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FASB simplifies accounting for convertible instruments and contracts in an entity's own equity

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KPMG reports on ASU 2020-06[1], which reduces the number of accounting models for convertible instruments and allows more contracts to qualify for equity classification.

Applicability

Entities that issue convertible instruments or contracts in an entity's own equity.

Key facts and impacts

— The ASU reduces the number of models used to account for convertible instruments, which will likely result in more convertible instruments being accounted for as a single unit. This will also result in lower interest expense for convertible debt.

— The ASU amends diluted earnings per share (EPS) calculations for convertible instruments, which will result in more dilutive EPS results.

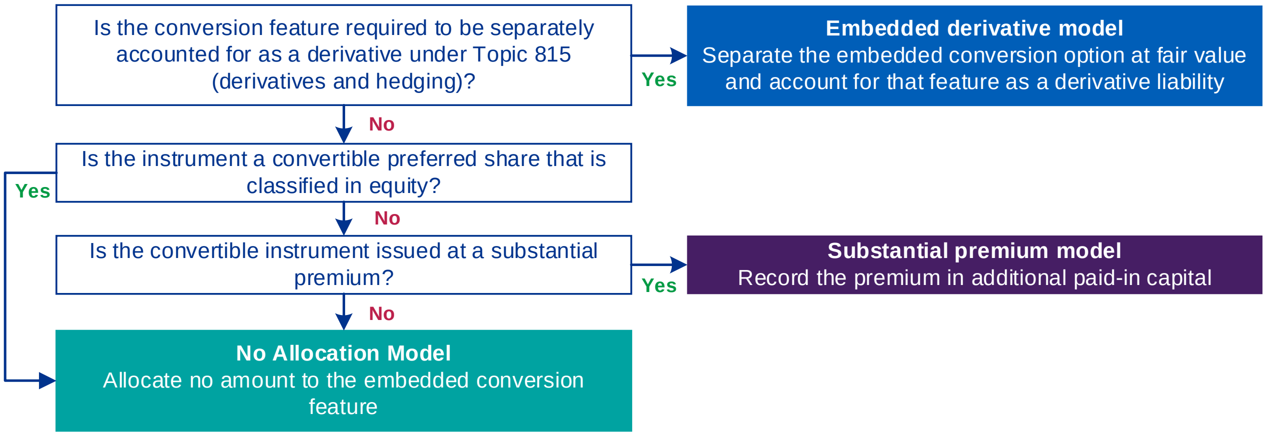
— The ASU amends the requirements for a contract (or embedded derivative) that is potentially settled in an entity's own shares to be classified in equity, which will likely result in more contracts being classified in equity (and more embedded derivatives meeting the derivative scope exception).

Simplifying the accounting for convertible instruments

Under the amendments, entities will account for convertible instruments under one of three models. The following decision tree summarizes the models and the steps for determining the appropriate model; these models do not apply when an entity has elected the fair value option[2] of Subtopic 825-10 (financial instruments) for the convertible instrument.

[1] ASU 2020-06, Accounting for Convertible Instruments and Contracts in an Entity's Own Equity

[2] An entity generally can elect the fair value option for convertible debt instruments that are accounted for as a single unit as a liability, or when the conversion option is bifurcated as an embedded derivative.



The amendments eliminate the beneficial conversion feature and cash conversion models. Because the conversion feature was separately recorded in equity for instruments accounted for under these models, eliminating them will likely result in more convertible instruments being accounted for as a single unit. The FASB believes the amendments will make the accounting for convertible instruments less complex and more relevant and decision-useful. The changes were largely informed by feedback from financial statement users who indicated they generally analyze convertible instruments as a single unit and that the coupon (cash) interest rate on that single unit is more relevant to them than the rate imputed under the beneficial conversion or the cash conversion models.

KPMG observation: Defining substantial premium

The FASB originally proposed to eliminate the substantial premium model. However, the model was ultimately retained due to concerns that a convertible debt instrument issued at a substantial premium and accounted for as a single unit could give rise to net interest income, rather than interest expense (e.g. when premium amortization exceeds contractual (cash) interest). By retaining the model, the premium will be recorded in additional paid-in capital (APIC) with no amortization.

Topic 470-20 (debt with conversion and other options) does not define the term 'substantial premium.' Historically, the substantial premium model was not commonly applied in practice because most conversion features that resulted in an instrument being issued at a premium were separately recorded in equity under the cash conversion or beneficial conversion feature models. While a premium of 10% over an instrument's par amount has generally been considered substantial in practice, we believe future judgments about what constitutes a substantial premium may be informed by the FASB's rationale for retaining this model.

Targeted changes to disclosures

The amendments add a disclosure objective and certain disclosure requirements to increase transparency and decision-usefulness about a convertible instrument's terms and features, including:

— information about events or conditions that occur during the reporting period that cause or indicate conversion contingencies to be met or conversion terms to be significantly changed;

— information on which party controls the conversion rights;

— alignment of disclosure requirements for contingently convertible instruments with other convertible instruments;

— requirement that existing fair value disclosures in Topic 825 (financial instruments) be provided at the individual instrument level rather than in the aggregate; and

- information about convertible debt instruments issued with a substantial premium, including the premium amount recorded as APIC and – for public business entities – the fair value and level of the fair value hierarchy for the convertible instrument in its entirety.

Simplifying the accounting for contracts in an entity's own equity (Subtopic 815-40[3])

Amendments to conditions that preclude equity classification

To be classified in equity, Subtopic 815-40 requires a contract that is potentially settled in an entity's own shares to meet certain requirements. The same requirements must be met when determining whether an embedded derivative (e.g. the conversion option in a convertible debt instrument) qualifies for a derivative scope exception.

Prior to the ASU, Subtopic 815-40 included seven additional conditions that preclude a contract from being classified in equity (or preclude an embedded derivative from meeting the derivative scope exception) because they may – or will – result in the contract being settled in cash rather than shares. The FASB removed some of those conditions and clarified another because they are difficult to apply, are internally inconsistent and may result in form-over-substance based conclusions. These amendments will result in more contracts being classified in equity (and more embedded derivatives meeting the derivative scope exception).

Removed conditions	Clarified condition
An entity is no longer required to consider whether: — settlement is permitted in unregistered shares (unless the contract explicitly requires settlement in cash if registered shares are not available); — collateral is required to be posted; and — counterparty rights rank higher than shareholder rights.	A penalty payment from the failure to make timely filings with the SEC does not preclude equity classification.

KPMG observation: Distinguishing liabilities from equity – Phase 2

The FASB originally proposed to disregard certain contingent events when determining whether other requirements of Subtopic 815-40 are met, provided there was only a remote likelihood that those events would occur. Those proposals would have resulted in additional contracts being classified in equity (and more embedded derivatives meeting the derivative scope exception). Based on feedback received, the FASB decided to further explore those proposals as a separate phase of its Distinguishing Liabilities from Equity project. As a result, they are not contemplated in the ASU.

Other clarifications to Subtopic 815-40

Additionally, the ASU clarifies that:

- Subtopic 815-40's disclosure requirements apply only to freestanding instruments;
- the requirement to reassess whether a contract (or embedded derivative) meets Subtopic 815-40's conditions applies to both freestanding instruments and embedded derivatives; and
- instruments that do not meet Subtopic 815-40's conditions for equity classification are required to be measured initially and subsequently at fair value, with changes reported in earnings. Previously, Subtopic 815-40 did not specify the appropriate measurement when certain of those conditions were not met.

[3] ASC Subtopic 815-40, Derivatives and hedging – Contracts in entity's own equity

Amendments to EPS guidance

Amendments for convertible instruments

The FASB chose to simplify EPS calculations for convertible instruments, and made the following primary changes.

Amended requirements	Current GAAP
All convertible instruments are to be included in diluted EPS using the if-converted method.[4] However, when the principal is required to be settled in cash, the interest charges are not added back to the numerator.	Certain convertible instruments are included in diluted EPS using the treasury stock method. These include, for example, convertible instruments for which the accreted value is required to be settled in cash and the conversion premium may be settled in any combination of cash or shares.
Instruments that may be settled in cash or shares are to be included in diluted EPS presuming share settlement if the effect is more dilutive, with no option for rebutting that presumption. There is an exception, however, for liability-classified share-based payment awards, for which the share-settlement presumption may be rebutted based on past experience or a stated policy.	If the decision to settle in cash or shares is at the issuer's option, the share settlement presumption may be rebutted based on past experience or a stated policy.
The effects of a down-round feature in convertible preferred stock (if the conversion feature has not been bifurcated in accordance with other guidance) will be measured as the difference in the fair value of the instrument before and after the down-round feature is triggered, and will only be recorded and reflected in EPS when it is triggered.	Currently this guidance applies only to an equity-classified freestanding financial instrument. In contrast, for convertible preferred stock with a down-round feature, the beneficial conversion feature model applies to measure the feature when triggered, and the effect may be recognized in EPS over several periods, depending on the instrument's terms.

Other clarifications to EPS guidance

In addition to the simplification of EPS calculations for convertible instruments mentioned above, the amendments clarify the following.

EPS topic	Amended requirements
Variable incremental shares when applying the if-converted method to convertible preferred stock or convertible debt	When the conversion rate or exercise price of an instrument varies due to changes in an entity's share price, the average market price for the period should be used to determine the shares for the diluted EPS denominator. This approach, however, would not apply for contingently issuable shares.
Year-to-date share computations	When calculating diluted EPS for the year-to-date period, the denominator is based on a weighted-average share count for each quarter, subject to certain existing exceptions (e.g. when there is a loss).

4 ASU 2020-06 retains the provisions of paragraph 260-10-55-11, which requires the treasury stock method be used to determine the denominator adjustment for convertible instruments that permit or require the payment of cash by the holder at conversion. The if-converted method is used to calculate the numerator adjustment.

Effective dates and transition

	Public business entities that are SEC filers and are not eligible to be a smaller reporting company[1]	All other entities
Annual periods – Fiscal years beginning after	December 15, 2021	December 15, 2023
Interim periods – In fiscal years beginning after	December 15, 2021	December 15, 2023
Early adoption allowed?	Yes, no earlier than fiscal years beginning after December 15, 2020, including interim periods within those fiscal years. An entity should adopt the guidance at the beginning of its annual fiscal year. An entity that has not yet adopted the amendments to the guidance for accounting for certain instruments with down-round features[5] may adopt the recognition and measurement amendments in this ASU for any convertible security that includes a down-round feature in financial statements that have not yet been issued or made available for issuance for fiscal years (or interim periods) beginning after December 15, 2019.	
Transition requirements	An entity may elect one of the following methods. — **Modified retrospective method:** Cumulative–effect adjustment to the opening balance of retained earnings at the date of adoption. EPS for prior periods is not restated. — **Full retrospective method**: Cumulative-effect adjustment to the opening balance of retained earnings in the first comparative period presented. Additionally, an entity may irrevocably elect the fair value option for any liability-classified convertible financial instrument that is eligible under Subtopic 825-10.	

Note:
1. An entity determines whether it is eligible to be a smaller reporting company (SRC) based on its most recent SRC determination as of August 5, 2020. [815-40–65-1(a)(1)]

KPMG observation: Transition guidance may result in phased adoption of the amendments

The accelerated early adoption date for an entity that has not yet adopted the amendments to the guidance for accounting for certain instruments with down-round features[5] may result in the same entity adopting the ASU at different dates for different instruments.

5 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 and (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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