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# FASB Simplifies Issuer's Accounting for Convertible Instruments and Contracts on an Entity's Own Equity

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On August 5, 2020, the FASB issued [ASU 2020-06](#),<sup>1</sup> which simplifies the accounting for certain financial instruments with characteristics of liabilities and equity, including convertible instruments and contracts on an entity's own equity. The ASU is part of the FASB's simplification initiative, which aims to reduce unnecessary complexity in U.S. GAAP. The ASU's key provisions, transition requirements, and effective dates are discussed below.

## Background and Key Provisions of the ASU

### Convertible Instruments

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

ASU 2020-06 simplifies the guidance in U.S. GAAP on the issuer's accounting for convertible debt instruments. Such guidance includes multiple disparate sets of classification, measurement, and derecognition requirements whose interactions are complex. Consequently, accounting restatements have not been uncommon.

There are currently five accounting models in ASC 470-20<sup>2</sup> for the allocation of proceeds attributable to the issuance of a convertible debt instrument. The table below outlines those models and their status under ASU 2020-06.

<sup>1</sup> FASB Accounting Standards Update (ASU) No. 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*.

<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."](#)

Instrument	Allocation Approach	Allocation Objective	Approach Retained Under ASU 2020-06?
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	Yes
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

As the table above notes, ASU 2020-06 removes from U.S. GAAP the separation models for (1) convertible debt with a CCF and (2) convertible instruments with a BCF. As a result, after adopting the ASU's guidance, entities will not separately present in equity an embedded conversion feature in such debt. Instead, they will account for a convertible debt instrument wholly as debt, and for convertible preferred stock wholly as preferred stock (i.e., as a single unit of account), unless (1) a convertible instrument contains features that require bifurcation as a derivative under ASC 815 or (2) a convertible debt instrument was issued at a substantial premium.



### Connecting the Dots

Under current guidance, applying the separation models in ASC 470-20 to convertible instruments with a BCF or CCF involves the recognition of a debt discount, which is amortized to interest expense. The elimination of these models will reduce reported interest expense and increase reported net income for entities that have issued a convertible instrument that was within the scope of those models before the adoption of ASU 2020-06.

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

## ***Disclosure Requirements Expanded***

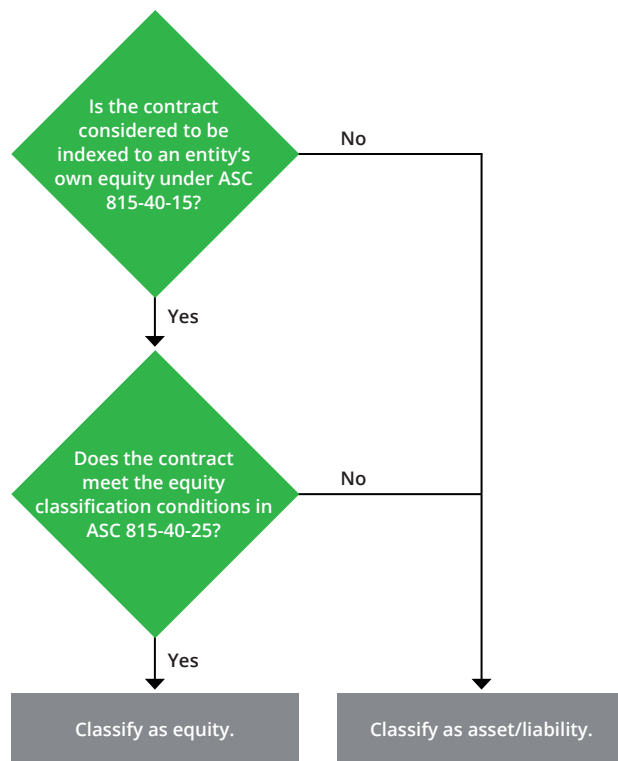
ASU 2020-06 requires entities to provide expanded disclosures about “the terms and features of convertible instruments,” how the instruments have been reported in the entity’s financial statements, and “[i]nformation about events, conditions, and circumstances that can affect how to assess the amount 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 and the level in the fair value hierarchy (public business entities only); and (4) information about reported interest expense, including the effective interest and the amount of interest recognized.
- For convertible debt instruments with a substantial premium, the premium amount recorded as paid-in capital.
- Information about “[e]vents or changes in circumstances that occur during the reporting period that cause conversion contingencies to be met or conversion terms to be significantly changed.”
- The “[n]umber 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 [subsequent] five years.”

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

Under current U.S. GAAP, a freestanding contract on an entity’s own equity (e.g., a warrant) is accounted for as an asset or a 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 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.

For a contract to qualify for equity classification under ASC 815-40-25, it must require or permit the issuing entity to share settle it (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. Those 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](#).

ASU 2020-06 removes from ASC 815-40-25-10 the following three conditions for equity classification:

- "Settlement permitted in unregistered shares. The contract permits the entity to settle in unregistered shares." (**However**, the ASU clarifies that if a contract explicitly states that cash settlement is required if registered shares are unavailable, the contract will not qualify as equity.)
- "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."

The following four equity classification conditions will continue to apply under ASU 2020-06:

- “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.”
- “Contract contains an explicit share limit. The contract contains an explicit limit on the number of shares to be delivered in a share settlement.”
- “No required cash payment . . . 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).” (**However**, the ASU clarifies that penalty payments made upon the entity’s failure to make timely SEC filings will not preclude equity classification.)
- “No cash-settled top-off or make-whole provisions. There are no cash settled top-off or make-whole provisions.”

Further, ASU 2020-06 requires 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 such contracts meet the definition of a derivative in ASC 815.



### Connecting the Dots

The FASB decided not to proceed with proposed amendments that would have (1) added a remote-likelihood threshold to the indexation and classification guidance in ASC 815-40 and (2) changed the reassessment frequency. Instead, it has added to its agenda a separate project to explore improvements to this guidance.

## Earnings per Share

ASU 2020-06 amends certain guidance in ASC 260 on the computation of EPS 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](#).

## ***If-Converted Method Required for Calculation of Diluted EPS for All Convertible Instruments***

Under the current guidance in ASC 260-10, entities use the following two main methods to calculate diluted EPS for convertible instruments:

- *If-converted method* — Assumes that conversion of convertible securities occurs 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.
- *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 ASU 2020-06, entities must apply the if-converted method to all convertible instruments; the treasury stock method is no longer available (e.g., for Instrument X<sup>4</sup>).

<sup>4</sup> See [Section 6.1.3](#) of Deloitte’s [A Roadmap to the Issuer’s Accounting for Convertible Debt](#) for more information.

However, if the principal amount must be paid in cash and only the conversion spread is settled in shares (such as for Instrument C<sup>5</sup>), the if-converted method is modified so that interest expense is not added back to the numerator, and the denominator only includes the net number of incremental shares that would be issued upon conversion.

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

Under the current guidance in ASC 260-10, share settlement is presumed for contracts that may be settled in cash or stock at the election of the counterparty, and that presumption may not be rebutted if the effect is more dilutive than cash settlement. Share settlement is also presumed for contracts that may be settled in cash or stock at the election of the issuer, but an entity may be able to rebut that presumption depending on its facts and circumstances.

ASU 2020-06 removes an entity's ability to rebut the presumption of share settlement. Paragraph BC113 of the ASU notes that the FASB 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."

### ***Recognition and Measurement Guidance Extended to Equity Classified Preferred Stock With Down-Round Features***

ASU 2020-06 extends the scope of the recognition and measurement guidance in ASC 260 on financial instruments that include down-round features to include equity-classified convertible preferred stock that contains such features. If 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." However, the scope of this guidance does not include convertible debt with down-round features.

### ***Average Market Price Used in Diluted EPS Denominator***

ASU 2020-06 clarifies that 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 and Effective Date**

### **Transition Requirements and Related Disclosures**

An entity can use either a full or modified retrospective approach to adopt the ASU's guidance. Under the modified retrospective approach, the entity would recognize the "cumulative effect of the change . . . as an adjustment to the opening balance of retained earnings at the date of adoption." Under the full retrospective approach, the entity would disclose "the effect of the change on income from continuing operations, net income (or other appropriate captions of changes in the applicable net assets or performance indicator), any other affected financial statement line item, and any affected per-share amounts for the current period and any prior periods retrospectively adjusted."

Under either transition approach, an entity must disclose the following in the year of the change (including both the interim and annual financial statements):

- "The nature of the change in accounting principle, including an explanation of the newly adopted accounting principle."
- "The method of applying the change."

<sup>5</sup> See [footnote 4](#).

- “The cumulative effect of the change on retained earnings or other components of equity in the statement of financial position as of the beginning of the first period for which the [ASU] is initially applied.”
- “For entities that present [EPS], the effect of the change on affected per-share amounts for the period of adoption.”

On the date of the ASU's adoption, an entity is permitted to make a one-time irrevocable election to apply the fair value option in ASC 825-10 for “any liability-classified financial instrument that is a convertible security.”

## Effective Date

The ASU's amendments are effective as follows:

- For public business entities that are not smaller reporting companies,<sup>6</sup> fiscal years beginning after December 15, 2021, and interim periods within those fiscal years.
- For all other entities, fiscal years beginning after December 15, 2023, and interim periods within those fiscal years.

The guidance may be early adopted for fiscal years beginning after December 15, 2020, and interim periods within those fiscal years.

For convertible instruments that include a down-round feature, entities may early adopt the amendments that apply to down-round features if they have not yet adopted the amendments in ASU 2017-11.<sup>7</sup>

<sup>6</sup> As defined by the SEC.

<sup>7</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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