

f. Subparagraph superseded by Accounting Standards Update No. 2020-06.

g. Subparagraph superseded by Accounting Standards Update No. 2020-06.

Paragraphs 815-40-25-39 through 25-42 explain the application of these criteria to convertible debt and other hybrid instruments.

ASC 815-40-25-10A

The following conditions are not required to be considered in an entity's evaluation of net cash settlement (that is, if any one of these provisions is in a contract [or the contract is silent on these points], they should not preclude equity classification, except as described below):

a. Whether settlement is required in registered shares, unless the contract explicitly states that an entity must settle in cash if registered shares are unavailable. Requirements to deliver registered shares do not, by themselves, imply that an entity does not have the ability to deliver shares and, thus, do not require a contract that otherwise qualifies as equity to be classified as a liability.

b. Whether counterparty rights rank higher than shareholder rights. If the provisions of the contract indicate that the counterparty has rights that rank higher than the rights of a shareholder of the stock underlying the contract, this provision does not preclude equity classification.

c. Whether collateral is required. A provision requiring the entity to post collateral at any time for any reason does not preclude equity classification.

The following examples apply the equity classification concepts in ASC 815-40-25 to a SAFE.

Examples – Determining whether a SAFE satisfies the equity classification criteria

Scenario A – SAFE satisfies the equity classification criteria

DEF Corp. issues a SAFE to Investor Z in exchange for $5 million in cash. If and when DEF Corp. completes a qualifying preferred stock issuance, the SAFE requires DEF Corp. to transfer a variable number of those preferred shares equal to the greater of (a) $6 million divided by the fair value of a preferred share, and (b) $6 million divided by a fixed price per share.

DEF Corp. determines that the SAFE is not in the scope of ASC 480 (see Section 3) and that the SAFE satisfies the indexation criterion in ASC 815-40-15[1] (see Section 4.1). DEF Corp. then applies ASC 815-40-25 to the SAFE: DEF Corp. first evaluates whether there is a requirement to net cash settle the

[1] These examples do not consider the outcome of an analysis under the indexation guidance in ASC 815-40-15, as their purpose is to illustrate the application of the equity classification guidance in ASC 815-40-25.

SAFE upon the occurrence of an event outside its control. DEF Corp. determines that under no circumstances could DEF Corp. be required to cash settle the SAFE.

- DEF Corp. then assesses the additional equity classification criteria in ASC 815-40-25-10 and 25-10A. Although a settlement provision that requires the issuer to transfer a variable number of shares equal to a fixed monetary amount does not meet the “explicit share limit” criterion, in this case, the settlement provision is linked to an event that is within the issuer’s control (a qualifying preferred stock issuance). Likewise, whether DEF Corp. lacks sufficient authorized shares to share settle the SAFE is irrelevant because the event requiring delivery of the shares is within the issuer’s control. Further, the SAFE does not explicitly require the delivery of registered shares or cash settlement if the issuer is unable to make timely filings with the SEC, and it does not include any cash-settled top-off or make-whole provisions.

DEF Corp. concludes that the equity classification criteria in ASC 815-40-25 are satisfied. Therefore, the SAFE is classified within equity.

Scenario B – SAFE does not satisfy the equity classification criteria

Assume the same facts as in Scenario A, except that if DEF Corp. undergoes a change in control that is outside its control prior to a qualifying preferred stock issuance, then it must transfer cash to Investor Z in an amount equal to the greater of (a) the fair value of a number of its common shares, calculated by dividing $6 million by a fixed price per common share, and (b) $6 million. A change in control could occur without DEF Corp.’s shareholders being entitled to receive cash in exchange for their shares.

As a result, the SAFE does not satisfy the equity classification criteria in ASC 815-40-25 and is classified as a liability, since the SAFE requires cash settlement upon a change in control that is outside DEF Corp.’s control and its shareholders are not entitled to redeem their shares for cash upon a change in control.

4.3 Initial and subsequent measurement of a SAFE under ASC 815-40

All financial instruments, whether classified as liabilities (or assets) or within equity in accordance with ASC 815-40, are initially measured at fair value in accordance with ASC 815-40-30-1.

ASC 815-40-30-1

All contracts within the scope of this Subtopic shall be initially measured at fair value.

Financial instruments that are classified as liabilities (or assets) in accordance with ASC 815-40 are subsequently measured at fair value, with changes in fair value recognized in earnings, under ASC 815-40-35-4. Therefore, the subsequent measurement guidance in ASC 815-40 and ASC 480 are the same for liability-classified SAFEs.

ASC 815-40-35-4

All other contracts classified as assets or liabilities under Section 815-40-25 or paragraph 815-40-15-8A shall be measured subsequently at fair value, with changes in fair value reported in earnings and disclosed in the financial statements as long as the contracts remain classified as assets or liabilities (see paragraph 815-40-50-1).

Financial instruments that are classified within permanent equity in accordance with ASC 815-40 are not required to be subsequently remeasured, as long as the instruments continue to be classified within equity. An issuer must continually reassess its financial instruments classified under the guidance in ASC 815-40 at each reporting date to confirm that they are appropriately classified as liabilities (or assets) or within equity, as noted in ASC 815-40-35-8.

ASC 815-40-35-2

Contracts that are initially classified as equity under Section 815-40-25 shall be accounted for in permanent equity as long as those contracts continue to be classified as equity. Subsequent changes in fair value shall not be recognized as long as the contracts continue to be classified as equity. Both of the following shall be reported in permanent equity:

a. Contracts that require that the entity deliver shares as part of a physical settlement or a net share settlement

b. Contracts that give the entity a choice of either of the following:

    1. Net cash settlement or settlement in shares (including net share settlement and physical settlement that requires that the entity deliver shares)

    2. Either net share settlement or physical settlement that requires that the entity deliver cash.

ASC 815-40-35-8

The classification of a contract (including freestanding financial instruments and embedded features) shall be reassessed at each balance sheet date. If the classification required under this Subtopic changes as a result of events during the period (if, for example, as a result of voluntary issuances of stock the number of authorized but unissued shares is insufficient to satisfy the maximum number of shares that could be required to net share settle the contract [see discussion in paragraph 815-40-25-20]), the contract shall be reclassified as of the date of the event that caused the reclassification. There is no limit on the number of times a contract may be reclassified.

Appendix

The following table contains the titles of guidance cited in this publication from both the FASB's Accounting Standards Codification (ASC) and relevant Accounting Standards Updates (ASUs), along with other referenced guidance.

Quick reference	Title
ASC 480	*Distinguishing Liabilities from Equity*
ASC 815-40	*Derivatives and Hedging – Contracts in Entity's Own Equity*
ASR 268	SEC Accounting Series Release 268, *Presentation in Financial Statements of "Redeemable Preferred Stocks"*
ASU 2020-06	*Debt – Debt with Conversion and Other Options (Subtopic 470-20) and Derivatives and Hedging – Contracts in Entity's Own Equity (Subtopic 815-40), Accounting for Convertible Instruments and Contracts in an Entity's Own Equity*
FAS 150	FASB Statement 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*

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