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To the Point

FASB simplifies an issuer's accounting for debt and equity instruments

The new guidance simplifies an issuer's accounting for convertible instruments and contracts in its own equity.

What you need to know

- The FASB simplified an issuer's accounting for convertible instruments by eliminating two of the three models in ASC 470-20 that require separate accounting for embedded conversion features; separate accounting is still required in certain cases.
- The guidance simplifies the settlement assessment that entities are required to perform to determine whether a contract qualifies for equity classification.
- The guidance requires entities to use the if-converted method for all convertible instruments in the diluted EPS calculation and include the effect of potential share settlement (if the effect is more dilutive) for instruments that may be settled in cash or shares, except for certain liability-classified share-based payment awards.
- The guidance requires new disclosures about events that occur during the reporting period and cause conversion contingencies to be met and about the fair value of a PBE's convertible debt at the instrument level, among other things.
- For PBEs other than smaller reporting companies as defined by the SEC, the guidance is effective for annual periods beginning after 15 December 2021, and interim periods therein. For all other entities, it is effective for annual periods beginning after 15 December 2023, and interim periods therein. Early adoption is permitted in fiscal years beginning after 15 December 2020.

Overview

The Financial Accounting Standards Board (FASB or Board) issued **final guidance**[1] that simplifies an issuer's accounting for convertible instruments and its application of the derivatives scope exception for contracts in its own equity.

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The FASB issued the Accounting Standards Update (ASU) in response to feedback from preparers, auditors and users that the legacy guidance is unnecessarily complex and often results in conclusions based on form rather than substance.

The new guidance eliminates two of the three models in Accounting Standards Codification (ASC) 470-20[2] that require separating embedded conversion features from convertible instruments. As a result, only conversion features accounted for under the substantial premium model in ASC 470-20 and those that require bifurcation in accordance with ASC 815-15[3] will be accounted for separately. For contracts in an entity's own equity, the new guidance eliminates some of the requirements in ASC 815-40[4] for equity classification.

The guidance also addresses how convertible instruments are accounted for in the diluted earnings per share (EPS) calculation and requires enhanced disclosures about the terms of convertible instruments and contracts in an entity's own equity.

Key considerations

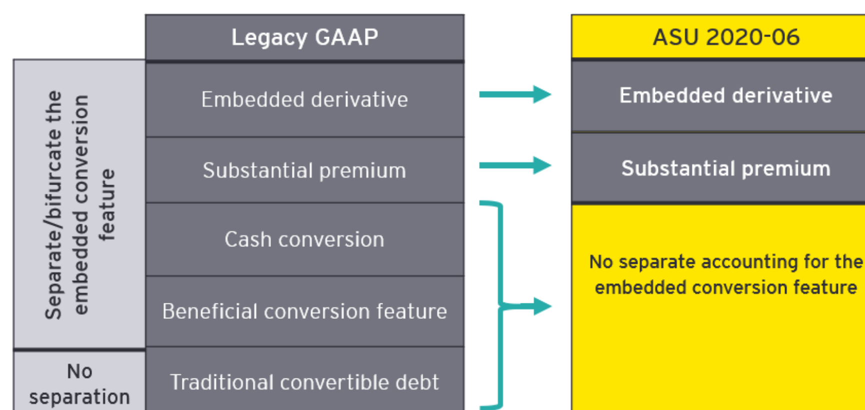
Convertible instruments

The new guidance is intended to reduce the complexity of accounting for convertible instruments and to provide investors and other users of the financial statements with more meaningful information.

The legacy guidance requires issuers to apply one of five different models to account for convertible debt, depending on the terms of the instrument. Four of those models (three in ASC 470 and the derivative model in ASC 815) require separate accounting for convertible features and provide different measurement guidance. Convertible preferred stock is required to be assessed using similar models. As a result, some convertible instruments are accounted for as a single unit of account but others are accounted for as two units of account (i.e., the embedded conversion feature is separated from the host contract and accounted for in equity or as a derivative asset or liability).

Preparers and auditors told the FASB they often find it difficult to understand and apply the guidance, while users of the financial statements said they generally analyze convertible instruments as a single instrument, which requires them to combine the two components if the conversion feature is accounted for separately.

As illustrated in the graphic below, the ASU eliminates the cash conversion and beneficial conversion feature models in ASC 470-20 that require an issuer of certain convertible debt and preferred stock to separately account for embedded conversion features as a component of equity. Instead, an issuer will account for these securities as a single unit of account, unless the conversion feature meets the criteria for accounting under the substantial premium model or meets the criteria in ASC 815-15 to be considered a derivative that must be bifurcated from the host contract.



The new guidance also requires issuers of convertible instruments to disclose all pertinent terms and features of the instruments and information about events, conditions and circumstances that can affect how users assess the amount or timing of an entity's future cash flows related to those instruments. When the instrument is accounted for under the substantial premium model, the entity must also disclose the premium amount recorded as paid-in capital.

In addition, public business entities (PBEs) must disclose the fair value and level of the fair value hierarchy for each convertible debt instrument issued. Under legacy guidance, PBEs only disclose the fair value of these instruments in the aggregate.

Contracts in an entity's own equity

The guidance also simplifies the settlement assessment that entities are required to perform to determine whether a contract qualifies for equity classification by removing certain conditions in ASC 815-40-25. Entities will no longer have to assess whether an equity contract permits settlement in unregistered shares. Instead, they will analyze whether the contract explicitly requires them to settle the contract in cash when registered shares are unavailable, and only contracts that require settlement in cash in this situation will be precluded from being classified as equity. Contracts that permit settlement in unregistered shares or are silent about how they will be settled when registered shares are unavailable can be classified as equity.

Further, entities will no longer have to assess whether an equity contract requires any collateral or provides the holder with rights that rank higher than shareholder rights upon bankruptcy. In addition, entities will exclude penalty payments from the equity classification assessment under ASC 815-40-25 because they do not settle an equity contract.

Entities will need to disclose information about events, conditions and circumstances that can affect how users assess the amount or timing of settlement.

How we see it

The elimination of the requirement that contracts legally permit settlement in unregistered shares to be classified as equity means entities will no longer have to make a determination that might require a legal analysis under the securities laws. We believe this change will reduce the complexity of evaluating these contracts.

The guidance also requires freestanding equity contracts that do not meet the definition of a derivative (e.g., physically settled warrants issued by private companies) to be subsequently measured at fair value through earnings if they are not indexed to an entity's own equity under ASC 815-40-15. Legacy US GAAP does not provide measurement guidance for these instruments.

The disclosure requirements for contracts in an entity's own equity are similar to those for convertible instruments and require the disclosure of information about the terms and features of the contracts as well as information about events, conditions and circumstances that affect how users assess the amount or timing of settlement. These requirements apply to freestanding instruments that are potentially indexed to, and potentially settled in, an entity's own equity, regardless of classification.

EPS calculation

The guidance addresses the diluted EPS calculation for instruments where the number of shares included in the denominator is variable, such as when (1) the exercise price may change based on an entity's share price or (2) changes in the entity's share price may affect the number of shares that may be used to settle a financial instrument. The ASU clarifies that the use of an average market price is required to calculate the diluted EPS denominator.

The guidance requires entities to use the if-converted method to calculate diluted EPS for all convertible instruments. Under legacy GAAP, the treasury stock method is used to calculate the dilutive effect on EPS for some convertible instruments (e.g., convertible debt where, upon conversion, the issuer must pay the principal of the debt in cash but may settle the conversion premium in cash or shares). The guidance modifies the if-converted method so that interest charges on convertible debt for which the principal is required to be paid in cash

would not be added back to the numerator. The if-converted method will continue to use the share price at the beginning of the period in the calculation, unless the number of additional shares is variable. In these cases, entities will use the average share price to calculate the number of shares included in the denominator, as described in the paragraph above.

For instruments that may be settled in cash or shares and aren't liability-classified share-based payment awards, the guidance requires entities to include the effect of potential share settlement (if the effect is more dilutive), regardless of whether the entity or the holder can choose between cash and share settlement, or the entity has a history or policy of cash settlement. As a result, the maximum potential dilution will be reflected in diluted EPS. The guidance in ASC 260[5] allowing an entity to overcome the presumption in certain cases will continue to apply to certain liability-classified share-based payment awards.

The amendments also include equity-classified convertible preferred stock that has a down round feature within the scope of the recognition and measurement guidance in ASC 260 because the beneficial conversion features model has been eliminated.

Effective date and transition

The ASU is effective for annual periods beginning after 15 December 2021, and interim periods therein for PBEs, that are not smaller reporting companies as defined by the Securities and Exchange Commission (SEC) as of 5 August 2020. For all other entities, it is effective for fiscal years beginning after 15 December 2023, and interim periods therein.

Early adoption is permitted for all entities for fiscal periods beginning after 15 December 2020, including interim periods within the same fiscal year. Entities may adopt the recognition and measurement guidance in this ASU to convertible securities with down round features for fiscal years beginning after 15 December 2019 if they have not yet issued or made available for issuance financial statements that reflect the guidance in ASU 2017-11[6] on accounting for those securities.

The ASU allows entities to use a modified or full retrospective transition method. Under the modified approach, entities will apply the guidance to all financial instruments that are outstanding as of the beginning of the year of adoption with the cumulative effect recognized as an adjustment to the opening balance of retained earnings. Under the full retrospective method, they will apply it to all outstanding financial instruments for each prior reporting period presented. An entity also may irrevocably elect the fair value option in accordance with ASC 825-10[7] for any liability-classified convertible securities. The difference between the carrying amount and the fair value will be recorded as a cumulative-effect adjustment to the opening retained earnings as of the beginning of the period of adoption.

Endnotes:

[1] 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*.

[2] ASC 470-20, *Debt — Debt with Conversion and Other Options*.

[3] ASC 815-15, *Derivatives and Hedging — Embedded Derivatives*.

[4] ASC 815-40, *Derivatives and Hedging — Contracts in Entity's Own Equity*.

ASC 260, *Earnings Per Share*.

[6] ASU 2017-11, *Earnings Per Share (Topic 260); Distinguishing Liabilities from Equity (Topic 480); Derivatives and Hedging (Topic 815): (Part I) Accounting for Certain Financial Instruments with Down Round Features*.

[7] ASC 825-10, *Financial Instruments — Overall*.

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