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# FASB Proposes Simplifications to the Issuer's Accounting for Convertible Instruments and Contracts on an Entity's Own Equity

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On July 31, 2019, the FASB issued a [proposed ASU](#)<sup>1</sup> that would simplify the accounting for certain financial instruments with characteristics of liabilities and equity, including convertible instruments and contracts on an entity's own equity. The proposed ASU is part of the FASB's simplification initiative, which aims to reduce unnecessary complexity in U.S. GAAP. Comments on the proposed ASU are due by October 14, 2019.

## Background and Key Changes in the Proposed ASU

### Convertible Instruments

#### **Current U.S. GAAP**

Navigating the guidance in U.S. GAAP on the issuer's accounting for convertible debt instruments can be challenging since there are multiple disparate sets of classification, measurement, and derecognition requirements whose interactions are complex. Consequently, accounting restatements are not uncommon.

<sup>1</sup> FASB Proposed Accounting Standards Update (ASU) No. 2019-730, *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*.

The guidance in U.S. GAAP contains five accounting models for the allocation of proceeds attributable to the issuance of a convertible debt instrument. These models and the proposed ASU's modifications are described below.

<b>Instrument</b>	<b>Allocation Approach</b>	<b>Allocation Objective</b>	<b>Approach Retained Under Proposed ASU?</b>
Convertible instrument with a bifurcated embedded derivative	With-and-without method. The embedded derivative is measured first at fair value, and the residual amount is allocated to the host contract.	To measure the embedded derivative at fair value in a manner similar to a freestanding derivative instrument	Yes
Traditional convertible debt	No separation. All proceeds are recorded as debt.	To reflect the mutual exclusivity of debt repayment and conversion option exercise (i.e., both cannot happen)	Yes
Convertible debt issued at a substantial premium	With-and-without method. The debt is measured first at its principal amount, and the residual amount is allocated to equity.	To record a substantial premium received in equity	No
Convertible debt with a cash conversion feature (CCF)	With-and-without method. The nonconvertible debt component is measured first at its fair value, and the residual amount is allocated to equity.	To reflect interest cost that is paid with the conversion feature	No
Convertible instrument with a beneficial conversion feature (BCF)	With-and-without method. The BCF is measured first at its intrinsic value and allocated to equity, and the residual amount is allocated to the host contract.	To record the intrinsic value of the conversion feature in equity	No



### **Connecting the Dots**

For an in-depth discussion of the application of the existing separation models in ASC 470-20,<sup>2</sup> see Deloitte's [A Roadmap to the Issuer's Accounting for Convertible Debt](#).

In response to feedback received from stakeholders regarding the complexity of current guidance, the FASB decided to seek to simplify the accounting for convertible instruments and enhance related disclosure requirements to improve the "usefulness and relevance of the information being provided to users of financial statements." The proposed ASU's significant amendments are described below.

### **Remove Separation Models in ASC 470-20 for Convertible Instruments**

The proposed ASU would remove the separation models in ASC 470-20 for (1) convertible debt issued at a substantial premium, (2) convertible debt with a CCF, and (3) convertible

<sup>2</sup> For titles of FASB Accounting Standards Codification (ASC) references, see Deloitte's "[Titles of Topics and Subtopics in the FASB Accounting Standards Codification](#)."

instruments with a BCF. As a result, no embedded conversion features would be separately presented in equity under ASC 470-20. Instead, a convertible debt instrument would be accounted for wholly as debt and convertible preferred stock would be accounted for wholly as preferred stock (i.e., as a single unit of account) unless a convertible instrument contains features that require bifurcation as a derivative under ASC 815.



### **Connecting the Dots**

The application of the existing separation models in ASC 470-20 involves the recognition of a debt discount, which is amortized to interest expense (for convertible instruments with a BCF or CCF), or the recognition of a debt premium in equity (for convertible instruments issued at a substantial premium). The elimination of these models would reduce reported interest expense and increase reported net income for entities that have issued a convertible instrument within the scope of those models.

## ***Incremental Disclosure Requirements About Convertible Instruments***

The proposed ASU would require an entity to provide expanded “disclosures about the terms and features of convertible instruments,” how the instruments have been reported in the entity’s financial statements, and “[i]nformation about events, conditions, and circumstances that can affect the assessment about the amount or timing of an entity’s future cash flows related to those instruments.” Examples of such disclosures include:

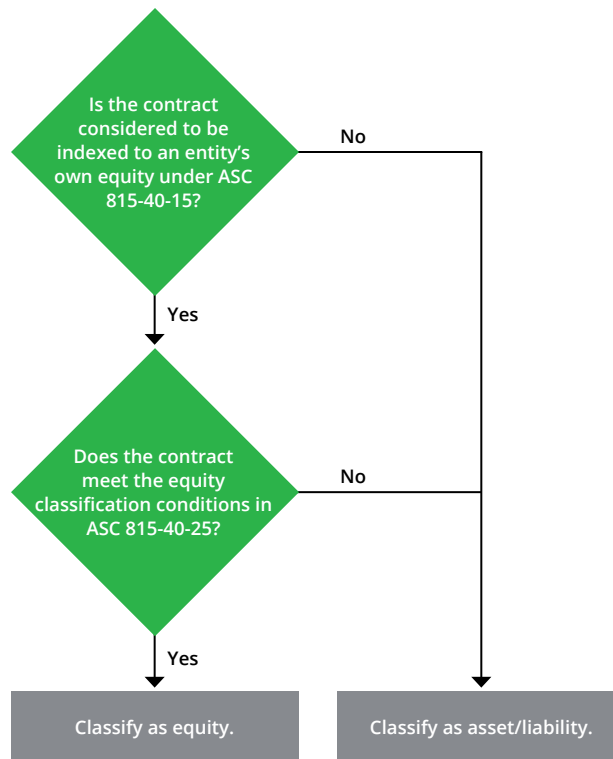
- The “pertinent rights and privileges of each convertible debt instrument outstanding,” such as the parties that control the conversion rights, settlement methods (e.g., cash or shares), and terms that may change conversion or exercise prices (excluding standard antidilution provisions).
- For contingently convertible instruments: (1) “[e]vents or changes in circumstances that would adjust or change the contingency or would cause the contingency to be met,” (2) “[i]nformation on whether the shares that would be issued if the contingently convertible securities were converted are included in the calculation of diluted earnings per share (EPS) and the reasons why or why not,” and (3) “[o]ther information that is helpful in understanding both the nature of the contingencies and the potential impact of conversion.”
- For convertible debt instruments: (1) the unamortized premium, discount, or issuance costs; (2) the net carrying amount; (3) fair value information (public business entities only); and (4) information about reported interest expense, including the effective interest and the amount of interest recognized.
- Information about events or changes in circumstances during the reporting period that significantly affect conversion conditions.
- Number of shares issued upon conversion, exercise, or satisfaction of required conditions during the reporting period.
- “Maturities and sinking fund requirements for convertible debt instruments for each of the [following] five years.”

## **Contracts on an Entity’s Own Equity**

### ***Current U.S. GAAP***

Under U.S. GAAP, a freestanding contract on an entity’s own equity (e.g., a warrant) is accounted for as an asset or liability unless it (1) is considered to be indexed to the entity’s own equity under ASC 815-40-15 and (2) meets the equity classification conditions in ASC 815-40-25, in which case it is accounted for as equity (see illustration below).<sup>3</sup>

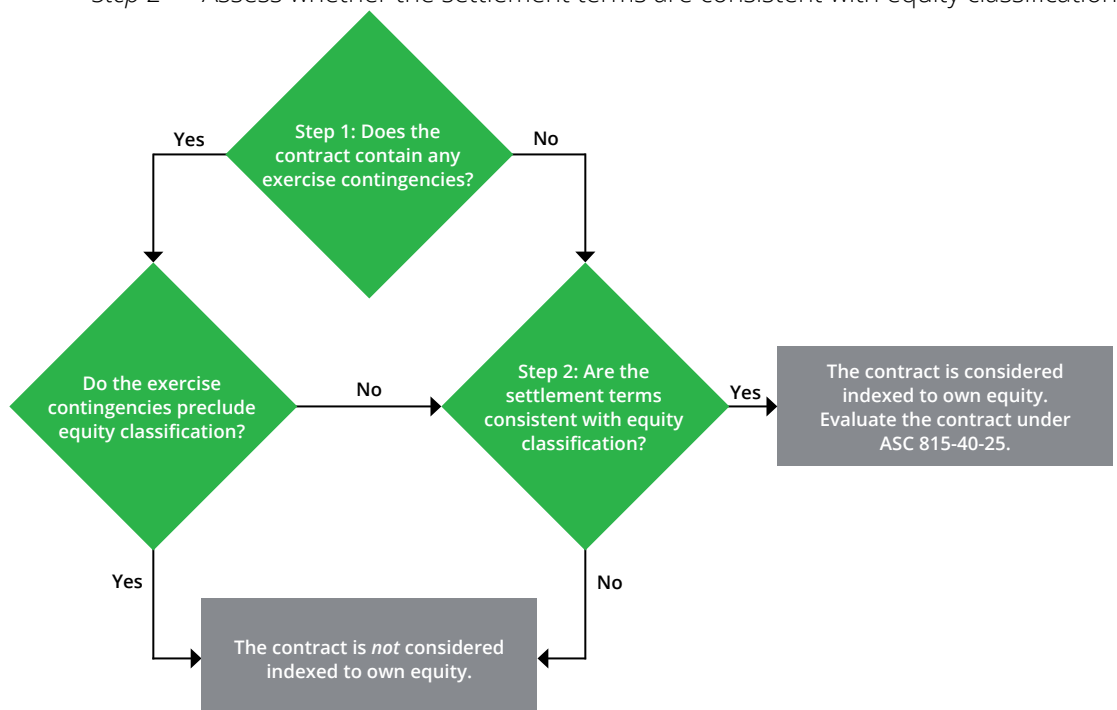
<sup>3</sup> Freestanding contracts on an entity’s own equity are also classified as assets or liabilities if they are within the scope of ASC 480 (e.g., certain warrants on redeemable shares).



If a freestanding contract on an entity's own equity has the characteristics of a derivative instrument, it is accounted for as a derivative at fair value under ASC 815 unless a scope exception applies. A contract that qualifies as equity under the indexation guidance and equity classification conditions in ASC 815-40 is eligible for a derivative scope exception. That scope exception also applies to an entity's evaluation of whether an equity conversion feature embedded in a convertible instrument must be bifurcated as a derivative under ASC 815.

To determine whether a contract is considered indexed to the issuer's own equity under ASC 815-40-15, an entity performs a two-step analysis, as illustrated below:

- *Step 1* — Evaluate whether the contract contains any exercise contingencies and, if so, whether they disqualify the contract from being classified as equity.
- *Step 2* — Assess whether the settlement terms are consistent with equity classification.



If after performing step 1 an entity concludes that an instrument's exercise contingency provisions (if any) would not preclude a conclusion that the instrument is indexed to the entity's own stock, the entity must perform step 2 to evaluate the instrument's settlement terms. Under step 2, an equity-linked instrument is considered indexed to the entity's own stock if either of the following two conditions is met:

- The instrument is a "fixed-for-fixed" forward or option on equity shares. That is, the instrument's settlement amount will always equal the difference between (1) the fair value of a fixed number of the entity's equity shares and (2) a fixed monetary amount denominated in the reporting entity's functional currency.
- The instrument is not fixed for fixed, but the only variables that could affect the instrument's settlement amount are inputs used in the pricing (fair value measurement) of a fixed-for-fixed forward or option on equity shares.

Many contracts contain adjustment provisions upon the occurrence of contingent events. In applying step 2, an entity is required to consider any potential settlement adjustment provisions, regardless of the likelihood of the occurrence of the contingent events. Certain adjustments (e.g., an adjustment upon the occurrence or the nonoccurrence of an initial public offering) indicate that the contract is not indexed to the entity's own equity and thus cannot be classified as equity.

For a contract to qualify for equity classification under ASC 815-40, it is not sufficient that it is considered indexed to the entity's stock under ASC 815-40-15 (as discussed above). In addition, the contract must require or permit the issuing entity to share settle the contract (either physically or net in shares). Any provision that could require the issuer to net cash settle the contract precludes equity classification with limited exceptions. For an entity to conclude that it cannot be required to net cash settle a contract, the entity must ensure that the equity classification conditions in ASC 815-40-25 are met. These conditions address whether there are any circumstances under which the issuer could be forced to net cash settle the contract given the contract's terms and the regulatory and legal framework.



### Connecting the Dots

For an in-depth discussion of the application of ASC 815-40, see Deloitte's [\*A Roadmap to Accounting for Contracts on an Entity's Own Equity\*](#).

The proposed ASU would make the significant amendments described below.

### ***Amendments to the Indexation Guidance in ASC 815-40-15***

Step 1 of the determination of whether a contract is considered indexed to the issuer's own equity would be unchanged. Step 2, however, would be amended to add a likelihood threshold. More specifically, entities would disregard potential adjustments to the settlement terms that have only a remote likelihood of being triggered (e.g., a contractual adjustment to the number of shares or the exercise price underlying the contract upon occurrence of a remote event) in evaluating whether a contract should be considered indexed to the entity's own equity under ASC 815-40-15.

### ***Amendments to the Equity Classification Conditions in ASC 815-40-25***

As mentioned, one of the conditions for equity classification is that the entity could not be forced to net cash settle the contract but is able to share settle the contract. Under U.S. GAAP, an entity is precluded from considering probability when assessing whether it could be forced to net cash settle a contract. Under the proposed ASU, however, an entity would disregard events that could require net cash settlement if they have a remote likelihood of occurring. Accordingly, a net cash settlement provision would no longer preclude equity classification if it has only a remote likelihood of being triggered.



### Connecting the Dots

The addition of likelihood thresholds to the indexation and classification guidance in ASC 815-40 will add some complexity to the guidance. While in some cases the evaluation of whether a contingent event is remote may be relatively clear cut (e.g., the consummation of a business combination), in other cases, it may require a more careful evaluation of all the relevant facts and circumstances (e.g., the occurrence of a qualified initial public offering).

The proposed ASU also removes the following three conditions in ASC 815-40-25-10 that currently must be met for equity classification:

- “Settlement permitted in unregistered shares. The contract permits the entity to settle in unregistered shares.”
- “No counterparty rights rank higher than shareholder rights. There are no provisions in the contract that indicate that the counterparty has rights that rank higher than those of a shareholder of the stock underlying the contract.”
- “No collateral required. There is no requirement in the contract to post collateral at any point or for any reason.”

Further, the proposed ASU would clarify that penalty payments made upon the entity's failure to make timely SEC filings do not preclude equity classification.



### Connecting the Dots

The assessment of whether settlement is permitted in unregistered shares involves legal determinations that may require the involvement of legal specialists. The removal of this condition will greatly simplify the accounting analysis.

Note that the proposed ASU does not amend ASC 480-10, under which certain contracts on an entity's own equity are classified as assets or liabilities if they embody obligations to transfer cash or other assets irrespective of the probability of such a transfer (e.g., certain warrants on redeemable shares). Further, under ASC 480-10-S99-3A and other SEC guidance, an SEC registrant is required to classify equity securities that it could be forced to redeem for cash or other assets outside of permanent equity (i.e., as temporary equity) irrespective of the probability of such redemption. The temporary-equity guidance does not apply to amounts presented as assets or liabilities under U.S. GAAP. Accordingly, contracts on the entity's own equity (e.g., warrants, options, or forwards that involve the purchase or sale of the issuer's equity shares) that are currently accounted for as assets or liabilities under ASC 815-40 because the issuer could be forced to settle them net in cash in accordance with ASC 815-40-25 are not currently within the scope of the temporary-equity guidance. If the FASB finalizes the proposed amendments to ASC 815-40, however, such a contract might be required to be presented as temporary equity if (1) it qualifies as equity under the proposed amendments to ASC 815-40 and (2) the issuer could be forced to cash settle it upon the occurrence of a remote event. For an in-depth discussion of the application of the SEC's temporary-equity guidance, see [Chapter 9](#) of Deloitte's *A Roadmap to Distinguishing Liabilities From Equity*.

### **Other Amendments to ASC 815-40**

The proposed ASU would require freestanding contracts on an entity's own equity that do not qualify as equity under ASC 815-40 to be accounted for at fair value with changes in fair value recognized in earnings irrespective of whether they meet the definition of a derivative in ASC 815.

The proposed ASU would also amend the reassessment guidance in ASC 815-40. Under U.S. GAAP, an entity must evaluate whether the equity classification conditions are met at each balance sheet date. The amendments would reduce the frequency of reassessment by requiring it only upon a reassessment event. A reassessment event, as defined by the proposed ASU, is:

- An “adjustment to the instrument’s strike price or the number of shares used to calculate the settlement amount.”
- The “[e]xpiration of a settlement feature that was evaluated under Section 815-40-15 or Section 815-40-25.”
- A “[c]hange in the condition for equity classification about sufficient authorized and unissued shares.”

The occurrence of a reassessment event and a requirement to reassess a contract do not necessarily imply that the contract will have to be reclassified.

## Earnings per Share

The proposed ASU would amend certain guidance related to the computation of EPS under ASC 260 for convertible instruments and contracts on an entity’s own equity.



### Connecting the Dots

For an in-depth discussion of the application of ASC 260, see Deloitte’s [A Roadmap to the Presentation and Disclosure of Earnings per Share](#).

## **Require the If-Converted Method for Calculation of Diluted EPS for Certain Convertible Instruments**

Under U.S. GAAP, there are two main methods used to calculate diluted EPS for convertible instruments: the if-converted method and the treasury stock method.

- The if-converted method assumes conversion of convertible securities at the beginning of the reporting period. Interest expense and dividends recognized during the period are added back to the numerator. The denominator includes the common shares issuable upon conversion of convertible securities. This method applies to traditional convertible debt.
- The treasury stock method assumes that the proceeds that would be received upon exercise are used to purchase common shares at the average market price during the period. This method applies to certain convertible securities that require or permit the issuer to cash settle some or all of the conversion value upon conversion.

Under the proposed ASU, the if-converted method would apply to all convertible instruments; the treasury stock method would no longer be available. However, interest expense would not be added back to the numerator for convertible debt for which the principal is required to be paid in cash.

## **Share Settlement Presumption in the Calculation of Diluted EPS**

Under ASC 260-10, for contracts that may be settled in cash or stock at the election of the counterparty, share settlement is presumed and may not be rebutted if the effect is more dilutive than cash settlement. For contracts that may be settled in cash or stock at the election of the issuer, share settlement is presumed but may be rebutted depending on the facts and circumstances.

The proposed ASU would remove the ability to rebut the presumption regarding share settlement. Paragraph BC104 of the proposed ASU notes that the Board had “concerns

about an entity being able to classify an instrument in equity because it contractually may be share settled but then exclude the shares from diluted EPS because of an assertion that the instrument would be cash settled.”

### ***Equity Classified Preferred Stock That Includes a Down-Round Feature***

Under the proposed ASU, “[e]quity-classified convertible preferred stock that includes a down round feature would be included in the scope of the recognition and measurement guidance” in ASC 260 on financial instruments that include down-round features. When the down-round feature is triggered, its effect “is treated as a dividend and as a reduction of income available to common shareholders in basic EPS.”

### ***Price to Use in Diluted EPS Denominator***

The proposed amendments clarify that for entities applying either the treasury stock method or the if-converted method of calculating diluted EPS, the “average market price should be used to calculate the diluted EPS denominator” when the exercise price or the number of shares that may be issued is variable, except for certain contingently issuable shares.

### **Transition Requirements**

If finalized, the guidance in the proposed ASU may be adopted by using either a full retrospective or a modified retrospective approach. Under the modified retrospective approach, an entity would recognize the “cumulative effect of the change . . . as an adjustment to the opening balance of retained earnings at the date of adoption.” Further, if finalized, the proposed ASU would apply “to transactions outstanding as of the beginning of the year in which the [standard is] adopted. Transactions that were settled (or expired) during prior reporting periods would not be affected.”

The proposed ASU would require entities to use the following approaches to apply the amendments to the EPS guidance:

- The full retrospective method “for instruments that may be settled in cash or shares.”
- “As of the date of adoption for the transition from the treasury stock method to the if-converted method for certain convertible instruments and for the transition to [the] use of an average market price.”

For convertible instruments that include a down-round feature, early adoption is allowed for entities that have not yet adopted the amendments in ASU 2017-11.<sup>4</sup>

The proposed ASU includes a transition expedient that would allow entities, upon adoption of the final ASU, to assess the likelihood of a contingent event as of the date of adoption rather than at contract inception. This transition expedient is aimed at reducing the cost for entities adopting the amendments.

<sup>4</sup> FASB Accounting Standards Update No. 2017-11, (Part I) *Accounting for Certain Financial Instruments With Down Round Features*, (Part II) *Replacement of the Indefinite Deferral for Mandatorily Redeemable Financial Instruments of Certain Nonpublic Entities and Certain Mandatorily Redeemable Noncontrolling Interests With a Scope Exception*.



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